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# Business Risk Management Handbook

*A sustainable approach*



Linda Spedding and Adam Rose

# **Business Risk Management Handbook**

Dedication from Linda Spedding

To All of My Family, especially Ajan and his Father

*The Greatest Service You Can Give to the World  
Is to Take Responsibility for Yourself,  
Your Relationships and the Environment*

Dr S. Purna, *The Truth Will Set You Free*

Dedication from Adam Rose

This book is dedicated to my family who have humoured me all this time, for their patience and support, and to all those people out there who are trying to reduce the impact us humans are having upon our home planet.

# Business Risk Management Handbook

A sustainable approach

Linda Spedding  
Adam Rose



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# Foreword

Never has risk been so much at the very heart of the management of both business and not-for-profit organisations. This is not only because of high profile damage and disasters we have been experiencing at the hands of terrorism, technology failures, crime, storms, earthquakes, tsunamis and hurricanes. There are other forces at play that are even more influential drivers towards this evolution in risk management. These forces are at play in the very business models that are now used.

In spite of the huge wealth, scale and internationalism of many a modern organisation, it is in fact much more exposed to organisation-wide, potentially destructive, damage from single incidents than were earlier business models. These new business models have brought us multinational empires that consist of only a very few, but nonetheless individually crucial, foundation stones. Many modern day organisations comprise only a range of outsourcing contracts for both supply and delivery, the support of powerful stakeholders, a brand, legality, tight financial margins, compliance, intellectual assets of many different types, and the continuance of the overarching entrepreneurial, control and communication mechanisms. Some of these 'assets' may even be rented and not owned, and some overseas. These include not least urgent supply chains and the brand value dependencies. These business models make promises to deliver products and information at high speed; often simultaneously through websites; and have financial models that have such tight margins that viability can be measured in just a very small range of percentage points.

You can add to this cocktail the increased demands of regulators; increased sophistication of, and information available to, customers and other stakeholders; and the ease by which these stakeholders can switch to other organisations once trust is beginning to fail. You are left with a modern day organisation that is so much more vulnerable to one risk incident that in the past they could have absorbed. Now that same incident or failure can cause very real damage and can even destroy.

While the outsourcing revolution allows the organisation itself to be flexible, the outsourcing model also enables competitors to upscale astonishingly quickly. No longer do competitors need to build new factories or production lines to upscale. A few additional outsourcing contracts can be all that is needed. No longer can chief officers simply delegate their risk problems to insurers and contract lawyers to handle. If only management was still that simple.

I am delighted therefore to see this book emerge. It covers vitally important areas that are ever increasing concerns for boards, regulators, auditors,

investors, customers, supply chain managers, compliance and risk managers and others. They are all facing greater challenges than ever before; and this book will provide much needed guidance right at the very heart of the organisation's strategic thinking.

David Kaye

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David Kaye is the Institute of Risk Management's lead examiner on business continuity, author of the Chartered Insurance Institute's textbook on Operational Risk Management and in 2006 has co-authored the book *A Risk Management Approach to Business Continuity*, published by Rothstein.

David is an author and lecturer on risk management and continuity subjects and guides a wide range of companies and public sector organisations around the world.

David has spent much of his working life resident and with bottom-line responsibility for financial services businesses in the United Kingdom, the Netherlands, the Caribbean, Singapore and Malaysia. David later became a divisional director within a multi-billion pound multinational with responsibility worldwide for operational risk and continuity planning.

David is a Fellow of the Chartered Insurance Institute, a fellow of the Royal Society of Arts, a Fellow of the Business Continuity Institute, and a Fellow of the Institute of Risk Management.

# About SERM and EFR

The SERM model was part of a project begun in 1993 with support from the London insurance industry the United Nations (UNEP), European Community (ESF funding) and representatives of industry and the big consultancies.

In 1994, Jonathan Barber, founded the Safety & Environmental Risk Management (SERM) Rating Agency. It set out for the first time to place a financial benchmark on environmental risk in terms of direct and indirect (reputation) residual risk. The methodology was developed in collaboration with industry and SERM's Advisory Panel, on which Adam Rose served as co-ordinator, chaired by John Rimington CB, former Head of the UK's Health & Safety Executive (HSE). SERM's ratings of UK FTSE companies and their international peer groups, and testing of the model by the Copenhagen Business School, enabled back-testing of the SERM model and the construction of a SERM Index which clearly demonstrated the improved financial performance of highly rated companies. From 2002 Dr Linda Spedding became an advisor to SERM with a view to prioritising aspects of corporate governance and to develop the approach bearing in mind international regulatory developments.

To operate effectively in emerging markets including India, the SERM model was adapted to analyse risk from a holistic stakeholder perspective in terms of Extra-Financial Risk (EFR). Since 2005 EFR has focused its research on the Indian Life Science Sector where, for the first time, complex interactive stakeholder issues can be assessed and company performance analysed to create a dynamic portfolio of sustainable Indian Life Science companies. Through the methodology that SERM has evolved EFR has developed the application of this model at a time when global risk management must take account of the emerging markets having regard to the need for sustainable best practice.

Consultancy work utilising the risk management framework is conducted under licence by: EFR; Sustainable and Economic Risk Management Ltd; and Sustainable Risk Management Ltd. Apply to the address in Appendix A for more details.

Jonathan Barber is Chairman of SERM and Managing Director of EFR.



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# About the authors

## **Dr Linda Spedding**

Dr Spedding holds an LL.B. (Hons), LL.M., Ph.D. She is a Solicitor (England & Wales), and Advocate (India) and an Attorney (USA). Having worked with international law firms, she set up her own practice and remains a consultant to law firms and institutions. International environmental lawyer, lecturer and writer, Dr Spedding has authored many articles for professional journals and several books law guides the professional and business audience. Dr Spedding provides the ideal mix of experience as a practitioner and editor who also has a substantial reputation as an author and lecturer ([www.lindaspedding.co.uk](http://www.lindaspedding.co.uk)). She has been an international advisor to many commercial and professional bodies both in the private and public sector. Throughout her career she has assisted an international multi – cultural charity as part of her life work balance. She serves on several committees, including the SCI Business Strategy Committee and the India Steering Group. Dr Spedding is International Sustainability Advisor to the CII and Sustainability and Governance Advisor to TERI in India and she has recently worked as an International Consultant and Advisor on economic crime, source countries and cultural issues with the Metropolitan Police Service, New Scotland Yard.

Over the last 18 years Dr Spedding's work has been published extensively in the areas of environmental law, due diligence and corporate governance: she has spoken regularly at conferences and training sessions. She is a specialist in International Environmental Law and Energy projects. Dr Spedding was awarded the Alexander Maxwell Law Scholarship Trust Award in the 1995–1996 awards for her contribution in this area. Her work experience covers commercial law, corporate advice, contracts , consultancy agreements, project finance, due diligence, joint ventures and technology transfer. She has thorough and extensive knowledge of comparative regulatory regimes within the EU and outside including Central Europe, India and the USA. She is Director of Women in Law (see [www.womeninlaw.com](http://www.womeninlaw.com)). In her capacity as international environmental lawyer and advisor to SERM and EFR Ltd she has developed corporate governance and corporate responsibility as specialist areas of advise to business and non profit organisations.

## **Adam Rose**

Adam Rose read economic geography at the London School of Economics and Political Science (LSE) and has postgraduate qualifications in Marketing and Management. He has specialised in Risk Management and Socially Responsible

Investment research techniques for over 10 years and has built up several research teams (including SERM's) and currently acts as a freelance consultant and research advisor for the SERM Rating Agency. He has contributed papers to Risk Books and Adam Rose is currently developing training material for the Sustainable Enterprise Risk Management framework.

## Additional contributors

**David Kaye:** David Kaye is an author and lecturer on risk management and continuity subjects and guides a wide range of companies and public sector organisations around the world.

David has spent much of his working life resident and with bottom-line responsibility for financial services businesses in the United Kingdom, The Netherlands, The Caribbean, Singapore and Malaysia. David later became a Divisional Director within the multi-billion pound Multinational with responsibility world-wide for operational risk and continuity planning.

He is the Institute of Risk Managements lead examiner on business continuity, author of the Chartered Insurance Institute's textbook on Operational Risk Management and in 2006 has co-authored the book *A risk management Approach to business Continuity*; published by Rothstein.

David is a Fellow of the Chartered Insurance Institute, A Fellow of the Royal Society of Arts, a Fellow of the Business Continuity Institute, and a Member of the Institute of Risk Management.

**Raj Patel:** An analytical chemist specialising in residue chemistry and chemical food contaminants with an in-depth knowledge of the science and legislation in food safety (e.g. food microbiology, pesticides, veterinary drug residues, natural toxicants, food authenticity, trace elements). Currently Research Fellow and Research co-ordinator at the Centre for Chemical and Bioanalytical Sciences, Royal Holloway, University of London. Current research focus is on the use of novel analytical techniques (proteomics and metabolomics) to food safety and authenticity issues, largely funded by the Food Standards Agency.

**Vijay Sardana:** Vijay Sardana is a well known food and agri trade expert with specialisation on food safety laws, with 15 years wide experience of working in corporate and policy making environment in various parts of the world, undertaken more than 100 projects, published more than 350 papers in various trade journal and trained more than 35 000 people in the sector on various aspects of agri-food trade. He is also the author of well known publication i.e. "A Guide Book to HACCP Implementation in Food Industries". He is a Director of Achievers' Resources Agribusiness Knowledge Services, a well known organisation in techno-legal services in India and Executive Director of Centre for International Trade in Agriculture and Agro-based Industries (CITA), New Delhi.

**Vikas Sharma:** Vikas Sharma is an Advocate in India and a Solicitor in England and Wales, holding an LL.M in International Commercial Law from Aberdeen

Business School, Aberdeen, UK. His dissertation focused on corporate governance reforms introduced in the USA and UK after the collapse of Enron and research into rules and regulations that would be preferable to emerging jurisdictions in framing their policies as to corporate governance.

**Cate Newnes-Smith:** Cate Newnes-Smith helps organisations to become Great Organisations using a range of facilitation, coaching and strategic planning techniques. She has experience in a wide range of industries and size of organisation, in both for profit and not for profit organisations.

**Mike Dance:** Mike Dance is a director of The UK Mercantile Contracts Enforcement Agency Ltd., specialising in the recovery of marine claims, and a consultant with Jackson Parton, Marine Solicitors, London.

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# Handbook overview

The aim of this book is to provide a practice-oriented overview of risk management issues, with particular reference to approaches which may be adopted in identifying and measuring risks, and, therefore, how action to address those risks may be prioritised. As will become clear from the following chapters, a cornerstone of this book is that risk management is a significant tool in enhancing the overall value or performance of any given organisation.

In this book we explore some of the current risk issues along with the concept of organisations creating a ‘Sustainable Enterprise Risk Management’ or SERM system to encapsulate these risk areas with more traditional and mainstream areas of risk management. We seek to incorporate examples of how these risks are quantified and can have a real ‘material’ financial impact on an organisation. Therefore we include best practice and case studies of how these risks are dealt with by organisations that are rising to the challenge to become more sustainable, financially, socially and environmentally.

A SERM system is a sustainable version, or extension, of an Enterprise Risk Management (ERM), Integrated Risk Management or even Interdisciplinary Risk Management system. A SERM system should include elements of the ERM and Operational Risk Management (ORM) systems. We include the elements described in the Basel Committee on Banking Supervision:

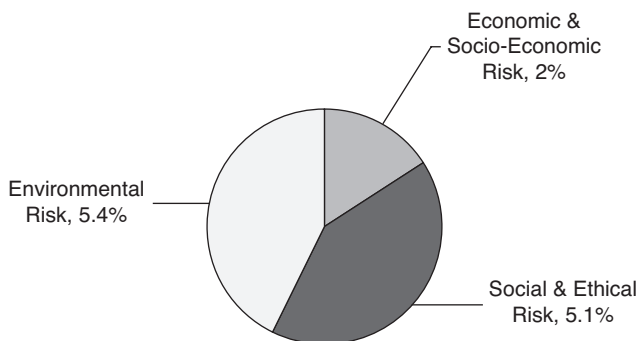
- Internal and external fraud (theft, robbery, hacking or phishing) (Chapter 7);
- Employment practices and workplace safety (Chapters 13 and 15);
- Clients, products and business practice (Chapters 9, 16 and 20);
- Damage to physical assets (Chapter 8 and others); and
- Business disruption and systems failures (Chapter 8).

As well as reviewing the largely economic risks issues above that are discussed in Parts A and B the book examines new research on the social (Part C) and environmental categories (Part D) of sustainability related risks including:

- Business culture practice (Chapter 12);
- Human rights inside and outside the workplace (Chapters 13 and 14);
- Health and safety inside and outside the workplace (Chapters 15 and 16);
- Environmental management risk (Chapter 17);
- Emissions to air, land and water and resource efficiency (Chapter 18); and
- Governance – corruption, crime (Chapter 21).

## What is at risk?

The pie chart below shows the 12.5% of market value at risk from these sustainability issues (of the average organisation reviewed), broken down by main part heading of economic, social and environmental issues.



## What are the benefits?

It is known that the majority of big companies concerned with corporate responsibility issues acknowledge that they lack an active strategy to develop new business opportunities based on these concerns, according to research carried out by the Center for Corporate Citizenship & Sustainability at Boston College (<http://www.bccccc.net/>).

The types of benefits that can be achieved if a SERM system is developed include:

- Enhancing corporate reputation and brand;
- Recruiting and retaining talent;
- Reducing risk; and
- Developing innovative products and services.

The business cases, risks and opportunities outlined will vary in magnitude depending on the type of organisation you are. The issues we raise will affect your competitiveness directly or indirectly.

We will move from strategic considerations to practical case studies for inclusion in any operational risk management plans. Many of the issues are not immediately apparent as business relevant issues, we have used models to analyse 'actual' loss histories and 'materiality' issues which are quantified to present the probabilities of these new risks impacting upon you. You can view the average scores for organisations in your sector on the attached CD-Rom.

In the event of lack of support from corporate financial officers (CFOs) regarding the business case for sustainability a three prong rationale has been recommended by the author of *The Triple Bottom Line*, Andrew Savitz, and is set out below. While the examples given refer to large organisations the drivers are also pushing smaller organisations.

*Substantiate the business case for sustainability*

Gary Pfeiffer, CFO at DuPont, described one of his roles as ‘sweeping up after the elephant parade’. His chief executive, Charles Holliday, has made a mantra of sustainability, pushing the idea that DuPont should shift from making petroleum to biotechnology-based products, for example. Mr Pfeiffer’s job is to apply a financial reality check to this and any other visionary ideas about sustainability.

Sustainability is not philanthropy; if there is no profit payback, your company should rethink its commitment. CFOs such as Mr Pfeiffer play an important role in making sure their companies’ investments in sustainability produce results.

*Measure the results from sustainability initiatives in financial terms.*

In his role as chairman and chief executive at PepsiCo, Steve Reinemund has shown his commitment to diversity. But diversity is not just a public relations exercise or merely an ethical choice: it brings competitive advantages to PepsiCo in the creation of new products, penetration of growing markets and access to the best employee talent. The company measures the financial benefits of diversity and has pegged them at more than \$100 m.

Now PepsiCo’s senior vice-president for finance, Matt McKenna, has helped to develop a CapEx sustainability model whereby capital investments of more than \$10 m are systematically screened and measured for environmental, social and financial results. This powerful ‘triple bottom line’ analysis ensures every big project the company undertakes is sustainable as well as profitable.

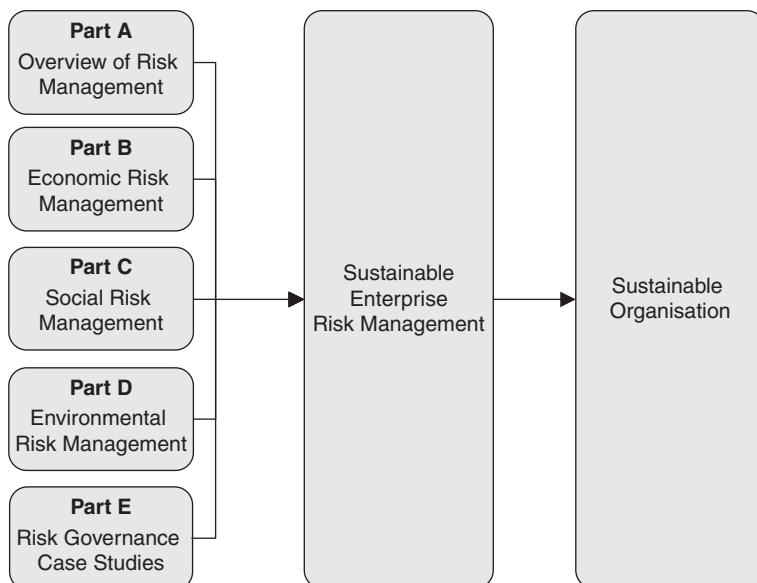
*Communicate the value of sustainability to shareholders.*

The CFO can play an important role in educating investors about the benefits of sustainability. Alan Schwartz, of Bear Stearns, the securities and investment banking group, said at a conference on sustainability in Washington in 2004 that companies should present sustainability goals the same way Warren Buffett presents Berkshire Hathaway’s annual business objectives: here’s what we are going to do, here’s how we’ll measure it and here’s how you can evaluate our performance this time next year. The CFO is uniquely positioned to explain the logic of sustainability to investors with this kind of straight talk.

Savitz, A. on FT.Com, 25 October 2006

The parts of the book include an overview part and the three main categories of what are considered to be the risks relevant to sustainability, with the addition of a case studies part to view how some of the ‘hot’ risk topics are being managed.





## Part A – Overview of Risk Management

The earlier chapters cover:

- The key issues and drivers of risk management;
- Trends in risk management; and
- The effects on organisational culture.

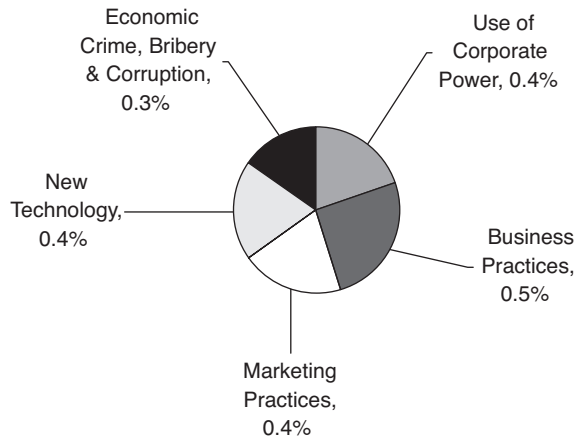
## Part B – Overview of the Economic Aspects of Business Risks

There is an average of 2% of risk to market value from the risk issues we have reviewed here. Others are discussed which will be quantified for future volumes. We cover the key aspects of the emerging risks which include:

- Economic crime;
- Fraud;
- Business interruption and disaster planning risk with crisis management;
- Stakeholder and reputation risk management; and
- Business, marketing and new technology-related risk, in addition to the more standard risks associated with business practice, accountancy and governance issues.

<b>Economic and socio-economic risk</b>	<b>Gross (inherent) risk</b>	<b>Risk management factor (RMF)</b>	<b>Net (residual) risk to value</b>	<b>Risk ranking</b>
Use of corporate power	0.6%	1.3	<b>0.4%</b>	1st
Business practices	0.7%	1.4	<b>0.5%</b>	2nd
Marketing practices	0.6%	1.4	<b>0.4%</b>	3rd
New technology	0.5%	1.3	<b>0.4%</b>	4th
Economic crime, bribery and corruption	0.5%	1.4	<b>0.3%</b>	5th
<b>Total</b>	<b>2.9%</b>	<b>1.36</b>	<b>2.0%</b>	

The chart below shows the economic risk categories by (net) risk to market value for the top 500 companies in the EU and US.



## Part C – Overview of the Social Aspects of Business Risks

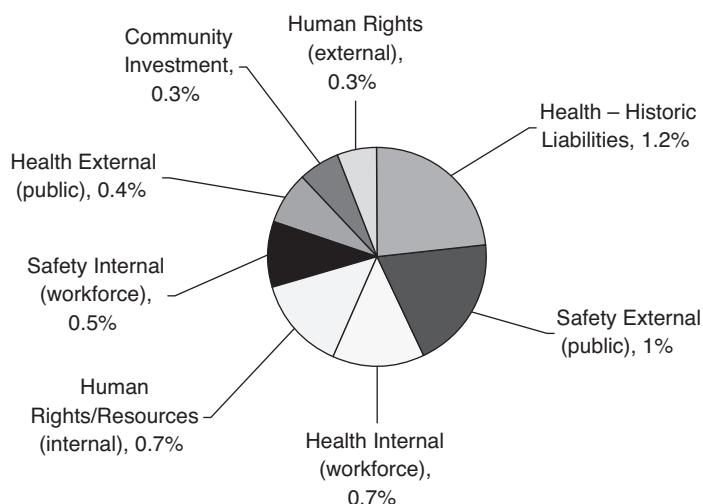
Social risks are as varied as the communities and cultural groupings from which they emanate. The average risk to market value is estimated at 5.1% of market share for the risks highlighted below, mostly from health and safety of staff and customer issues. Many mistakes are made by organisations that are far removed from their marketplaces, physically or culturally or both, such as:

- Fast food chains trying to sell beef burgers in countries where the cow is sacred; or
- The addition of alcohol to soft drinks popular with religious groups who shun consumption of alcohol.

SERM reviews these types of risks as well as external issues such as product safety, human rights and employment law.

Social and ethical risk	Gross (inherent) risk	Risk management factor (RMF)	Net (residual) risk to value	Risk ranking
Health – historic liabilities	1.9%	1.5	<b>1.2%</b>	1st
Safety external (public)	1.6%	1.6	<b>1.0%</b>	2nd
Health internal (workforce)	1.5%	2.1	<b>0.7%</b>	3rd
Human rights/resources (internal)	1.2%	1.8	<b>0.7%</b>	4th
Safety internal (workforce)	1.1%	2.2	<b>0.5%</b>	5th
Health external (public)	0.6%	1.7	<b>0.4%</b>	6th
Community investment	0.7%	2.0	<b>0.3%</b>	7th
Human rights (external)	0.4%	1.4	<b>0.3%</b>	8th
<b>Total</b>	<b>9.0%</b>	<b>1.8</b>	<b>5.1%</b>	

The chart below shows the total social and ethical risks broken down by category by (net) risk to market value for the top 500 companies in the EU and US.



We also look closely at internal risks associated with the hindering of the smooth running of operations. Health and safety in the workplace (Chapter 16) is still a very active risk area with a raft of existing compliance issues and emerging risks that affect sectors differently, such as:

- DVT affecting air travellers and staff;
- SIT (seated immobility thromboembolism) is the white collar office version;
- Popcorn lung;
- Sick building syndrome;
- Mental health issues; and
- Bullying.

Experience demonstrates that the list is growing exponentially, as well as the costs and claims for compensation, together with trends in favour of class actions.

The existing and newer risks associated with health and safety issues have even meant that insurers are seeking governmental insurance as the estimated costs associated with claims begin to spiral. In the UK in April 2005 a report from the *British Medical Journal* (BMJ) (Henderson, M. *et al.*, Vol. 330, 802–803) has reported that stress-related mental health problems have now overtaken physical ailments as the chief cause of long-term sickness in Britain. The UK is estimated to lose 12.8 million working days a year due to stress-related issues alone. A new risk management regime is obviously called for as depression and anxiety now account for more benefit claims than the more traditional back pain issues. These newer pressures account for an average of 29 days off work per individual involved with an estimated cost to the UK economy and business of £6.9 billion.

Chapter 16 explores why what is seen by employers as yet more red tape, is seen differently by the economists that advise governments. As their 'Regulatory Impact Assessments' (RIAs) are confronted by such large costs to economies of poor management-related incidents and their impacts, they regard the burden on companies as justified. In their view it reduces the vast costs of work-related accidents, ill health, pain, grief and suffering which results from people trying to earn a living. In the UK the analysis for 2001–02 placed the annual impact at a range from £20 billion to £31.8 billion, of which £3.9 to £7.8 billion in costs is borne by the employer and £10.1 to £14.7 billion is borne by individuals.

The global picture is more extreme, for example the ILO estimated that in 2000 a total of 2 001 717 people were work-related fatalities, although of these only 57 468 had been reported to the ILO (*Global Estimates of Fatalities Caused by Work Related Diseases and Occupational Accidents*, 2002). Further details are found at: [http://www.ilo.org/public/english/protection/safework/accidis/globest\\_2002/dis\\_world.htm](http://www.ilo.org/public/english/protection/safework/accidis/globest_2002/dis_world.htm)

## Part D – Overview of the Environmental Aspects of Business Risks

The term 'sustainability' often means a paradigm shift towards a greater understanding of things in the direction of natural processes, which are more durable in their efficient use of resources and inputs and outputs from systems. There is a review of how to reduce the 5.4% average risk to organisations from these issues.

In this part the book explores the potential for living within ecological limits and reducing the negative environmental impacts of organisations' activities, while at the same time enhancing the resilience to resource shortages of the future, via energy and materials efficiency, and reducing potential overheads. The challenges we face as a species are immense with global warming and climate change being recognised as the biggest risks to human society:

- The Global Development and Environment Institute at Tufts University in the US says that trillions of dollars of damage could be avoided by the end of the century if resolute action is taken now to reduce global warming; and

- These findings are echoed by the ‘Stern’ report on the *Review of the Economics of Climate Change* published at the end of October 2006. The author, Sir Nicholas Stern, is the head of the UK government’s Economic Service and is a former chief economist at the World Bank; he said, ‘We can grow and be green’ and estimates that the costs of doing nothing are:
  - £3.68 trillion in damages, that’s £3 680 000 000 000 as the ‘do nothing’ scenario means 5–20% of the global economy will be at risk;
  - Up to 200 million extra refugees;
  - Up to 40% of species lost; and
  - Water shortages for 1 in 6.

So our new business environment could well be one where there will be sea level rises, melting glaciers, increased storm and drought severity. This means increased market forces of taxation, more green power, etc. It was also announced there will be a climate change bill in the UK. Some commentators say the signs are visible across the United States, according to some experts, who point to an increase in tornadoes, brushfires, hailstorms, hurricanes, and droughts.

There is large-scale pollution of land, sea and air and we can barely begin to understand the consequences. For example, it is estimated that 5500 children die each day from diseases linked to polluted food, air and water (WHO quoted in *State of the World*, 2003).

A SERM system can demonstrate that being green is good business. The rewards and opportunities from environmental management seem to be increasing almost as rapidly as the risks. There are new markets emerging:

- According to a report published in 2006 by the Institute of Grocery Distribution, more than half of British shoppers care about the green credentials of what they purchase. The report has argued that the market for ‘ethical consumerism’ is now worth £25 billion a year; and
- Shell Springboard (a consultancy) has noted that the challenge of tackling climate change-induced damages could be worth £30 billion for British businesses over the next 10 years.

There are other benefits like improved fuel security, and massive energy efficiency savings to make in an era of high demand for energy resources. The macro-economic benefits can also be large as:

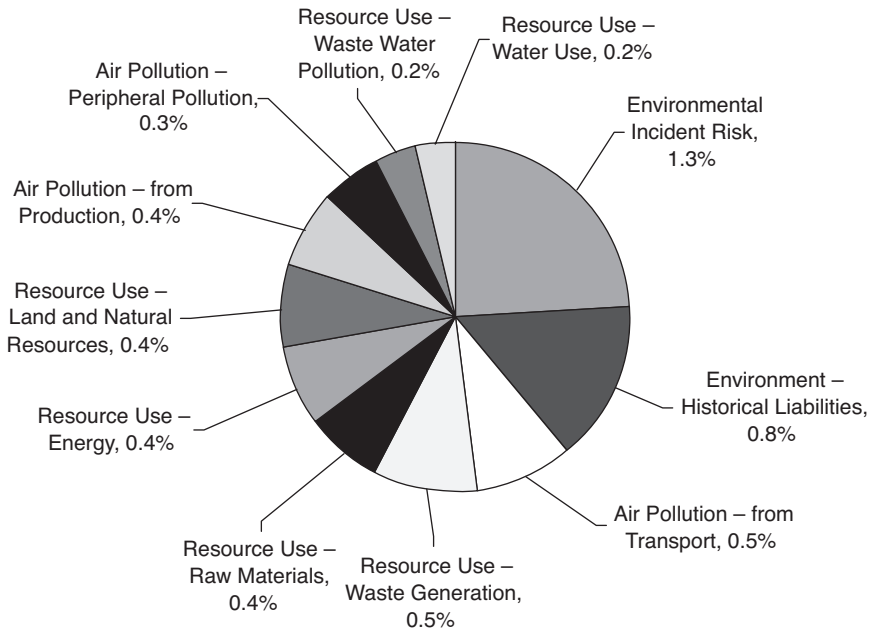
- The European Environment Agency (EEA) estimates Europe could save \$15.4 billion a year in air pollution-control costs by 2030 through ‘burning smaller amounts of fossil fuels’.

As with other areas of risk, when dealing with environmental risk, the SERM model considers:

- The gross or inherent risk;
- The risk management factor; and
- The net or residual risk.

Environmental risk	Gross (inherent) risk	Risk management factor (RMF)	Net (residual) risk to value	Risk ranking
Environmental incident risk	1.8%	1.4	<b>1.3%</b>	1st
Environment – historical liabilities	1.1%	1.4	<b>0.8%</b>	2nd
Air pollution – from transport	0.8%	1.5	<b>0.5%</b>	3rd
Resource use – waste generation	0.9%	1.7	<b>0.5%</b>	4th
Resource use – raw materials	0.6%	1.4	<b>0.4%</b>	5th
Resource use – energy	0.6%	1.6	<b>0.4%</b>	6th
Resource use – land and natural resources	0.7%	1.7	<b>0.4%</b>	7th
Air pollution – from production	0.6%	1.6	<b>0.4%</b>	8th
Air pollution – peripheral pollution	0.5%	1.5	<b>0.3%</b>	9th
Resource use – waste water pollution	0.4%	1.5	<b>0.2%</b>	10th
Resource use – water use	0.3%	1.5	<b>0.2%</b>	11th
<b>Total</b>	<b>8.2%</b>	<b>1.6</b>	<b>5.4%</b>	

The chart below shows the environmental risk categories by (net) risk to market value for the top 500 companies in the EU and US.



## Part E – Case Studies of Business Risks

Whereas the book includes case studies throughout, with some emphasis on key global risks facing the world today, such as climate change and food safety, there is no doubt that the Enron catastrophe that included economic crime and mismanagement was the moment in corporate history which defined the need for urgent change and ushered in a new era to corporate governance and strategic risk management. It highlighted the need for a review and reappraisal of corporate behaviour and accountability. In turn this had major implications for sustainable risk management.

Therefore the book concludes with some analysis and comment on the comparative responses to the Enron case study, with some recommendations based on the need to consider emerging risks in emerging economies that are so rapidly taking place at the forefront of globalisation.

### Overview of emerging SERM risk issues

Risk issue	Role (and expectations) of business?
<b>Economic risks</b>	
Economic crime (Chapter 7)	Bribery and corruption – responsible procurement and governance procedures Systems to prevent fraud and money laundering
Business interruption risk (Chapter 8)	Disaster and act of terrorism recovery programmes and contingency plans in place
Stakeholder value and reputation risk (Chapter 9)	Defining the value of your reputation and protecting this intangible asset
Business and marketing practices (Chapter 10)	Political agendas, public/private partnerships
New technology (Chapter 11)	Access to technology (internet and computers) Use of technology/training/engagement
<b>Social and ethical risk</b>	
Business culture practice (Chapter 13)	Education and access to mentoring, capacity building and training Change management risks
Human rights in the workplace (Chapter 14)	Employment law and confronting discrimination
Human rights outside the workplace (Chapter 15)	A realisation of the issues surrounding poverty and inequality Community relations and investment: generate secure employment; provision of food, shelter, healthcare, education and training; loans, micro credit; promote access of local services/products; staff involvement in the local community; partnership development Avoidance of forced, slave or child labour Labour translocation and outsourcing

*(Continued)*

<b>Risk issue</b>	<b>Role (and expectations) of business?</b>
Health and safety in the workplace (Chapter 16)	Access, infrastructure for provision of health services for staff Workplace disease prevention Provide adequate health and safety awareness programmes Gaining of standards ISO 18000 series
Health and safety outside the workplace (Chapter 17)	Health of products and product life cycle analysis Ensuring that a robust product recall system is in place Gaining of quality standards, i.e. ISO 9000 series
Governance – corruption, crime (Chapters 7, 21, 22 and 23)	Promote transparent governance Abide by the laws (but unfair and unjust laws) Reform of laws
<b>Environmental risk</b>	
Environmental management risk (Chapter 18)	Environmental management systems Gaining of EMS standards, i.e. ISO 14000 series Implementation of precautionary principle Following the principles of sustainable development
Emissions to air – air pollution (Chapters 18, 19 and 20)	Becoming carbon neutral and energy efficient; reduced reliance on external energy sources
Emissions to land – waste/reuse/recycle (Chapter 19)	Reduce waste, increase reuse and promote recycling – leadership Develop products with fewer materials, energy
Emissions to water – water scarcity (Chapter 19)	Waste water use policy; water recycling and reuse
Resource efficiency – sustainable production and consumption (responsible consumerism) (Chapter 19)	Communicate benefits of sustainable production Improve labelling and communication of information of products Maximise efficiency of products and consider by-products Use components produced in a socially and environmentally responsible manner
Supply chain management (Chapters 18 and 19)	Indirect damage to purchaser's reputation

## How to use this book

### Approach to the methodology

Your organisation's goals will benefit from aspects of this book: some chapters may prove to be more relevant to different sectors of your activities than others. The issues raised may even help focus upon new opportunities to improve management activities, take balanced risks and look for opportunities, or strengthen the business case for risk management activities previously viewed as peripheral, or even irrelevant.



The primary aim of the following chapters is to help individual organisations evaluate their level of risk and to prioritise action in order to address these risks. The chapters outline methodologies which may be adopted for assessing both tangible and intangible risks.

## Sector priorities on a range of current issues

Analysis of SERM Rating Agency research suggests where the critical issues are for your sector of operation with a ✓ being key reading.

### A recommended reading checklist, by industrial sector

Sectors	Part A	Part B					Part C						Part D				
	Introduction chapters	Economic chapters	Social chapters	Environment chapters	7	8	9	10	11	12	13	14	15	16	17	18	19
	2–6																
Aerospace & Defence	✓	✓	✓	✓	✓					✓	✓	✓	✓	✓			
Automobiles & Parts	✓			✓						✓		✓		✓	✓		
Banks	✓	✓	✓	✓	✓	✓				✓	✓	✓	✓				
Beverages	✓			✓	✓					✓		✓				✓	
Chemicals	✓			✓	✓					✓	✓	✓		✓	✓	✓	✓
Construction & Materials	✓			✓	✓					✓		✓	✓	✓	✓	✓	✓
Electricity	✓			✓	✓	✓				✓		✓		✓	✓	✓	✓
Electronic & Electrical Equip'	✓			✓						✓		✓					
Equity Investment Instruments	✓			✓		✓				✓		✓	✓				
Fixed Line Telecommunications	✓			✓	✓					✓		✓					
Food & Drug Retailers	✓			✓	✓					✓		✓	✓			✓	
Food Producers	✓			✓	✓					✓		✓	✓			✓	
Forestry & Paper	✓			✓	✓					✓		✓					
Gas, Water & Multi-utilities	✓			✓	✓	✓				✓	✓	✓		✓	✓	✓	✓
General Financial	✓			✓	✓	✓						✓					
General Industrials	✓			✓	✓					✓		✓			✓		
General Retailers	✓			✓	✓					✓	✓	✓	✓	✓	✓	✓	✓
Health Care Equipment & Services	✓			✓	✓							✓			✓		
Household Goods	✓			✓	✓					✓		✓	✓	✓	✓		
Industrial Engineering	✓			✓	✓					✓	✓	✓		✓			
Industrial Metals	✓			✓	✓					✓		✓		✓		✓	✓
Industrial Transportation	✓			✓	✓					✓	✓	✓		✓	✓	✓	✓
Leisure Goods	✓			✓	✓					✓	✓	✓	✓		✓		
Life Insurance	✓			✓	✓	✓		✓				✓					
Media	✓			✓	✓	✓				✓		✓					
Mining	✓			✓						✓	✓	✓	✓	✓	✓	✓	✓

(Continued)

	<b>Part A Introduction chapters</b>	<b>Part B Economic chapters</b>					<b>Part C Social chapters</b>						<b>Part D Environ- ment chapters</b>			
Mobile Telecommunications	✓	✓	✓	✓	✓	✓	✓									
Non-equity Investment Instruments	✓		✓	✓	✓		✓									
Non-life Insurance	✓	✓		✓	✓	✓		✓								
Oil & Gas Producers	✓	✓	✓	✓			✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Oil Equip', Services & Distribution	✓	✓	✓	✓			✓	✓	✓	✓	✓					
Personal Goods	✓			✓	✓		✓		✓	✓	✓	✓	✓			
Pharmaceuticals & Biotechnology	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Real Estate	✓			✓			✓		✓					✓	✓	
Software & Computer Services	✓			✓			✓		✓							
Support Services	✓			✓		✓	✓		✓		✓	✓	✓			
Technology Hardware & Equip'	✓			✓			✓	✓	✓	✓	✓					
Tobacco	✓	✓		✓	✓		✓		✓	✓			✓			
Travel & Leisure	✓			✓	✓	✓	✓	✓	✓	✓				✓	✓	
Government Departments	✓		✓	✓		✓	✓	✓	✓		✓	✓		✓	✓	
Not-for-Profit Organisations	✓			✓	✓	✓		✓	✓		✓					
	<b>2-6</b>	<b>7</b>	<b>8</b>	<b>9</b>	<b>10</b>	<b>11</b>	<b>12</b>	<b>13</b>	<b>14</b>	<b>15</b>	<b>16</b>	<b>17</b>	<b>18</b>	<b>19</b>		

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# Abbreviations and acronyms

A\$	Australia Dollars
ADB	Asian Development Bank
AGM	Annual General Meeting
AMD	Accounts Modernisation Directive
AOSIS	Alliance Of Small Island States
APG	Asia-Pacific Group
APOSHO	Asia-Pacific Occupational Safety and Health Organisation
BAT	Best Available Technique
BAU	Business As Usual
BCI	Business Continuity Institute
Bcm	Billion cubic metres (unit of volume, e.g. for gas)
BGE	Balanced Growth Equivalent
Bl	Barrel of oil
BoD	Board of Directors
Boe	Barrels of oil equivalent
BPM	Best Practicable Means
BPO	Business Process Outsourcing
BSI	British Standards Institute
BSR	Business for Social Responsibility (US)
C\$	Canadian Dollar
C	Carbon (to convert 1 tonne of C into CO <sub>2</sub> , multiply by 12/44)
CA	Corporate Accountability
CBA	Cost Benefit Analysis
CBC	Commonwealth Business Council
CCGT	Combined Cycle Gas Turbine
CCOHS	Canadian Centre for Occupational Health and Safety
CCS	Carbon Capture and Storage
CDD	Cultural Due Diligence
CDM	Clean Development Mechanism
CDP	Carbon Disclosure Project
CEO	Chief Executive Officer
CEP	Council for Economic Priorities
CER	Certified Emission Reduction
CERCLA	Comprehensive Environmental Response, Compensation & Liability Act
CERES	Coalition for Environmentally Responsible Economies
CFCs	Chloro Fluoro Carbons
CFL	Compact Fluorescent Lamp
CFO	Chief Financial Officer

CG	Corporate Governance
CGE	Computable General Equilibrium
CH <sub>4</sub>	Methane (greenhouse gas)
CHP	Combined Heat and Power
CIMA	Chartered Institute of Management Accounting
CIO	Chief Investment Officer
CITES	Convention on the International Trade in Endangered Species
CO <sub>2</sub>	Carbon dioxide
CO <sub>2</sub> e	CO <sub>2</sub> equivalent
COP	Conference Of the Parties
COSHH	Control of Substances Hazardous to Health Regulations
CR	Corporate Responsibility
CRO	Corporate Responsibility Officer
CSD	Commission for Sustainable Development
CSR	Corporate Social Responsibility
dCHP	Decentralised Combined Heat and Power
DEFRA	Department for Environment, Food and Rural Affairs (UK)
DEHP	Di(2-ethylhexyl)phthalate
DFID	Department For International Development (UK)
DFIU	French-German Institute for Environmental Research
DFT	Department For Transport (UK)
DG	Directorate General (EU)
DTI	Department for Trade and Industry (UK)
DVT	Deep Vein Thrombosis
EA	Environment Agency (UK)
EA	Environmental Assessment
EBITDA	Earnings Before Interest, Taxes, Depreciation and Amortisation
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EDR	Enhanced Directors' Report
EEA	European Environment Agency
EES	Economic, Environmental and Social
EFR	Extra-Financial Risk
EHS	Environment, Health and Safety
EIA	Environmental Impact Assessment
ELV	End-of-Life Vehicle
EMAS	Eco-Management Auditing Scheme (EU)
EMAS	Environmental Management Assistance System
EME	Established Market Economies
EMS	Environmental Management System
EP	Equator Principles
EPA	Environmental Protection Agency (US)
EPCRA	Emergency Preparedness and Community Right to Know Act
EPS	Earnings Per Share
ERM	Enterprise Risk Management
ESG	Environmental, Social and Governance issues

ETI	Ethical Trading Initiative
ETS	Emission Trading System (EU)
EU	European Union
EUROSIF	European Sustainable and Responsible Investment Forum
FAO	UN Food and Agriculture Organisation
FATF	Financial Action Task Force
FCCC	Framework Convention on Climate Change (UN)
FDI	Foreign Direct Investment
FM	Fund Managers
FOB	Free On Board
FoE	Friends of the Earth
FPB	Forum for Private Business
FRRP	Financial Reporting Review Panel
FSA	Financial Services Authority (UK)
FSA	Food Standards Agency
FSB	Federation of Small Businesses
FT	<i>Financial Times</i>
FTSE	Financial Times Stock Exchange
G	Giga: 10 to the power of 9
GATT	General Agreement on Trade and Tariffs
GCM	Global Climate Model
GDP	Gross Domestic Product
GEF	Global Environment Facility
GHG	Greenhouse Gas
GHS	Globally Harmonised System of Classification of Chemicals
GM	Genetically Modified
GMO	Genetically Modified Organism
GMT	Global Mean Temperature
GNP	Gross National Product
GO	Governmental Organisation
GPG	Global Public Goods
GPP	Gross Primary Production
GRI	Global Reporting Initiative
GSP	Global Sullivan Principles
GtC	Gigatonne of Carbon
GWP	Global Warming Potential
GWP	Gross World Product
H <sub>2</sub> O	Water Vapour
HDI	Human Development Index
HFC	Hydro Fluoro Carbon
HR	Human Resources
HMT	Her Majesty's Treasury (UK)
HSE	Health & Safety Executive (UK)
HSMS	Health and Safety risk Management System
HVAC	Heating, Ventilation and Air Conditioning
I-INCE	International Institute of Noise Control Engineering



IA(M)	Integrated Assessment (Model)
IAEA	International Atomic Energy Agency
IBE	Institute of Business Ethics
ICAEW	Institute of Chartered Accountants in England and Wales
ICC	International Chamber of Commerce
ICCP	International Climate Change Partnership
ICSA	Institute of Chartered Secretaries and Administrators
ICT	Information Communications Technologies
IEA	International Energy Agency
IEA	International Ergonomics Association
IEMA	Institute of Environmental Management and Assessment
IEPA	Irish Environmental Protection Agency
IETA	International Emission Trading Association
IFRS	International Financial Reporting Standards
IIASA	International Institute for Applied System Analysis
IIGCC	Institutional Investors Group on Climate Change
iP	Investors in People
IISD	International Institute for Sustainable Development
ILO	International Labour Organisation
IMF	International Monetary Fund
INGO	International Non-Governmental Organisation
IP	Intellectual Property
IPCC	Intergovernmental Panel on Climate Change
IPR	Intellectual Property Rights
IR	Investor Relations
ISIC	International Standard Industrial Classification
ISO	International Organisation for Standardisation
IT	Information Technology
ITES	Information Technology Enabled Services
IUCN	International Union for the Conservation of Nature
J	Joule = Newton $\times$ Metre (International Standard unit of energy)
JI	Joint Implementation
JRC	Joint Research Centre (EU)
K	Kilo: 10 to the power of 3
KPIs	Key Performance Indicators
KWh	Kilowatt hour
Lb	Pound (unit of weight. 1 lb = 0.454 kg)
LCCI	London Chamber of Commerce and Industry
LDC	Least Developed Country
LIC	Low Income Country
LLP	Limited Liability Partnership
LNG	Liquid Natural Gas
LPG	Liquid Petroleum Gas
LSE	London Stock Exchange
M	Mega: 10 to the power of 6
MAC	Marginal Abatement Cost

MARPOL	The Convention for the Prevention of Pollution from Ships (1973)
MDGs	Millennium Development Goals
MERs	Market Exchange Rates
MIC	Middle Income Country
MIT	Massachusetts Institute of Technology
MPS	Metropolitan Police Service
Mtoe	Mega tonnes oil equivalent
N <sub>2</sub> O	Nitrous oxide (greenhouse gas)
NAFTA	North American Free Trade Agreement
NASA	National Aeronautics and Space Administration
NASDAQ	National Association of Securities Dealers Automated Quotation System Stock Market
NCGGs	Non-Carbon Greenhouse Gases
NED	Non-Executive Director
NEPSE	Nepal Stock Exchange
NGO	Non-Governmental Organisation
NIC	Newly Industrialised Country
NMHC	Non-Methane Hydro Carbon
NO <sub>x</sub>	Nitrogen oxides (local air pollutants)
NRD	Natural Resource Damages
NYSE	New York Stock Exchange
ODA	Official Development Assistance
ODS	Ozone Depleting Substances
OECD	Organisation for Economic Co-operation and Development
OFR	Operating Financial Review (UK)
OPEC	Organisation of Petroleum Exporting Countries
ORM	Operational Risk Management
OSHA	Occupational Safety & Health Administration (US)
OSPAR	Convention of the Marine Environment of North-East Atlantic (1992)
P	Peta: 10 to the power of 15
P/E or P:E	Price-to-Earnings ratio
PBB	Polybrominated Biphenyls
PBDE	Polybrominated Diphenyl Ethers
PCAOB	Public Company Accounting Oversight Board
PCB	Polychlorinated Biphenyls
PDA	Personal Development Assistant
PFC	Per Fluoro Carbon
PICG	Pakistan Institute of Corporate Governance
PLC	Public Limited Company
POP	Persistent Organic Pollutant
PPC	Pollution Prevention and Control
ppm	parts per million (by volume/weight)
PPP	Polluter Pays Principle
PPP	Purchasing Power Parity
PR	Public Relations

R&D	Research and Development
RD&D	Research, Development and Demonstration
REACH	Registration, Evaluation and Authorisation of Chemicals
RIA	Regulatory Impact Assessments
RMF	Risk Management Factor
RoHS	Restriction of Hazardous Substances Directive 2002/95/EC
ROI	Return on Investment
ROSC	Report on the Observance of Standards and Codes
SARA	Superfund Amendments and Reauthorisation Act (1980)
SD	Sustainable Development
SEBI	Securities Exchange Board of India
SEC	Securities and Exchange Commission
SEE	Social, Environmental and Ethical Risks
SEPA	Scottish Environmental Protection Agency
SERM	Safety & Environmental Risk Management
SERM	Sustainable Enterprise Risk Management
SF <sub>6</sub>	Sulphur Hexafluoride (greenhouse gas)
SIF	Social Investment Forum
SIR	Standard Information Return
SME	Small and Medium Enterprise
SMS	Supplier Management System
SO <sub>x</sub>	Sulphur dioxide
SOE	State-Owned Enterprises
SOX	Sarbanes-Oxley Act of 2002
SPE	Special Purpose Entities
SRI	Socially Responsible Investment
SSSI	Sites of Special Scientific Interest
SWOT	Strength, Weaknesses, Opportunities and Threats analysis
T	Tera: 10 to the power of 12
Tce	Tonnes of coal equivalent
TI	Transparency International
Toe	Tonnes of oil equivalent (Mtoe – mega tonnes of oil equivalent)
UDHR	UN Universal Declaration of Human Rights
UK	United Kingdom
UKSIF	UK Social Investment Forum
UN	United Nations
UNCED	UN Conference on Environment and Development
UNDP	UN Development Programme
UNECE	United Nations Economic Commission for Europe
UNEP	UN Environment Programme
UNEP FI	UN Environment Programme (UNEP) Finance Initiative
UNFCCC	UN Framework Convention on Climate Change
US\$	United States Dollars
US/USA	United States (of America)
US CCSP	United States Climate Change Science Programme
US EIA	United States Energy Information Administration

VAT	Value Added Tax
VOC	Volatile Organic Compound
W	Watt = Joule/second (International Standard unit of power)
WB	World Bank
WBCSD	World Business Council for Sustainable Development
WCED	World Commission on Environment and Development
WEC	World Energy Council
WEO	World Economic Outlook
WG (I–III)	Working Group (One to Three) of the IPCC
Wh	Watt hour
WHO	World Health Organisation (UN)
WMO	World Meteorological Organisation
WRI	World Resources Institute
WTO	World Trade Organisation
WTP	Willingness To Pay
WWF	World Wildlife Fund

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1

Introduction

# 1

## Introduction

### Business risk overview

#### CHAPTER OVERVIEW

Organisations are always aiming to balance their risks and reward ratio but the implications of not managing these risks seem to be increasing exponentially. Competitive pressures are leading organisations to become more proactive in their management of issues, often after learning the lessons the hard way. More is required of managers in the future than just fire fighting and being reactive. Practical methodologies are necessary. With newly emerging risks there needs to be improved preparation to:

- \* Help understand and reduce these risks;
- \* Seek them out;
- \* Measure; and
- \* Manage them.

### General introduction

In order to be competitive, organisations must constantly review their methods and models to check that they are operating correctly. In addition, they must examine new areas of emerging risk and develop sustainable systems of risk analysis and management.

These increasingly significant risks traditionally fall into non-financial areas of business activity, often referred to as environmental, social and governmental (ESG) issues. Experience and case studies demonstrate that they do have financial impacts upon organisations, both positively and negatively.

This book seeks to help minimise the risks and exemplify the opportunities that can be followed as a result of SERM's new thinking, and more sustainable and external risk management appraisal techniques.

SERM's view is that what is needed is for the understanding of the term 'risk management' to be greater than the currently accepted meaning and for a more diversified approach to be accepted.

For this purpose, and to assist the review of the emerging risk issues within a framework, a Sustainable Enterprise Risk Management (SERM) system is explored for its use in supporting an organisation's stability in this fast moving era. The need to incorporate more enlightened systems of risk management, new models and methods of interpreting the risk 'environment' is essential to becoming 'sustainable'.

The main difference in the SERM approach to risk over time is the ability to include newer risks and their relevant probabilities of occurrence into our systems, and the ability to be risk takers in the first place, without which progress would be lethargic at best. Peter Bernstein in his risk classic, *Against the Gods: The Remarkable Story of Risk*, summarises this as:

The revolutionary idea that defines the boundary between modern times and the past is the mastery of risk. (Peter L. Bernstein, John Wiley & Sons Inc., 1996)

Essentially the SERM system is an Enterprise Risk Management (ERM) system that includes more external and contemporary risk issues than is traditional. It covers a portfolio of risk issues which can then be managed by many elements of the organisation, as opposed to risk management generally falling on the shoulders of a SRO (senior risk officer).

It is important to recognise that the board is responsible for monitoring all types of risk. It is not just a matter of financial risk. Operational risks are at least as important. (*Tolley's Corporate Governance Handbook*, 2nd Edition (2003) by Andrew Chambers)

By bringing together various risk issues the system helps to develop the executive view of strategic risk and the appetite for it. The sustainable risk concept may also assist in achieving a common risk culture and language that should improve the understanding of the importance of managing a variety of risks. It should help with the inclusion of all elements of the organisation into the risk management system. It has the potential to facilitate the unifying of corporate visions and objectives with their risk management systems.

In some cases, firms may be practicing good risk management on an exposure-by-exposure basis, but they may not be paying close enough attention to aggregation of exposures across the entire organisation. (Susan Schmidt Bies, 'A bank supervisor's perspective on enterprise risk management', from RiskCenter ([www.riskcenter.com](http://www.riskcenter.com)), 3 May 2006)

Risk management practitioners understand the importance of not being blinded by the internal risk aspects of an organisation alone. Bearing in mind the old adage of what gets measured gets managed, SERM has sought to measure these newer elements of the sustainable risk matrix. The type of risk issues taking centre stage as defining the new competitive environment are:

- The external environment in which organisations operate (Chapters 4 and 9);
- The organisational culture (Chapters 6 and 13);
- Staff recruitment and retention and human rights in the workplace (Chapter 14); and
- Health and safety considerations (Chapters 16 and 17).



Organisations are now transferring more expertise to their supply chains as they recognise their indirect, as well as direct, employee count is a major component in distinguishing themselves from other organisations.

Risks that previously seemed operational are now being recognised as strategic as issues change their level of importance and probabilities of occurring. A good example is the importance of preserving your organisation's reputation and brand value (Chapter 9), which can now make up a large proportion of the value of companies. This is deemed to be such a strategic issue among global business executives that reputation risk is often considered as the most problematic issue, more so than the risks posed by terrorism, foreign exchange, natural hazards and political risk.

Related issues include how it is critically important to look after the health and safety of customers, ensuring brand integrity and the retention of customers' loyalties (Chapter 17). Customer retention is now a key element of many business strategies. It is recognised to be economically sound since the costs of retention are small compared to the cost of recruiting replacement customers. Indeed there has been a deluge of loyalty schemes and other methods to understand and communicate with this stakeholder group, demonstrating that it is too risky to lose customers. Other risk management techniques to build customer loyalties have been Cause Related Marketing (CRM) and Community Investment (CI) initiatives. These are designed to foster a belief in stakeholder groups that the organisation supports human rights for their customers, local communities and the public as a whole, thus maintaining brand value(s) and organisational reputation.

These are just a few examples of how new or emergent components of today's risk 'landscape' or risk 'environment' are interconnected and a holistic approach can have additional benefits than just the sum of the parts.

One point that is for certain is that change is always with us: a SERM system seeks to help an organisation to become truly sustainable via a wider view and interpretation of the risk management 'landscape' through the prism of a SERM system, a Sustainable ERM methodology.

The type of benefits that can be achieved through a functioning sustainability (corporate responsibility, corporate citizenship) system that includes the management of 'sustainability' risks as well as more traditional ones includes:

- Protecting and enhancing corporate reputation and brand;
- Recruiting, retaining and protecting talented staff;
- Reducing risk; and
- Developing innovative products and services.

The book aims to develop these and additional themes that highlight the changing risk 'environment' over successive editions. The requirement exists as it is recognised that most large companies concerned with corporate responsibility issues acknowledge that they lack an active strategy to develop new business opportunities based on those concerns. According to the Center

for Corporate Citizenship & Sustainability at Boston College (<http://www.bccccc.net/>):

- A total of 90% of participating companies confirm that their company's approach to corporate citizenship and sustainability issues reflects at least some belief in the potential rewards of a CSR or sustainability approach.

To assist companies to meet this need we have set out the SERM objectives in the box below.

### **SERM objectives**

SERM aims to help an organisation to:

- \* Achieve existing goals and objectives and develop new ones;
- \* Improve an organisation's business capabilities by seeing emerging risks as new opportunities for activity;
- \* Reduce risk to the organisation through:
  - Analysis and reduction techniques across a wide range of risk issues;
  - The provision of case studies;
  - Best practice suggestions;
  - Checklists; and
  - Methodologies for specific tasks like due diligence operations;
- \* Assist an organisation to become more stable and sustainable;
- \* Enhance profitability potential as there can be real rewards from:
  - Minimising non-compliance;
  - Improving the quality of business operations;
  - Enhancing the quality of life of staff and customers; and
  - Reducing the use of resources by minimising ecological 'footprints', that is the impact that humans have upon the planet.

SERM seeks to achieve these objectives by bringing contemporary research and analysis, new regulations and risk management suggestions and the SERM model to the attention of the readers. Evolving standards, codes, regulations, compliance and governance issues are monitored and SERM seeks out which ones are useful in order to maintain a licence to operate. A functioning SERM system should help maintain stability and the confidence of stakeholders (investors, customers, staff, governing bodies, etc.) in organisations that demonstrate a commitment to being sustainable and to playing a constructive role in society.

## Risk overview summary

Traditional scientific risk assessments can often fail to take into account the stakeholders' view of organisations which: in the context of investors, affects

their market and brand value; in the case of customers their market share; or the general public's perception of the organisation and the risks it faces. They will not necessarily be based upon objective criteria.

With so much value being of a non-, or extra-financial nature, i.e. brand value, a new method of risk assessment is required to include various approaches to viewing value. It has been estimated that, among the companies analysed by the SERM risk rating system (UK, EU and US markets), non-financial issues alone put at risk an amount equivalent to 20.1% of the total market capital if left untreated. This represents the 'gross' or 'inherent' risk borne by those companies by virtue of the nature of their current operations. The risk management measures actually adopted by those companies are taken into account to mitigate this risk, the sustainability of their risk management systems, and the value threatened falls to 12.5% – a measurement of the 'net' risk to market value of the organisations.

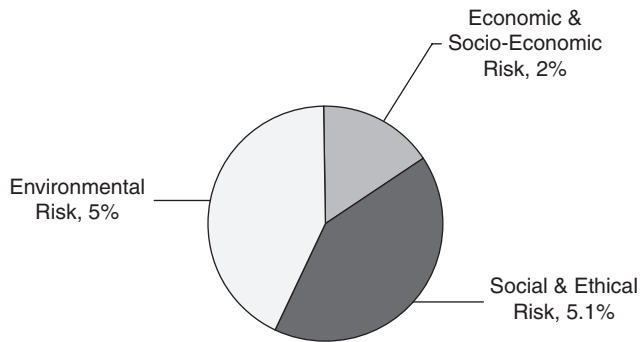
## Headline summary

An examination of the results in more detail shows a breakdown of this risk level in accordance with the main section headings of the book, that is the three main elements of sustainability: the economic, social and environmental pillars of sustainable development. Research is still progressing on the measurement of these risks and there will be much more evidence to increase the economic risk component in the next volume. The methodology is described below and in Appendices C and D.

Risk to value from sustainability issues	Gross (inherent) risk		Risk management factor (RMF)		Net (residual) risk
Economic and socio-economic risk	2.9%	/	1.4	=	2.0%
Social and ethical risk	9.0%	/	1.8	=	5.1%
Environmental risk	8.2%	/	1.55	=	5.4%
<b>Combined risk issues</b>	<b>20.1%</b>	/	1.6	=	<b>12.5%</b>

This indicates that the analysed organisations have safeguarded approximately 7.6% of their collective market value through management of the relevant risk issues (the variance/differences between the 'gross' and 'net' figures). It also gives some measure of the level of resources which it may be appropriate to utilise in those management activities. A review will take place as to how these organisations are managing down their risk by use of the best practice case study sections in each chapter.

The remaining risk can be seen in the following diagram: one aim of this book is to reduce this 12.5% of risk to organisational value still further.



The majority of operational risk from sustainability issues is derived from environmental risks and social and ethical issues. These include indirect effects such as increased resource/fuel costs and climate change impacts. These summary sections can hide the relative importance of risk categories within each of them; for example, health and safety element issues make up 3.8% of the 5.1% net risk that constitutes the social risk category.

The primary sustainability risk within the organisations reviewed is still as a result of environmental issues, representing a 5.4% risk to market value; followed by social and ethical issues at 5.1% (including health and safety issues) and economic ‘sustainability’ factors at 2.0%. We therefore need to view each of the risk elements in more detail, and this is done in the chapters of this book, we provide some summary overview in this chapter.

## Overview of sustainability risk issues

The primary sustainability risks that the model has analysed have been ranked according to their total level of net risk, as researched over the last 10 years of loss experiences.

Sustainability risk issues	Gross (inherent) risk	Reduction management factor – RMF	Net (residual) risk to value	Risk ranking
Environmental incident risk	1.8%	1.5	1.3%	1st
Health and safety – historic liabilities	1.9%	1.5	1.2%	2nd
Safety external from workplace (public)	1.6%	1.6	1.0%	3rd
Health internal (workforce)	1.5%	2.1	0.7%	4th
Environment – historical liabilities	1.1%	1.4	0.8%	5th
Human rights/resources (internal)	1.2%	1.8	0.7%	6th
Business practices	0.7%	1.4	0.5%	7th
Safety internal (workforce)	1.1%	2.2	0.5%	8th
Air pollution – from transport	0.8%	1.5	0.5%	9th
Emissions to land – waste generation	0.8%	1.7	0.5%	10th

(Continued)

Sustainability risk issues	Gross (inherent) risk	Reduction management factor – RMF	Net (residual) risk to value	Risk ranking
Marketing practices	0.6%	1.4	0.4%	11th
Use of corporate power	0.6%	1.3	0.4%	12th
Resource use – raw materials	0.6%	1.4	0.4%	13th
Resource use – land and natural resources	0.7%	1.7	0.4%	14th
Resource use – energy	0.6%	1.6	0.4%	15th
New technology use	0.5%	1.3	0.4%	16th
Health external (public)	0.6%	1.7	0.4%	17th
Air pollution – from production	0.7%	2.0	0.4%	18th
Community investment/involvement	0.6%	1.4	0.3%	19th
Bribery and corruption	0.5%	1.6	0.3%	20th
Air pollution – peripheral pollution (noise, light, etc.)	0.5%	1.5	0.3%	21st
Human rights (external)	0.4%	1.4	0.3%	22nd
Resource use – waste water pollution	0.4%	1.5	0.2%	23rd
Resource use – water use	0.3%	1.5	0.2%	24th
<b>Total risks quantified to date</b>	<b>20.1%</b>	<b>1.6</b>	<b>12.5%</b>	

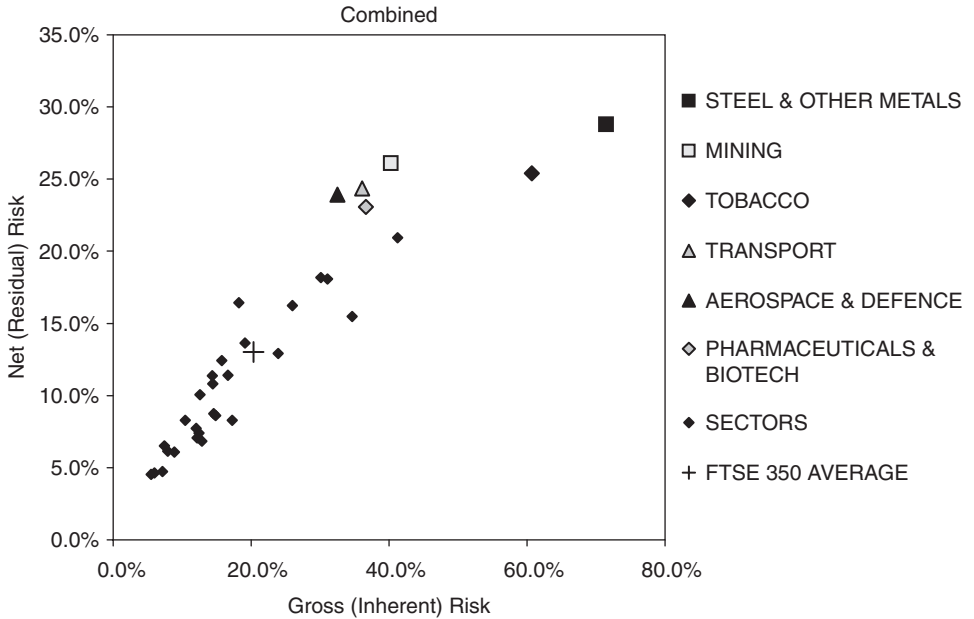
## Overview of sector risk

The sector risks are displayed according to their total level of net risk from a range of business risk issues that are explored in this book. The six sectors with the most risk exposure from non-financial related to environmental, health and safety, product liability and social issues are displayed.

The sectors with the highest net risk (left-hand scale) are displayed, this takes into consideration an organisation's risk management activities (resources, staff, systems and board-level support), which help reduce their gross risk profiles (right-hand scale). For example, although the Tobacco sector has a very high gross high-risk level of 60%, they are putting resources into their risk management efforts, thus reducing their risk to a potential 25% of organisational value. Some sectors, like Oil production do not make the top six as they devote vast amounts of resources to managing their risks, which are still substantial, but so is their value so these are proportional results.

Examples of the issues hitting some of the higher risk sectors include:

- Construction companies have suffered from their worker health and safety record with the government stating that those with poor performance will be excluded from contracts;
- Clothing companies have painful experience of how allegations over sweat-shop labour can become reputational disasters, diminishing the value of brands and making offerings appear overvalued;
- Fast-food and confectionery companies are about to learn the lessons of the Tobacco sector;



- Pharmaceutical companies suffered similar damaging coverage over access to AIDS drugs in South Africa. Along with newer risks like Bayer facing shareholder suits seeking compensation for the damage that the Baycol fall-out did to its stock price;
- There is also an increase in liability through indirect association, as it possible for companies involved with the Baycol lawsuit to be potentially liable for 5% of all damages; and
- Tobacco companies suffered grave reputational and financial damage from society's changing perception of the risks of smoking.

The risk issues of some sectors are more obvious than others, the product liability issue of the Tobacco sector and the environmental impact of the Mining sector are well known as high-risk sectors with regards to these sorts of issues. There are surprises like: the Steel and other metals sector that is exposed to energy costs and safety risks; & the Aerospace & Defence sector, which has a high gross risk level and sustainability risk management that is not as developed as other elements of their business.

The highest risk sectors have been ranked.

Sectors	Risk level	Ranking
Industrial Metals	High	1
Mining	High	2
Tobacco	High	3
Industrial Transportation	High	4

(Continued)

Sectors	Risk level	Ranking
Aerospace & Defence	High	5
Pharmaceuticals & Biotechnology	High	6
Oil & Gas Producers	High	7
Banks	High	8
Oil Equip', Services & Distribution	High	9
Food Producers	High	10
Beverages	High	11
Forestry & Paper	High	12
Chemicals	High	13
Mobile Telecommunications	High	14
Gas, Water & Multi-utilities	High	15

A key issue for management therefore is how to identify the most significant threats to corporate value, internally, externally and sector related and how those threats can be managed most effectively. There are practical explanations of how this can be achieved within this book.

## Definitions of risk

### Risk

In this section we explore some concepts and definitions to set the scene for the sustainable enterprise risk management framework. Mainly we are reviewing non-financial risk issues and how they can impact upon your organisation's sustainability. This approach examines how economic, social, governance and environmental issues can: help or hinder the continued existence of your organisation; improve competitiveness; and increase economic, social and environmental performance thus assisting your sustainability.

There is no single accepted definition of risk; we explore some descriptions of risk in terms of both positive and negative aspects:

- 'Risk can be defined as the combination of the probability of an event and its consequences. In all types of undertaking, there is the potential for events and consequences that constitute opportunities for benefit (upside) or threats to success (downside)' ('A risk management standard', IRM/AIRMIC/ALARM, 2002 [www.airmic.com/AIRMIC\\_RiskManagementStandard.pdf](http://www.airmic.com/AIRMIC_RiskManagementStandard.pdf));
- '... "Risk" is defined as something happening that may have an impact on the achievement of objectives ... It includes risk as an opportunity as well as a threat' ('Supporting innovation: managing risk in government departments', National Audit Office, 2000);
- 'Risk' can be used to describe the uncertainty surrounding events and their outcomes, which may have a significant effect, either enhancing or inhibiting:
  - operational performance;
  - achievement of aims and objectives; or
  - meeting expectations of stakeholders

(*Charities and Risk Management*, Charity Commission for England and Wales).

- ‘Any problem or disruption that triggers negative stakeholder reactions and results in potentially damaging public scrutiny.’ This will be explored in more depth in Chapter 9 (Institute of Crisis Management, *Annual Report 2002*, May 2003 from [www.crisisexperts.com/](http://www.crisisexperts.com/)); and
- ‘Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events’ (‘The next frontier’, ISDA, 1999).

Notwithstanding the views of commentators such as those quoted above, in this book the term ‘risk’ will be viewed by SERM to mean:

anything which prevents an organisation from achieving its business objectives.

In part, this merely follows the natural usage of the word ‘risk’ as an essentially negative concept – for example, one would not generally describe the possibility of obtaining a higher than expected return from an investment as a risk.

However, it is clear that a risk could relate as much to the failure to achieve a positive benefit as to the incidence of liability or loss. Furthermore, an organisation’s ability to tolerate or manage risk may constitute a competitive advantage in itself.

The inter-relationship of risk with uncertainty in positive outcomes may become blurred. Increasingly, even good surprises may be regarded unfavourably by stakeholders. The last thing an investor would want to see after having recently reduced a shareholding in any given company would be a sudden and unexpected upturn in share price, or analysts who placed moderate profit estimates being made to look inaccurate by outperformance. This kind of risk issue is probably best described as a stakeholder risk, with current and potential market investors constituting one of the important categories of stakeholders of a publicly listed company (see Chapter 9).

The view of risk as essentially negative does not deny the importance of the management of uncertain positive outcomes, we merely recognise that risk analysis, while an important tool for management, is not a panacea for managing an organisation as a whole.

## Direct cost risk

Direct costs are primarily those that financially impact upon the organisation, they include: fees, fines, remediation costs, lost materials and production ‘down’ time, or the loss of contracts.

## Intangible and indirect risks

One of the difficulties in establishing an effective framework for evaluating and managing risks is the treatment of intangible or indirect risks. Intangible value



is often regarded as difficult to measure and break down into its constituent parts. Nevertheless, it is estimated that intangible assets and goodwill constitute 71% of the total market value of FTSE100 companies (Interbrand and Citibank research from 1998). Any framework that does not effectively address risk issues affecting that value is therefore unlikely to deliver reliable business information.

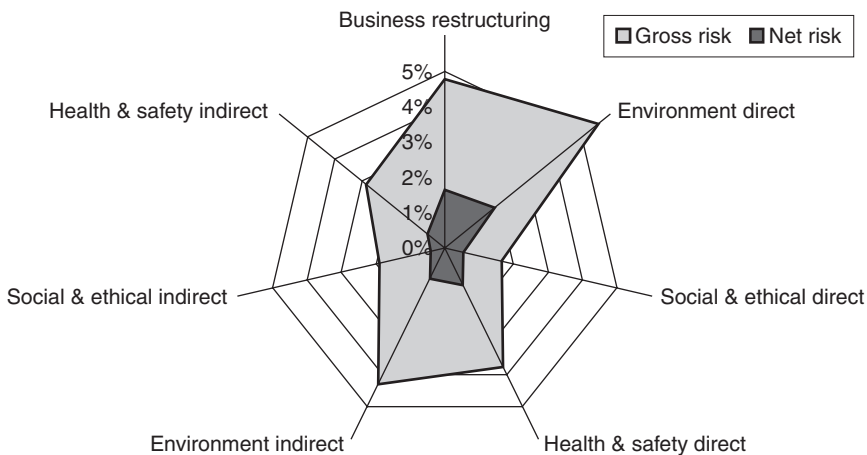
The intangible factors, which should be considered in the context of a risk framework, include the following:

- Corporate reputation: i.e. the perception of the company's strength, corporate governance, credibility, reliability and trustworthiness;
- Individual brand values: reflecting customer perception of the branding associated with particular products or services; and
- Stakeholder value: being a function of the company's relationship with stakeholders such as investors, employees, government and the media. An element of how and where a risk arises is from which group of stakeholders it originates. We have developed a stakeholder template to review their impacts which is covered in more detail in Chapter 9. It is a useful aide memoir for your organisation with which to view the variety of stakeholders comprehensively.

Indirect (intangible) costs are the losses sustained from things such as:

- Reputation damage;
- The loss of business opportunities; and
- Reduced sales and brand damage.

The diagram below shows a sample risk profile for a company, demonstrating the gross and net direct and indirect risk. By presenting it in a common radar format, it provides the company and its stakeholders with a visible corporate risk/liability 'health check'.



It also identifies risk ‘hot spots’ and management underperformance. The outer ring is the gross risk the company faces and the management of risk issues reduces this to the inner ring.

## Sustainability risk

In the last decade, a set of inter-related social and cultural, environmental and economic factors have been forged into the sustainable development framework. The increase in ecological stresses has been accompanied by an increase in the severity of breakdowns in our life support systems and this will have an impact upon our ability to produce economic development and ‘wealth’ from the limited resources this planet has to offer. These pressures will impact upon the level of social development we can achieve as local environments are damaged. Without economic income there is not the capital revenue to support the development of social capital and the preservation of ecological capital.

## Risk management

Generally, risk management is the process of identifying, measuring and assessing risks and developing strategies to manage them. Strategies include: transferring the risk to another party; avoiding the risk; reducing the negative effect of the risk; and accepting some or all of the consequences of a particular risk.

Overcontrol of risk can be as damaging to business interests as the lack of controls. The objective of risk management is not necessarily the elimination or reduction of risks, but how they are actively managed in a business context. This could mean that particular risks are being overcontrolled, and unnecessary costs incurred. Robert Winter’s dictum that ‘undue aversion to risk can be the riskiest behaviour of all’ can ring very true (*Risk Management Reports*, volume 21, number 2, February 1994).

## Potential risk treatments

Once risks have been identified and assessed, all techniques to manage the risk fall into one or more of four major categories (Dorfman 1997). Some ways of managing risk fall into multiple categories:

- Risk transfer means causing another party to accept the risk, typically by contract or by hedging;
- Risk avoidance includes not performing an activity that could carry risk. An example would be not buying a property or business in order not to take on the liability that comes with it;
- Risk reduction (mitigation) involves methods that reduce the severity of the loss. Examples include sprinklers designed to put out a fire to reduce the risk of loss by fire, even though water damage can be severe; and

- Risk acceptance (retention) involves accepting the loss when it occurs. True self insurance falls in this category. Risk retention is a viable strategy for small risks where the cost of insuring against the risk would be greater over time than the total losses sustained.

Traditional risk management focuses on risks stemming from physical or legal causes (e.g. natural disasters or fires, accidents, death and lawsuits). Financial risk management, on the other hand, focuses on risks that can be managed using traded financial instruments. In this book very significantly we also look at how to measure intangible risk, a new type of risk – a risk that has a high probability of occurring but is ignored by the organisation due to a lack of identification.

#### *Useful web links*

Within the book there are extensive sections dedicated to abbreviations, glossaries and definitions (like appendix B). The following web sites will also assist your research into the terminology used within the book.

Electronic glossaries:

- \* <http://investopedia.com/>
- \* <http://www.investorwords.com/>
- \* <http://www.nytimes.com/library/financial/glossary/bfglosa.html>

A useful business search engines can be found at the following site:  
<http://www.allsearchengines.com/business.html>



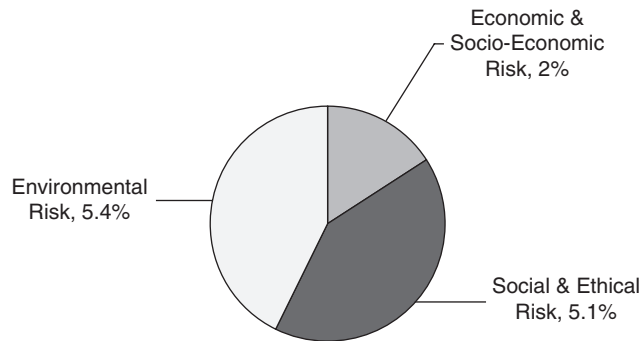
# PART A

## Overview of Risk Management

The chapters in this part cover introductory risk management themes:

- What is a Sustainable Enterprise Risk Management system? (Chapter 2);
- Trends and drivers in risk management (Chapter 3);
- Background to key aspects of legal risk management (Chapter 4);
- The relevance of due diligence (Chapter 5); and
- How risk management themes affect your organisational culture (Chapter 6).

The net risks to market value from all the issues discussed in the book are outlined in the pie chart below:





2

A Sustainable Enterprise Risk  
Management (SERM) system

# 2

## A Sustainable Enterprise Risk Management (SERM) system

### CHAPTER OVERVIEW

The overall objective of the SERM system is twofold: to help organisations avert risks stemming from corporate social responsibilities issues; and seize opportunities from becoming more sustainable. This can be achieved with limited additional financial and staffing resources if existing systems are expanded to cover sustainability risk management and the aligning of risks and rewards to your business objectives.

### Introduction to a SERM system

We will explore the business case for sustainability and the benefits from ensuring that a Sustainable Enterprise Risk Management (SERM) system leads you towards becoming a sustainable organisation. There are benefits to be derived from proactively seeking opportunities for new markets in a world of increasingly constrained resource supplies and increasing demands. The approach seeks to minimise the risks, the negative aspects of not yet being sustainable. In so doing it should be understood that an enlightened view of the risk environment can:

- Reduce overheads and material costs;
- Increase compliance;
- Reduce fines and penalties; and
- Improve competitiveness and marketing opportunities.

Outstanding economic, environmental, social health and safety and governmental performance can have practical benefits for the organisation. Actions to mitigate risk can include the taking of opportunities as they present themselves. Companies like BT, General Electric and Wal-Mart are changing their competitive game by taking sustainability risk factors and turning these into benefits for their competitive strategy.

There is some debate regarding whether the *modus operandi* of business is anything other than business. To support the view that sustainability issues are

crucial to business operations, a survey conducted by the Center for Corporate Citizenship & Sustainability (<http://www.bcccc.net/index.cfm>) of 198 medium to large multinational companies found that:

- A total of 90% of participating companies say their company's approach to corporate citizenship and sustainability issues reflects at least some belief in the potential rewards;
- Two-thirds of survey participants say that corporate citizenship and sustainability issues are of growing importance for their businesses; and
- A majority of big companies concerned with corporate responsibility issues acknowledge that they lack an active strategy to develop new business opportunities based on those concerns.

An emerging example of the new mode of operations and how values-led brands are helping to create value is a recent quote from Unilever's CEO Patrick Cescau:

For us, social responsibility is about creating social benefits through our brands and through our interactions as a business with society. It's the business of doing business responsibly ... The business case for corporate responsibility can be summarised in four ways: sustainable development, building reputation, growing markets, and fuelling innovation. (Business as an Agent of World Benefit Forum in Cleveland, USA, 24 October 2006)

The SERM framework seeks to highlight that there is a broader definition of business risk which covers a wider range of current and emerging risks that can impact upon an organisation. Quite often these risks affect intangible assets and value as opposed to the more tangible damage we are used to as risk managers. Many of the triggers can originate from outside the organisation, yet still require management. So we offer the following version of what we perceive to be risk as,

anything which prevents an organisation from achieving its business objectives.

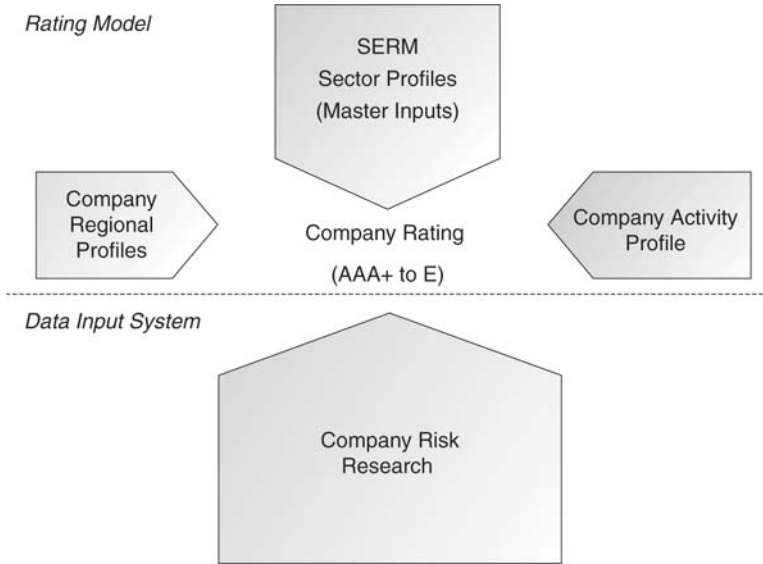
To demonstrate this wider definition of business risk we quantify other loss experiences of companies, many of whom were unprepared and did not view them as risks as they were outside their traditional view of what was business and business risk. In this book we use research supplied by the SERM Rating Agency Ltd who have analysed a wide range of companies' loss episodes, which can be quantified as having had an economic impact, including:

- Non-compliance fines and enforcement notices;
- Reputation and brand damage;
- Work stoppages, labour disputes and strikes; and
- Product recalls and loss of stakeholder confidence.

Through this research it is possible to develop an overview of the organisation and their past losses in relation to their market value and to predict the future probabilities of reoccurrences, or of new risk impacts occurring based upon their sector of activities averages. The quality of management on SERM-related



risk issues is then considered to see to what extent these risks are mitigated and if actions have been taken to prevent the repetition of previous occurrences. These risks quite often impact most upon intangible assets, brand value and reputation, and it can be difficult to insure against losses that arise from them. The new risk environment is more intangible and further away from a traditional tangible asset-based view of the organisation. The process is diagrammatically presented below, with more detailed explanation in Appendices C and D.



The methodology has been tested and refined over 10 years, originally developed in partnership with: the insurance industry, the United Nations Environment Programme (UNEP), the Association of Chartered Certified Accountants (ACCA), the Association of British Insurers (ABI) and the Centre for the Study of Financial Innovation (CSFI), among many others. It can be used to access any size of organisation.

A key element of a SERM system is the concept of ‘sustainability’ or sustainable development as it is also known; sustainable development is one of the guiding philosophies behind our investigating the potential of a Sustainable ERM (SERM) system. The term is generally traced back to the World Commission on Environment and Development (the Brundtland Commission) report which coined the following definition: ‘Sustainable Development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs’.

Sustainable development reporting can help companies to mitigate risk, protect their corporate brands, and gain competitive advantage. (World Business Council for Sustainable Development)

A more current corporate version offered by Lord John Browne, Group Chief Executive of BP in a speech on sustainability, notes:

Our purpose is to supply the goods and services which people want to buy at a cost they can afford. If a business can't meet the needs of its customers it will cease to trade ... The business of business is business and sustainability is about achieving enduring commercial success. (6th Annual Peter M. Wege Lecture, University of Michigan, Flint, USA, 14 November 2006)

The need to find new frameworks like a Sustainable Enterprise Risk Management system has been emphasised by Richard Evans, President and Chief Executive Officer of Alcan Inc.:

Sustainability requires new approaches, innovative solutions and stronger partnerships. All of those, when executed and managed well, build value ... Sustainability is not a challenge. It is a path – I would argue the only path – to a successful future. (The 2006 Banff Forum, in Mont-Tremblant, Canada, 6 October 2006)

The risk management system also sits well with the frameworks within corporate social responsibility (CSR) frameworks (also known as corporate responsibility (CR), corporate accountability (CA) and corporate citizenship (CS)), which follow a sustainable development style framework, as this quote on the definition of CSR demonstrates:

A company's commitment to operating in an economically, socially and environmentally sustainable manner, while recognising the interests of its stakeholders, including investors, customers, employees, business partners, local communities, the environment and society at large. (Canadian Business for Social Responsibility)

Ensuring business legitimacy and licence to operate are the overreaching aims of the wider business community. To ensure this, there are concepts of: non-financial performance measurement; corporate social responsibility (CSR) also known as corporate responsibility and corporate accountability; sustainability; and business durability. Some prominent business organisations are also promoting these concepts. The Confederation of British Industry (CBI) has proclaimed:

It is a prime responsibility of managements to ensure that companies are good corporate citizens, caring not just for those with a direct stake in business – shareholders, employees, customers, suppliers – but for the general public and the environment, in the broadest sense of the term. Social responsibility encompasses many different aspects of business life. It means putting customers first, and providing them with good, safe and reliable products and services. It means being a first class employer, providing fair pay, good conditions and decent pensions for employees. It involves genuine concern for health and safety, and a commitment to good employee involvement and communications. (Quoted in *A Practical Approach to Corporate Governance*, Dr Saleem Sheikh, Lexis Nexis Tolley, 2003, p. 297)

The linking of risk management to business strategies plays a vital role in developing an appropriate performance-focused approach to risk management at board and executive management level. This has been outlined in the ICC

Business Charter for Sustainable Development: <http://www.icc.se/policy/miljo/charter/charter2.htm>

### *Sustainable risk management*

Sustainability without a real business case is mere philanthropy; without measurement, mere whimsy; without meaningful reporting to shareholders, mere public relations. Today's best-run companies – and smartest investors – are seeing sustainability for what it truly is: a strategic business driver that will separate the winners from the losers in the next decade. Companies seeking to establish strong, successful sustainability programmes will need the active participation of their CFOs.

(A. Savitz, author of *The Triple Bottom Line – How Today's Best-Run Companies are Achieving Economic, Social and Environmental Success and How You Can Too*)

## A Sustainable ERM strategy

A Sustainable ERM system includes the more traditional elements of risk embedded within your organisation: financial, operational, infrastructure and IT risks, as well as regulatory and compliance issues but within the structure of the three pillars of sustainable development.

Yet it has a wider inclusion of external risk factors, and more emphasis on reviewing the risks that pose a threat to intangible assets such as reputation. In the risk reward analyses and strategic risks analysis there is a wider scope and time length than more 'traditional' systems.

These newer elements may still impact either directly or indirectly upon your business activities and we seek to demonstrate the risk levels by the use of a non-financial risk rating system, the SERM risk rating system, as a template of average loss experiences. The SERM model will offer quantitative measure of impacts upon companies with relevance to their bottom line, or rather, their market value.

While most organisations have a core of risk management capability to conform to legal requirements, it is beneficial for performance to invest in risk management processes if they are in line with business objectives and strategy. Generally speaking, a SERM strategy should contain the following key areas.

## Planning and people

- A review of the *regulatory and risk environment*, including extensive coverage of stakeholder influences and risks as well as the probabilities of external risk occurring. The risk environment means the risks evident in the environment in which the organisation operates. When preparing the business objectives and strategy of an organisation it is important that this risk environment,

after it has been agreed and communicated across the organisation, is taken into consideration;

- A *valuation* of the risks – which outlines the risks to the organisation and the benefits of managing the risk environment in line with business objectives. Herein lies the difficulties of allocating resources, the opportunity cost of the resources spent on risk management being better spent on more profitable activities. Again, ideal risk management minimises spending while maximising the reduction of the negative effects of risks;
- An analysis of the *risk appetite* of the organisation and its willingness to accept risk. Risk appetite relates to the amount an organisation is willing to ‘bet’ in pursuit of its objectives. Defining the amount and type of risk that is acceptable allows an organisation to design a strategy that is appropriate to it. A company which has a low appetite for risk but follows a high risk strategy can expect a hazardous time. In practice, the risk appetite will be different for different parts of the organisation. Thus different operations or individual business units will have different appetites with a central function taking a portfolio view and monitoring the risk/return ratio. For example, a pharmaceuticals company will have a low risk appetite when addressing its quality assurance activity, understanding that this activity has to be well controlled, but may have a different risk appetite for risk in its research and development area;
- Formulation of a *risk strategy*. It is clear that a well-defined risk appetite, and risk environment, will influence the setting of the overall business strategy. All strategy documents that go to the board for approval should include a commentary on the key risks associated with the organisation’s objectives and strategy and their acceptability in line with the agreed risk appetite, based on the organisation’s understanding of the risk environment;
- A properly designed and formalised *business strategy* should describe how an organisation will prioritise, focus and allocate its resources to exploit identified opportunities. To help an organisation achieve its business strategy a number of supporting strategies, such as HR and IT, will be developed for the allocation of resources and investment. The allocation of risk management resources and investment is no different in this respect; and
- A *risk management statement* based on organisational objectives and business strategy.

## People

- An analysis of the *organisational risk culture* of the organisation. Failing to communicate organisational risks and risk appetite across the organisation can lead to inconsistent decisions and a diminishment in the board’s ability to challenge management’s recommendations. Neither outcome is particularly healthy to the fortunes of an organisation, whether viewed from a conformance or performance perspective; and
- A review of the *ownership of responsibilities* for the risk management strategy at all levels, the people and teams involved and the training required to equip these staff with the relevant capabilities.

## Processes

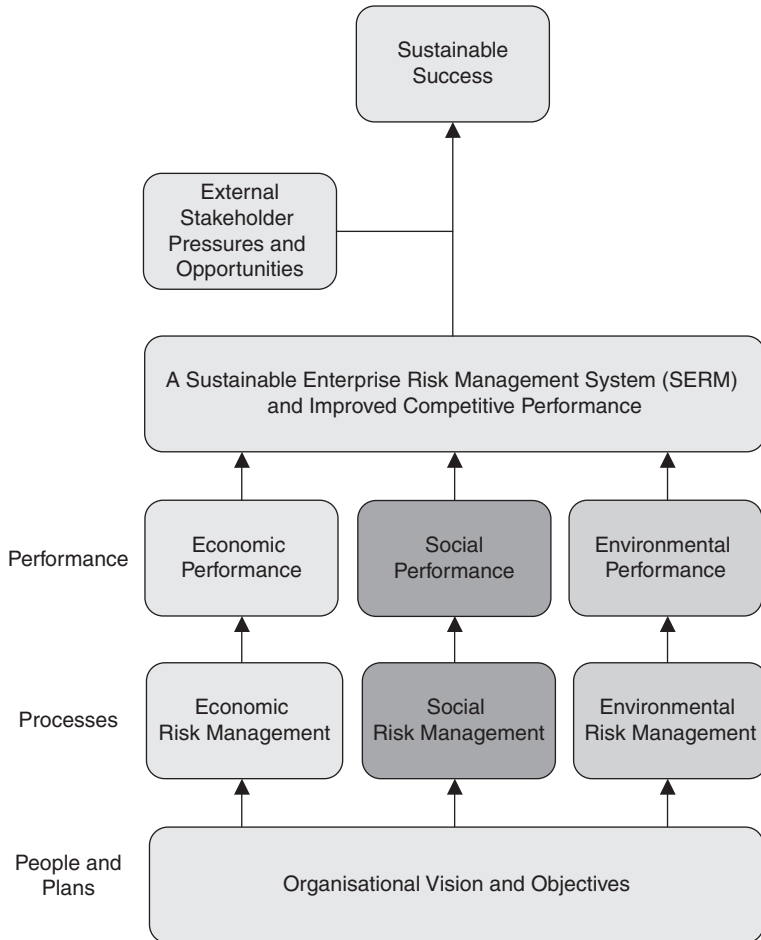
- A *risk identification* process seeking out the potential source of problems, or with the problem itself, based on a source analysis (risk sources may be internal or external to the system that is the target of risk management), problem analysis (risks are related to identified threats), or event basis. Common risk identification methods are: common-risk checking (previous or sector occurring risks); objectives-based, scenario-based analysis; taxonomy-based risk identification (a breakdown of possible risk sources);
- A *risk assessment*. Once risks have been identified, they must then be assessed as to the probability of occurrence multiplied by the potential severity of loss; this crudely equals the risk level. These values can be either simple to measure or near to impossible to know. Therefore it is critical to make the best informed assessment to assist the next stage of the risk management plan, prioritisation. A crucial point is that research has shown that the financial benefits of risk management are more dependent on the frequency of the risk assessment than on any formula used;
- A *risk prioritisation process* should follow, with the greatest loss and the greatest probability of occurrence being handled first, and risks with lower probability of occurrence and lower loss handled later. In practice the balancing between risks with a high probability of occurrence but lower loss versus a risk with high loss but lower probability of occurrence can prove difficult; and
- A *risk management framework or system* employed to deliver the above requirements and develop the organisational risk management culture. While risk environment, risk appetite and the risk management strategy are key elements to organisations achieving their business strategies, these need to be supported by a unifying risk management framework.

## Performance

- A definition of the *performance criteria* employed for reviewing the effectiveness of the Sustainable Enterprise Risk Management framework. An organisation's plan for actively targeting its risk management resources, so as to manage risk both effectively and appropriately to deliver performance, should be reviewed and revised regularly in line with its overall business strategy.

As the diagram below suggests, organisational sustainability is dependent upon sufficiently compliant performance in the economic, social and environmental categories, which are in turn dependent upon the people, plans and processes in place, including your risk management elements. Progress in the three pillars of sustainable organisational development should ensure a strong enough foundation to weather the matrix of future risks and opportunities.

Indeed many Sustainable ERM suggestions are just good management practice and the integration of them into the organisation's objectives is quite often a constitutional requirement of the management, whether related to profit generation or loss minimisation, i.e. they represent legal compliance issues.



## The organisational benefits of a SERM system

The sustainable management of risk can prove beneficial for those adopting a proactive approach; it may be that there are also business opportunities. The potential business benefits include the following:

- Enhanced corporate reputation and brand value is seen as ‘extremely important’ or ‘very important’ by 91% of respondents in the Center for Corporate Citizenship & Sustainability survey of 2006;
- Improved recruitment and retention of talented staff is seen by 78% of survey organisations as ‘very’ or ‘extremely important’;
- Reduced risk is seen as ‘very’ or ‘extremely important’ to 64% of companies. An improved *risk assessment* and management process and the corresponding reduction in liabilities should improve reputation in the marketplace;

- Improved finances from: reduced insurance premiums; access to capital; reduced fines; and fewer enforcement action costs;
- Improved stakeholder relations through:
  - Development of productive *business relationships* with suppliers and contractors;
  - Enhancement of *customer* loyalty;
  - Obtaining a licence to operate in local *communities* – positive community relations, generating local support for operations;
  - Building *employee* trust – increasing morale and productivity, retaining and attracting talented staff and reduction in dispute levels;
  - Positive regulatory and legal relations with host and own *governments*;
  - Positive relationship with local and international *NGOs*; and
  - Positive *media* relations/coverage.
- Development of innovative products, services and systems;
- Enhanced responses to societal concerns, building infrastructure, contributing to long-term sustainability which in turn can lead to larger, stable markets and continued availability of resources; and
- Assistance in *decision-making processes*, for example in the handling of ethical dilemmas.

## The challenges facing the development of a SERM system

According to the findings of the Center for Corporate Citizenship & Sustainability the major challenges facing sustainability programmes are:

- The measurement of results (cited by 75% of the companies surveyed);
- Their implementation while coping with limited financial and staffing resources (58%); and
- The aligning of sustainability with business objectives (57%).

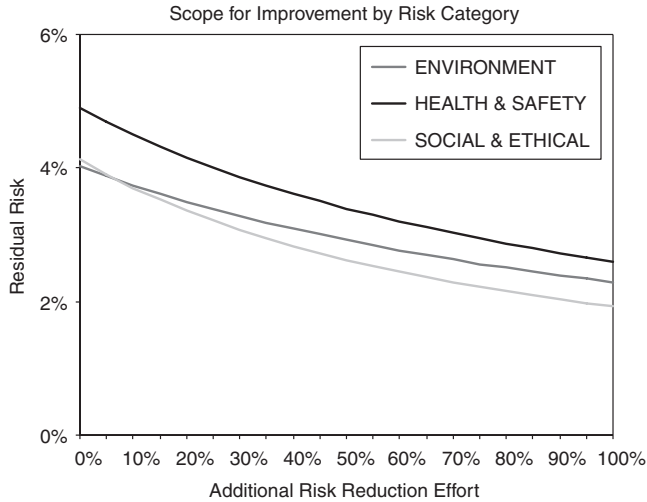
Other challenges are the:

- Difficulties in implementing ‘sustainability’ and CSR programmes;
- The difficulties of integrating internal management systems and procedures with sustainability/CSR programmes;
- Lack of staff training and executive awareness of the risks and rewards from sustainability issues. This is described by David J. Vidal, the Research Director of the Global Corporate Citizenship programmes of the Conference Board, as:

a glass more than half full of market awareness and nearly half empty of product response demonstrates that there is work to be done in bringing corporate citizenship, sustainability, or ‘CSR’ programs to the forefront of top executives’ minds.

- Balancing the risks and rewards; and
- The trade-off between different areas of risk reduction prioritisation.

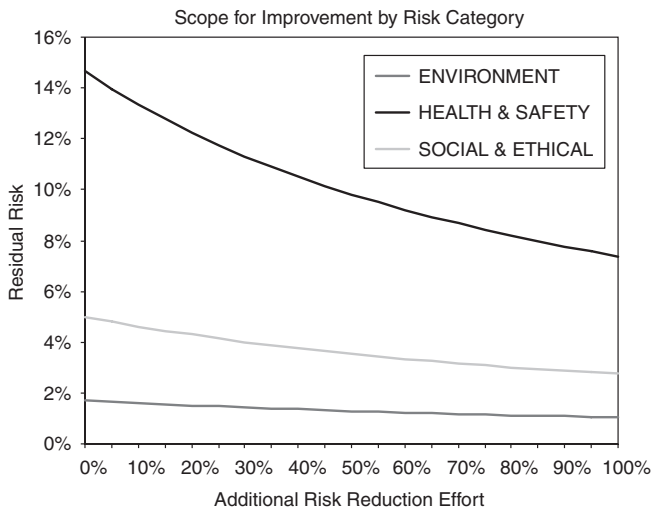
To demonstrate the last point, the two graphs below are from sectors which have very different risk profiles. They both display where the greatest potential for improvements as compared to the additional effort and resources applied to reducing the risk.



The first graph is for a company in the construction sector and indicates that there are proportionally more risk reduction gains from addressing health and safety risks, than by addressing environmental ones. A well-managed organisation would seek to reduce the risk of both simultaneously, but the priority and most reward is in addressing health and safety risks.

The diagram further indicates that the organisation can benefit from all risk reduction efforts as their investment and return curves are elastic.

The same could not be said for the next sector graph where there are large benefits to be gained from addressing health and safety issues (in this case mostly from reducing product liabilities of a particularly harmful product), but little additional risk reduction can be gained by additional efforts to reduce environmental issues.





This graph demonstrates that there are limits to the amount of risk that can be removed from the systems, and when the risk issues curves become inelastic the organisation could be argued to be at a sustainable level of risk.

*Key web links and further reading*

The following sites have been voted as the best four for information on sustainable development by practitioners in a GlobeScan research report:

- \* WBCSD – <http://www.wbcsd.org/> The World Business Council for Sustainable Development (WBCSD) brings together some 180 international companies in a shared commitment to sustainable development through economic growth, ecological balance and social progress.
- \* IISD – <http://www.iisd.org/> The International Institute for Sustainable Development contributes to sustainable development by advancing policy recommendations on international trade and investment, economic policy, climate change, measurement and assessment, and natural resources management.
- \* UN websites – <http://www.un.org/> for multilingual access or <http://www.un.org/esa/> for the main topics page in English. The United Nations Environment Programme (UNEP) Finance Initiative has released a report: *Show Me the Money: Linking Environmental, Social and Governance Issues to Company Value*, which finds that environmental, social and governance (ESG) issues are material and have a financial effect upon shareholder value in both the short- and long-term time frames. UNEP FI report is available from: [www.unepfi.org/fileadmin/documents/show\\_me\\_the\\_money.pdf](http://www.unepfi.org/fileadmin/documents/show_me_the_money.pdf)
- \* WRI – <http://www.wri.org/> The World Resources Institute is an environmental think tank that goes beyond research to create practical ways to protect the Earth and improve people's lives.



# 3

Drivers and trends in sustainability risk management

# 3

## Drivers and trends in sustainability risk management

### CHAPTER OVERVIEW

This chapter reviews some of the contemporary drivers of changes in the risk environment, utilising three tools for analysing which drivers and trends will have an effect upon your organisation:

- \* Tool 1: The Value Drivers of the organisation;
- \* Tool 2: An Environmental Scan, in a sustainable development format; and
- \* Tool 3: A Stakeholder Analysis of drivers.

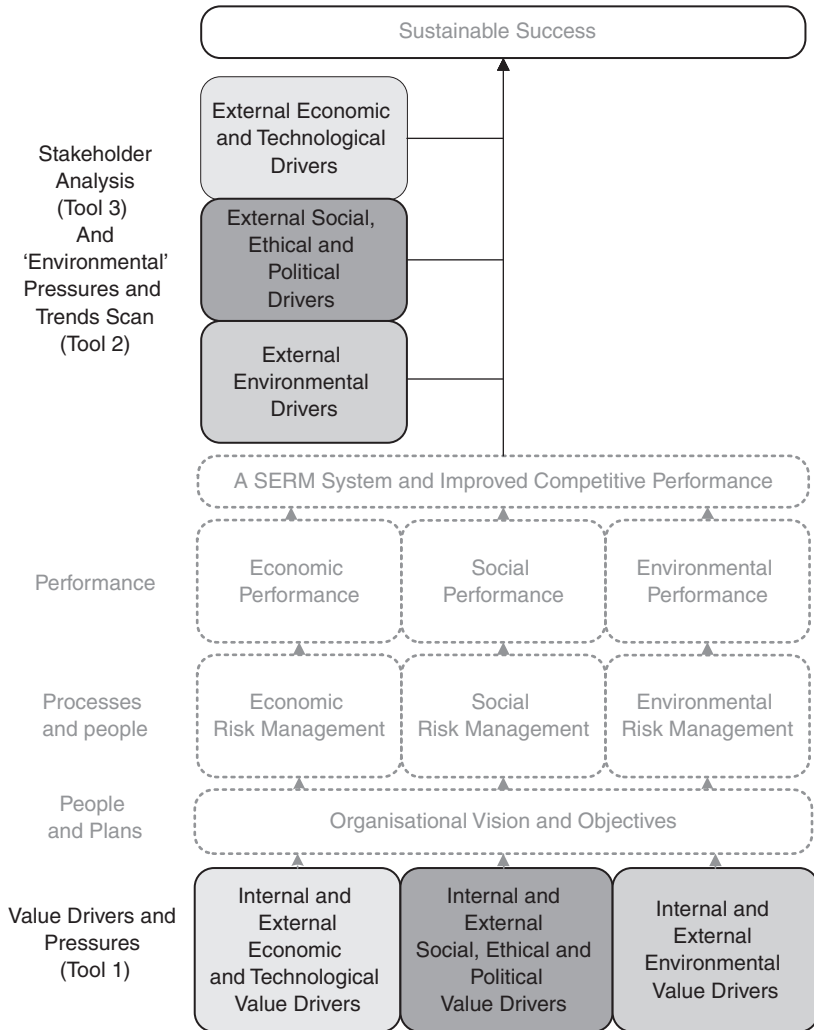
### Opening remarks

This chapter considers in great detail the 'Internal' and 'external' trends and drivers of sustainable risk management. The following assessment tools are reviewed in the following sections:

- Tool 1: The *Value Drivers* of the organisation: costs, revenue, taxes and investment;
- Tool 2: An *Environmental Scan*, the 'external' risk environment trends are reviewed through a sustainable development template of economic, social and environmental considerations; and
- Tool 3: A *Stakeholder Analysis* of the drivers and trends in managing risk.

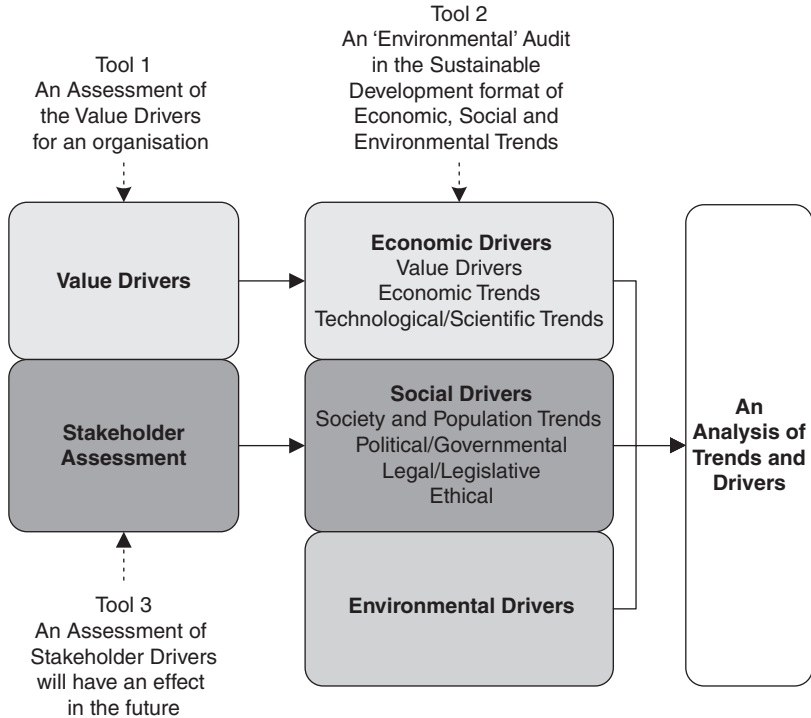
In brief the current trends are:

- Risks and the pressures to address them are both increasing;
- Reputation and intangible assets are increasingly more important than fixed assets;
- Stakeholder pressure is growing, with more investor, consumer and NGO pressure upon organisations to change and face the challenges of the future more effectively. The customer used to be 'king', now they are concerned rulers. There are increases in legislation, standards and fines associated with non-compliance with these types of sustainability issues; and



- There is an increased measurement of benefits, reporting of the results and verification of these reports.

The SERM rating system estimates that just over half of all the 'sustainable' risk to organisations' value is due to indirect risks and pressures for change emanating from the wider 'external' environment. The resultant figures are that companies have an average sustainability risk of 12.5% of value environmental issues, representing a 5.4% risk to market value; followed by social and ethical issues at 5.1% (including health and safety issues) and economic 'sustainability' factors at 2.0%.



## How to use the tools?

The tools for trends analysis can be used to cross-reference each other for level of effect upon your organisation. The key stakeholders from tool 3 can be viewed for significance against the main trends and drivers from tools 1 and 2.

### 1. Value and Internal Drivers (tool 1)

This section reviews some of the trends and drivers of value creation within organisations in the context of sustainability and risk management. Sustainability issues can be economically relevant to all the main management decisions companies undertake, from strategies to investment decisions. These decisions can have effects upon the economic levers which in turn influence the competitiveness and value drivers of an organisation (Schaltegger and Wagner, 2006).

Sustainability management and risk management have an effect on operations and productions and are therefore related to revenue and profits.

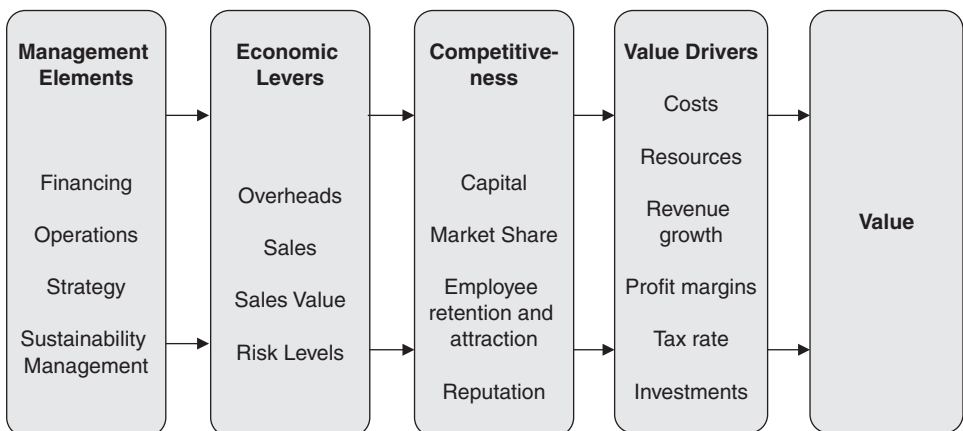
**Costs:** costs are increasing as demand for resources spirals and resources' base prices increase if supply cannot expand sufficiently to meet demand and this is having an inflationary effect upon entire supply chains. Costs are being decreased by not investing in fixed assets where possible, although estimates are for continued increases in costs.

The enhanced communication that is often part of corporate accountability efforts can help build trust between companies and stakeholders, which can

✓ indicates key significance

		Environmental scanning categories (tool 2)							
		Economic drivers			Social drivers			Environment drivers	
		Value Drivers (Tool 1)	Economic trends	Technological and scientific	Society and demographics	Political and governmental	Legal	Ethical	Environmental trends
Stakeholder analysis (tool 3)	Academic and research organisations			✓			✓		✓
	Business partners, suppliers and trade bodies	✓	✓	✓				✓	
	Customers and representatives	✓			✓	✓		✓	✓
	Direct actions groups and NGOs				✓			✓	✓
	Employees and representatives	✓						✓	
	Financial institutions	✓	✓				✓		
	Governmental organisations		✓	✓		✓	✓		
	Local and regional government				✓	✓			✓
	International government					✓	✓		
	Journalists and media				✓			✓	
	Key competitors	✓	✓	✓					
	Local communities				✓			✓	✓

Value drivers



reduce costly conflict and improve decision making. For example, companies that proactively and effectively engage shareholders and address their concerns can reduce the costs associated with shareholder proposals. Also, according to Ann Svendsen, author of *The Stakeholder Strategy* (Berrett-Koehler Publishers, 1998), ‘When firms and their suppliers trust each other, the costs of monitoring and managing contracts are lower. Companies experience less conflict with their suppliers, resulting in fewer lawsuits, and there is a heightened capacity for innovation.’

Some trends are:

- There have been near doublings of costs relating to many naturally occurring primary resources within the last year or two, like: coal, oil, gas, copper and other metals;
- This has had a direct impact upon secondary resources that require large natural inputs to their processes: paper pulp and construction and building materials have all increased in price;
- Natural hazard incidence and insurance premiums for liabilities cover with regard to sustainability issues are increasing as claims increase, i.e. flood risk cover is becoming expensive or has been removed entirely in large parts of the developed world, even years before hurricane Katrina; and
- Due to the dropping price of green building materials and other supplies, many businesses find that renovations to increase sustainability pay for themselves in only a few years.

**Resource availability:** the other side of the market equation is that supply cannot always be increased. The scarcity of resources is having an effect upon revenue as the natural world’s capacity for production is exceeded by consumption. Current estimates are that we would need two and a half planet Earths to meet current demand for materials in a sustainable manner. Some industries like fishing will require over three planets to meet current demand in a sustainable way. This leads eventually to crisis points in the supply chain, i.e. frozen food producers are finding fish increasingly scarcer unless farmed.

Some trends are:

- Economic, social and environmental accounting and measurements will converge more;
- Business process changes. The following trends will continue to occur:
  - Dematerialisation: fewer natural resources require less expenditure;
  - Decarbonisation: the energy required for processes will need to be progressively decarbonised, especially as carbon taxes increase;
  - Eco-efficiency: increases will improve productivity increases as fewer materials will be required to produce each unit of production of service. This is referred to as moving from the value chain to the value loop emphasising the close system nature of resource use;
  - Innovation and eco-design: this also includes industrial metabolism and increased efficiency from chemical reactions and materials flows in systems as most leaks of materials are as a result of poor design or from accidents;
  - Miniaturisation: fewer resources will be required to make the same item;
  - Simplification: fewer items, parts and materials will be required;

- Substitution: switching to cheaper or more sustainable materials will bring stability to processes over the long term. Where rare natural material dependency occurs this has caused large delays in meeting financial targets, like game systems missing their launch dates due to shortages of rare metals; and
- Waste reduction: if you are purchasing resources and then not using them all, this is in effect throwing away money. In the Japanese business philosophy of Kaizen (Japanese for ‘change for the better’ or ‘improvement’) an important goal is the elimination of wasteful processes which are viewed as ‘activities that add cost but do not add value’.
- Purchasing of fewer fixed assets in the form of premises, etc.; and
- Improved organisational effectiveness through improved self-assessment and evaluation as a result of increasing accountability. For example, social and environmental auditing and reporting can give companies the opportunity to assemble and assess more comprehensive information on operations and impacts. This information can help improve efficiencies and collaborations across departments, facilities and business units.

**Revenue growth:** sales and profits could move towards durable/sustainable sales and profits.

Some trends are:

- Towards building customer loyalty as a compensation against price competition with the rest of the world;
- Reputation has become an influence upon organisational value – either directly from product boycotts, etc., or from damage to corporate reputation from media, NGO campaigns, shareholder activities and changing customer preferences;
- Growth of niche markets in the developed world. The European market for environmental goods and services is now worth €227bn and is increasing rapidly. Increased competitive advantage and sales from ‘green’ and ‘social’ embedding within the marketplace. Mainstream businesses are purchasing these types of niche players rapidly to brand build in emerging markets for these products and services, examples include Unilever’s purchase of Ben & Jerrys, L’Oréal Group’s purchase of the Bodyshop, and Cadbury’s purchase of Green & Black’s organic chocolates;
- Growth of developing world markets. There has been a realisation that although the initial sales volumes seem small in comparison to developed markets, the return on assets and investment can be much more superior in the developing world, and the demand is much more closely linked with actual ‘needs’;
- Cause-related marketing will increase as the successes of those closely linked to business strategies become apparent; and
- Pressure upon and from key suppliers and business partners. An example is that according to Terra Choice Environmental Marketing (who administers the Government of Canada’s EcoLogo environmental certification programme) in their annual EcoMarkets survey there is a surprisingly high desire among corporate procurers to buy green:
  - Approximately 30% of professional purchasers are subject to green purchasing policies and/or programmes;



- More than 90% of professional purchasers consider environmental factors at least ‘some of the time’; and
- More than 60% of purchasing professionals work for companies with sustainability policies.

**Profit margins:** many sustainability products currently receive a premium price and margin as there is first mover and premium product advantages still to be gained. In addition, an increasingly global economy means that companies must find ways of making their products compliant with stricter environmental policies from other regions and this can impact upon costs and therefore margins.

**Taxes and fines:** governments and other bodies are utilising market forces to correct what they see as market imperfections and make organisations more accountable for their external costs.

Some trends are:

- New green taxes, tariffs and regulations like:
  - Carbon emission taxes;
  - Usage billing, i.e. congestion charges for vehicles in urban areas;
  - Waste disposal levies;
  - Water use and clean-up tariffs; and
  - Vehicle and petrol costs and taxes.
- Increased fine levels for transgression of rules like: environmental incidents and clean-up costs; contaminated land reclamation; employment laws; and breaches of health and safety laws; and
- Increased court costs of defending against legal actions, court cases and class actions, including product liability expenses.

**Investment:** the cost of capital can be influenced by non-market factors like reputation. These issues are discussed in the Stakeholder Assessment part of this chapter. The value of organisations is being adjusted as methods for measuring intangible assets, like reputation, increase.

The financial community are adopting more rigorous investment and lending policies, some trends are:

- Banks: are increasingly applying rules to investment lending decisions. An example is the environmental screening that will be required by all project financings with capital costs above US\$10 million by borrowers of the banks that are signatories to the ‘Equator Principles’ ([www.equator-principles.com/](http://www.equator-principles.com/)). This threshold was lowered from US\$50 million in July 2006;
- Insurers: premiums for sustainability issue cover are increasing as is the level of research into future claims of these types. Some of the big reinsurers have estimated that human-induced climate change could cost them up to €10 billion a year by 2010. Insurance products designed specifically for environmental and sustainability risks can help transfer some of the biggest potential losses; and

- Investors: asset managers and stock markets are requiring greater disclosure on sustainability risks so investors can factor these into their own investment decision-making processes.

**Internal drivers:** there are many other internal drivers that have an effect on an organisation's value and sustainability; some examples include the following category headings (with appropriate chapter reference):

- Risk management and general management (all chapters and the section below);
- Finance systems (Chapter 7);
- Licence to operate/reputation (Chapter 9);
- Marketing (Chapter 10);
- Information systems (Chapter 11); and
- Human resources and employee motivation (Chapter 14):
  - Employment law changes are seen as having a financial impact upon organisations and motivation a positive influence; and
  - Health and safety issues are becoming crucial bottom-line concerns (Chapters 16 and 17).

**Risk management:** trends and recommendations.

Some trends are:

- Key risks identified by a range of CSR surveys of companies highlight product impacts and liabilities, supply chain management and ethical business conduct and governance as major risks;
- There is improvement in the integration of these sustainability risks within risk management processes;
- More companies are providing internal training and briefings on specific responsibility issues; and
- There will be an increase in the risks and potential for damage to a company's reputation from the use of subcontractors. The contracting company can come under increasing accusation of outsourcing of risk which could indirectly impact upon reputation.

Recommendations:

- The management of these types of risk issues should become incorporated within the mainstream management of the assets (operations, reputation and markets);
- Organisations should become more transparent about their dealings with these risk issues. They may be conducting much more in the way of risk mitigation work that they are not disclosing to stakeholders. By disseminating this knowledge, stakeholders should take a more appropriate view of the organisation's position in the marketplace and society;
- There needs to be some clarification on where the limits of responsibility are, that is where does the company's corporate responsibility ends and the government's or other stakeholders' begin? An example of this is the level at which customer data can be used for social benefits before there is an infringement of the Data Protection Act; and

- Identification and reduction of potential liabilities: a more accountable company (including social and environmental auditing and reporting and stakeholder dialogue) can identify practices or situations that could pose liabilities to a company. Early identification can provide companies with the opportunity to resolve problems before they result in costly legal actions or negative public exposure.

## 2. Environmental Scan (tool 2)

What is an environmental scan?

The external operating environment is seen as a significant influence on the performance of organisations of any size. We use what is described as tool 2. Key aspects of turbulence include changes in the market, technology, customer demands and competition.

An effective environmental scan:

- Focuses on dominant issues, and involves trying to understand which issues might take an organisation beyond its current ways of doing things;
- Indicates the nature of the world in which the organisation will find itself in the future, what it wants and what it needs to do to get there;
- Gives the organisation a wider and longer-term view of the future, stretching strategic and innovative thinking beyond normal boundaries in order to:
  - View risks by scale, whether they are local, national or international, or global; and
  - View risks by current situation or conditions; probable trends, events or developments; and urgent implications.
- Attempts to identify events, trends and developments, or drivers, shaping the future, across the following category areas (similar to the marketing PESTLE matrix):
  - 2.1 Economic drivers:
    - Value Drivers (tool 1);
    - Economic trends; and
    - Technological and scientific.
  - 2.2 Social drivers:
    - Society and demographics;
    - Political and governmental;
    - Legal; and
    - Ethical.
  - 2.3 Environment drivers:
    - Environmental trends.

### 2.1 Economic drivers

#### 2.1.1 Value Drivers

These were analysed in the previous section of this chapter and tool 1 elements are included within the economic scan of the ‘environmental scan’.

### 2.1.2 Economic trends

An overview of the structural nature of the economic environment from the University of Cambridge Programme for Industry Sustainable Economy Report (available at [www.cpi.cam.ac.uk](http://www.cpi.cam.ac.uk)) finds the followings conclusions:

- It is seen that economic systems and pressures are prejudiced towards the short term at the expense of more sustainable opportunities. There is a growing realism that this short-term perspective and other economic values may be incompatible with drives towards sustainability;
- There seems to be a lack of consensus on the long-term goals and objectives of many economies and economic groupings;
- Inappropriate market incentives, failures and interventions can distort markets and create incentives for unjust and unsustainable trade;
- There are embedded weaknesses in: governments who should be providing good governance and policies; the education system in its role to promote sustainability; and the economic distribution systems as there are wide inequalities of opportunity, wealth, health and well-being;
- Traits such as selfishness and greed are prevalent and encouraged by the current systems of economic behaviour;
- Current pricing mechanisms and metrics for measuring progress reinforce any bias as current measures are misleading, or poor indicators of:
  - Social factors like the quality of life and well-being;
  - Health quality issues rather than just duration;
  - Environmental performance and the full economic value of resources; and
  - Prices fail to capture social and environmental costs; therefore there can be an undervaluing of people and nature.

Some relevant trends include the following.

#### **Economic growth:**

- Growth rates of 5% worldwide will return and be more characteristic of the next two decades. However, there is to be an expected slowdown in the developed world as debt correction occurs.

#### **Internationalisation and the globalisation of commerce:**

- The industrialised countries still account for over two-thirds of manufactured exports although the developing countries' share of this trade will increase, especially from Asia.

**Globalisation of crime, justice, legislation, trade, commerce and terrorism** (these are covered under the 'Social drivers' section below and the 'International government' section of the stakeholder matrix analysis in this section):

- Companies and governments are concerned that the US watchdogs are extending their powers abroad, post-Enron (see also Chapter 22);
- Growing fears of US financial rules that are encroaching further into the city have led UK companies to remove US customers from their books so they do not come into the remit of the SEC Investment Advisers Act of 1940 which

calls for companies providing advice to more than 14 US citizens to register with the SEC and make regular reports;

- Recent interpretations of the US Alien Tort Claims Act have allowed companies to be sued for their actions in foreign countries; and
- The European Union is currently the most regulatory-intensive environment, and EU companies are rapidly realising the benefits of environmentally sustainable policies. This means that competitor nations must find ways of making their products compliant with these stricter environmental policies.

**Technology revolution** (covered in the next section) and Chapter 11:

- The pace of technology development will continue at accelerating rates, and when business investment picks up, so will the deployment of new and transformative technologies, especially in biology, life sciences and energy technology.

**Shift to eco-economics:**

- There will be an increase in the inclusion of environmental assets and liabilities onto the balance sheet and into company processes like product design and life cycle analysis economics.

**Shift to micro-economics:**

- There is a branch of economics that is addressing the real developing world issues. An example is Muhammad Yunus who won the Nobel Peace Prize in 2006 for his work in tackling poverty in Bangladesh by granting tiny loans known as microcredit, via his Grameen bank. Their repayment success has caught the attention of Citigroup and other commercial banks as the loan recovery rate is almost 99%, despite interest rates up to 20%.

**Competitive marketplace trends in sustainability:**

- There is growing competition for sustainability leadership within sectors;
- There is an increase in measuring and reporting on sustainability issues;
- There is more quantification of extra financial risks and enhanced valuing of items like brands as market differentiators;
- There is greater activity with regards to implementing sustainability programmes. The top three activities that are the focus of current citizenship and sustainability attention are community and stakeholder involvement, corporate giving to worthy causes and environmental sustainability/climate change. Climate change continues to attract increased stakeholder attention (see Chapter 20). More companies also recognise that climate change will have a major impact on their future operations and product offering;
- Companies are developing a wide range of management systems to measure, apply, assess and report their efforts to integrate corporate social responsibility (CSR) into all aspects of their operations;
- There has been greater participation in ‘corporate responsibility’ (CR) initiatives, the gaining of standards and reporting by companies. There has been

an eightfold increase in ISO 14001 certifications and over 1000 companies are reporting under the Global Reporting Initiative (GRI);

- The proliferation of sustainability indexes continues: FTSE4Good (July 2001); Dow Jones STOXX Sustainability Indexes – launched by Dow Jones Indexes, STOXX Limited and SAM Group (October 2001); and
- Yet, the majority of companies say they are not active in citizenship and sustainability-related business product developments.

**Marketplace trends – opportunities:** the European market for environmental goods and services is now worth €227bn, equivalent to 2.2% of the EU's GDP. Environment industries represent around 3.4 m jobs in the EU, according to a study for the European Commission DG Environment entitled 'Eco-industry, its size, employment, perspectives and barriers to growth' by consultants Ernst & Young, the report estimates that there will be:

- Growth for existing markets for sustainable products:
  - Wells Fargo's third annual US homeowners' study showed that if given US\$50 000, some 24% of those surveyed 'dream green' and would purchase insulation, double-paned windows, solar panels and energy-efficient appliances for their homes. Doreen Woo Ho, president of Wells Fargo's consumer credit group, said 'we found that Americans are showing signs of becoming more environmentally aware and want to take actions that save money, help preserve the environment, as well as add value to their home', Planetark.com, 31 October 2006.
- New markets:
  - Water quality trading, certified sustainable products, wetland banking and threatened species banking.
- New technologies and products:
  - That will serve as substitutes, reduce degradation, restore ecosystems or increase efficiency of ecosystem service use.
- New businesses:
  - Such as ecosystem restoration and environmental asset finance or brokerage.
- New revenue streams:
  - For fixed and variable assets that are currently unrealised, such as land and forests which may act as carbon credits.
- Increased use of standards and certification:
  - Companies will increasingly use standards for quality (ISO 9000), the environment (ISO 14 000 series), social issues (Investors in People) and health and safety (OHSAS 18 000 series) to distinguish themselves from competitors.

**Marketplace trends – risks and impacts:**

- Market reduction and loss: products are being banned, or their use curtailed as their impacts become apparent. This ranges from chemicals to endangered species of food sources:
  - This trend will continue and examples are the EU REACH chemical plan where some of the 120 000 man-made chemicals we use will be more stringently tested for their toxicity and removed from use if their impacts are

- too large. The European Commission has proposed legislation to ban all European Union exports of mercury from 2011; and
  - Zanzibar and Bangladesh have both made plastic bags illegal, whereas the UK government says it doesn't ban or tax them. Zanzibar and Bangladesh have said they couldn't afford not to, as they are impoverished nations.
- Market manipulations taxation:
  - As set out in the 'Value drivers' section, the internationalisation of taxation and increasing relevance of sustainability-related taxes will continue. Countries are eyeing a raft of green measures to help combat climate change, including higher taxes on cars, air travel, fuel, lighting and consumer electronics.

**Marketing environment:** considering that perception is so important to maintain reputation and brand value, marketing claims can have a huge impact on stakeholders' perception of the organisation. It is also true that many companies carry out positive activities that are not being reported and are not therefore contributing to the intangible value of the organisation:

- There is an increase in award schemes that are highlighting these best practices, such as the Green Awards for sustainability communications ([www.greenawards.co.uk](http://www.greenawards.co.uk)) aimed at rewarding marketing campaigns that best communicate the importance of sustainable development and responsible business practices to consumers (see Chapter 10 for examples and case studies).

### 2.1.3 Technological and scientific

The pace of technology development will continue at accelerating rates, especially in information, nano, biological and energy technologies.

The continued growth and development of information technology has practical effects:

- Cost reductions: there has been a doubling of performance versus price curves for computer chips, memory systems, data networks, and this trend will continue to speed up;
- Digital format: more and more information is digitised, and more information will become available in digital format only;
- Reporting and communications: the internet has provided companies and those seeking greater corporate accountability an unprecedented ability to share and exchange information on a large scale, cost effectively. Some of the most innovative companies are planning to provide 'sustainability' information in a real time format;
- Market and process opportunities: the next decade will see computing and telecommunication increase in capacity five to seven times. This could mean that:
  - Computers will become imbedded in clothing and the built environment;
  - Business transactions will involve virtual personalities as intermediaries; and
  - Translating devices and phones will be common, as will voice recognition systems and automatic language translation.

- Security and surveillance systems will become available on a micro scale posing competitive and information security issues and new dilemmas with regards to the balancing of privacy and access concerns.

The growth of nanotechnology: in simplest terms, nanotechnology means constructing materials at the molecular or atomic level, and in nanoscale size. The possibilities of making computers that fit in your wristwatch or even a button on a shirt, or even one of the fibres of that shirt, Hewlett-Packard Laboratories have predicted:

- Future implications: issues of interest in the nearer term will include embedded and eventually invisible computing. A decade ahead, perhaps less, will witness the development of super surveillance devices. Beginning with ‘robotflies’ and possibly leading to nearly invisible ‘dust motes’ with nanoscale cameras and listening devices, both investigative and privacy issues will be in the forefront.

The growth of biotechnology: developments will involve the applications of genomics, life sciences and bioethics sciences and there is no greater promise of improvements in human well-being, or so fraught with ethical and risk issues. The list of associated issues is long, including stem cell research, DNA evidence, cloning, genetically modified foods, animals, and people, genetic screening and discrimination:

- Future trends: the impacts of these developments could mean things like DNA security identification chips and faster DNA testing methods will make DNA evidence gathering commonplace. Genetic screening for disease risks will become faster, easier and more widespread. Stem cell research will lead to applications of stem cell therapies, including the possible farming of biologically created organs and tissues.

Sustainability technology will see a sharp rise in investments and management energy. An example of potential benefits is:

- The collaborative study conducted by members of the Truck Manufacturers Association (TMA) and the US Department of Energy (DOE) could save nearly one billion gallons of fuel annually as a result of new aerodynamic technologies on truck trailers.

## 2.2 Social drivers

These drivers are largely covered by the stakeholder matrix analysis, in Chapter 9, for example education is in section A (Academic and research organisations trends) and cultural dissent is in section D (Direct actions groups and NGOs).

There are large-scale risks present within the socio-economic aspects of our global society which includes: income differentials and the widening gap between rich and poor; human rights violations; debt and economic slavery; inadequate diets and distribution of food supplies; the prevalence of preventable and curable diseases; global conflicts increasingly fought over resources, and



the rapidly increasing number of refugees from these conflicts as well as from political, environmental and natural disasters.

These are all vast challenges for human society but here we review these types of risk and societal trends in a business context:

- There will be increased moves to understand and account for social capital by organisations and society.

Social capital refers to the institutions, relationships and norms that shape the quality and quantity of society's social interactions. Increasing evidence exists that social cohesion is critical for societies to prosper economically and for development to be sustainable.

Social capital is not just the sum of the institutions which underpin a society – it is the glue that holds them together. (World Bank)

### 2.2.1 Society and demographics

#### Demographics:

- Growing global population: the human population of the earth is increasing at approximately 70 million persons per year;
- There is real population decline in 61 countries, accounting for 44% of the Earth's population; fertility rates are now at or below replacement levels; and
- Aging population: the global economy faces a transition of unprecedented dimensions caused by rising old-age dependency and shrinking working-age populations among the world's largest economic powers.

**Cultural changes:** there will be a wide range of cultural changes, with the potential for a renewed emphasis on traditional values of religion and family, as well as on issues like education, relationships, diversity and an emphasis on women in positions of power, and a reorientation of the environmental movement.

**Polarisation of people by class, race, ethnicity and lifestyle preferences:** less than positive cultural trends will also be seen, including the polarisation of people by race, ethnicity, lifestyle and class.

**Emergence of 'cultural creatives':** this is a trend occurring in the developed world at quite a rapid pace as society releases some of the challenges facing it and the ineffectiveness of some institutions. For instance, research by sociologist Paul Ray and psychologist Sherry Anderson of over 100 000 Americans identifies three primary cultural types: traditionalist, moderns and cultural creatives. The former two groups are in decline and will continue to do so, the latter are growing in size, and they estimate accounts for 50 million people in the US (about 26% of the population), and 80–90 million in the EU. They have the following types of characteristics:

- Environmentally: love nature, aware of the problems of the whole planet, would pay more to clean up the environment and stop global warming;

- Socially: they value relationships; value and volunteer for helping other people; want more equality for women at work and want more women leaders in business and politics; care intensely about psychological or spiritual development; and
- Politically: are unhappy with current politics; want politics and government to emphasise children's well-being; rebuild neighbourhoods and communities; support the creation of an ecologically sustainable future.

**Emergence of corporate awareness:** there are strengthening views of what companies' place in society should be, as the University of South Africa's research (from their Corporate Citizenship in partnership with the Bureau of Market Research [www.unisa.co.za](http://www.unisa.co.za)) finds:

- Three-quarters of consumers questioned in a survey responded that government should play a more proactive role in encouraging greater corporate citizenship;
- Over three-quarters of respondents expected companies to improve the social and environmental impacts of their products and services; and
- Two-thirds expected companies to implement socially responsible practices in their supply chain.

## 2.2.2 Political and governmental

There is the direct impact upon organisations of legislative developments which is covered in the following section and with tool 3 the Stakeholder Analysis Matrix (elements G, H and I), and within each chapter in more detail. Governments (locally, nationally and increasingly internationally) also have strong influences upon organisations by other direct mechanisms, like their purchasing decisions.

Trends are that:

- There has been a general turning away from the notion that government was the best or primary institution for solving large social problems. This trend is expected to continue as welfare reforms continue globally. There will be increased awareness of some of the barriers to this process. In the US in a post-9/11 era there have been decisions to replace private safety inspectors with a federalised public screening agency staff in the view that government management in this area is superior;
- Governments are exerting more covert influence by implementing tendering processes whereby organisations have to reach a minimum standard (like achieving ISO 14001 to be able to tender), or demonstrate that they have responsible processes and risk management systems (like having few or no fatalities at work in order to tender for government building contracts);
- Government also affect the risk agenda indirectly and an increasing trend is the growth in government informal recommendations: Government regulators at all levels are calling on companies to increase the quantity and quality of information they disclose to the public about their practices and performance;

- Corporate governance legislation and more active public prosecutors are having an effect on bringing corruption and bribery matters to the public attention; and
- Becoming green is a vote winner, for example in the US a recent heading read: ‘Environment wins in democratic landslide in 2006’. The story refers to the House Minority Leader, Nancy Pelosi of California, who will move into the Speaker’s seat, becoming the first woman Speaker of the House in US history. Her environmental views match those of conservationists, particularly on climate and energy issues.

Recent examples include:

- The European Commission has recently published an outline of how it envisages corporate social responsibility taking shape within the EU, encouraging all firms to adopt the ‘triple bottom line’ of economic, social and environmental responsibility (ED 19/07/01);
- There are greatly increased calls for more product responsibilities and controls as the European Commission supports moves to tighten vehicle emissions limits further than those foreseen in current proposals after European Union governments and lawmakers called for tougher standards. The Commission proposed ‘Euro 5’ vehicle standards, which would slash emissions of particulates from diesel cars by 80% and nitrogen oxides (NO<sub>x</sub>) by 20%. They would also cut NO<sub>x</sub> and hydrocarbon emissions from gasoline or petrol-powered cars by 25%; and
- The OECD is backing greater corporate responsibility as corporate social responsibility will take on ever greater importance in the coming decades, presenting companies with a set of clear challenges.

### 2.2.3 Legal/Legislative

There are increased legal threats and penalties to individuals and organisations as governments seek to shape markets and govern corporations by market forces and public regulation as well as implementing laws that shape the structure of corporate governance (see also Chapters 21, 22 and 23).

Some examples include:

**Increased litigation:** in the US the number of class-action lawsuits against US companies rose sharply in 2004 according to a report by Stanford Law School and Cornerstone Research, the *Securities Class Action Clearinghouse Report* cited a 17% increase in the number of actions filed for 2004 and that the companies being sued lost \$169 billion in market value. This figure was almost treble the figure for 2003.

**Personal liability of directors:** there are increasing legal grounds for personal liability of directors and managers. The legal duties inherent in office for company directors may expand in the post-Sarbanes-Oxley world. These may involve increased risks for individuals who may be held accountable. Enterprise Act/cartel offences; false accounting; corporate manslaughter; assumption of personal duty of care; and wrongful trading are examples. The new UK Company

Law 2006 has in it, aside from the duty to report on environmental and social matters, a specific duty for company directors to ‘have regard to’ their impacts on the environment, employees, suppliers and communities.

**Growth in government legislation:** particularly in the area of reporting and of the environment, companies are facing new and growing amounts of regulation and legislation aimed at increasing their accountability to society.

Recent activities include:

**Economic and governance rules:**

- There will be increased moves to standardise accountancy standards, the internationalisation of rules and legislation as companies are held accountable outside their home countries, or fall under the remit of legislation in other countries as a result of economic activity with them (US Sarbanes-Oxley and Alien Tort laws);
- Within the UK there has been the Combined Code on Internal Controls (the Turnbull Code); the Pensions Act (1995) Amendments; the Company Law Review; the Companies Act which may make it mandatory for business to report anything concerning the welfare of the employees, community, environment and the company itself; and a newly proposed carbon emissions Kyoto-related bill for 2007;
- New rules on anti-bribery are slowly being drafted as there is a realisation that bribes are not in the interest of the global economy and only add costs of contracts to projects indirectly and covertly. The World Bank has launched a renewed anti-graft (anti-bribery) campaign but admits it lacks resources at present;
- The legal infrastructure has gained a boost as they seek to let cartel members escape prosecution in exchange for information on their agreements with other parties; and
- The Institute for Public Policy Research (IPPR) says the UK should introduce a throw-away culture tax as their report calls for a new tax on items such as throw-away cameras, disposable razors and non-rechargeable batteries following the success of European countries that have imposed similar taxes.

**Employment and social legislation:**

- Employment laws and those covering equal opportunities and diversity have increased in occurrence (Chapter 14), as have health and safety laws (Chapter 16). There are a wide range of external factors that influence the workforce including: codes and standards, legislation and trade union factors.

**Environmental legislation:** there are several hundred new environmental laws newly passed each year globally. This large body of legal statutes is likely to continue growing. Examples of emerging new laws are that:

- Under newly adopted EU laws, some manufacturers are required to accept returned product packaging, and certain products such as computers, at the end of their shelf life. Risk experts say such regulations will force companies to use materials that recycle more easily or contain fewer toxic ingredients.

EU countries will be more aggressive in adopting and enforcing pollution laws;

- The European Commission supports moves to tighten vehicle emissions limits further than those foreseen in current proposals; and
- Many US states are going ahead with their own legislation as a local response to climate change and other air quality issues, in the face of what they view as limited national action. For example, state officials in Wisconsin are developing new rules to limit emissions from coal-burning power plants and other sources of ozone, particle pollution, visibility-reducing haze, and mercury. The new limits are estimated to cost industries in excess of US\$1 billion. One of those measures, the Clean Air Interstate Rule (CAIR), places additional pollution control requirements on utilities and certain factories to cut emissions linked to a variety of health problems like respiratory illnesses.

### 2.2.4 Ethical trends

The following are ethical issues (viewed as the difference between right and wrong conduct) of increasing importance and focus:

- Those covered in other chapters, but which have an ethical dimension, for example it is wrong to eradicate species, pollute the planet, use inappropriate marketing, etc., these are most specifically reviewed in Chapters 7, 10, 12, 14 and 15;
- There may be moves to reinforce values, regenerating community, and protecting, guiding and supporting children, the mentally ill, the disabled and other parties;
- UN General Assembly may consider adopting the Declaration on the Rights of Indigenous Peoples, and companies like Alcan are already advancing corporate practice by launching their own policy; and
- Bribery and corruption will become an issue of increased significance to policy makers and the public (see Chapter 7).

## 2.3 *Environmental drivers*

The industrial revolution of the last century and a half was enabled by a shift in energy technology to oil and gas, mechanisation and the tremendous exploitation of natural resources of all kinds, including clean air, water and soil, to enable massive production and increases in wealth.

This has led to a wide range of associated costs, including:

- Rising sea levels and desertification together will present the world with reduced land resources and an unprecedented flow of environmental refugees – and the potential for civil strife;
- Within this reduced land area the Earth is required to accommodate a population growth of humans and animals which is adding increasing demands to our ecosystem at a rate of 70 million extra humans and 35 million livestock per year; and

- There are also losses of biodiversity, losses of quality drinking water, damage to the ozone layer and the increased risk of damage from ultraviolet radiation as a result of this and other examples of the damage we are causing.

Some further trends more directly relevant in a business context are:

**Resource scarcity:** some resources are becoming in short supply as we alter our ecosystem:

- Signs appear to indicate that this revolution is facing challenges as global supplies of oil are estimated to peak in 2010 and then start to decline. About 50 countries, including the US have already passed their production peak. Therefore the shift away from the internal combustion engine and to fuel cells will gain momentum;
- Reduced land resources as civilisation is being squeezed between advancing deserts and rising seas:
  - Nearly 1400 square miles are going to desert annually in China, and Nigeria is losing 1355 square miles of rangeland and cropland to desertification each year. All the countries in central Asia are also losing land to desertification.
- Water shortages are occurring and will gain in severity of impact. Companies requiring water resources for their processes will find their business models endangered in some severely hit countries. The WBCSD report entitled *Business in the World of Water* at [www.wbcd.org](http://www.wbcd.org) highlights that the water crisis can hit all business and how the issue will drive up business operating costs; and
- To sustain present levels of seafood consumption, humans would need more than 2.5 times the area of all the Earth's oceans, *The Fishprint of Nations 2006* report estimates that 91 countries, including the United States, over-fished their biological capacity in 2003. The report is by Redefining Progress, the Ocean Project, and the Center for Sustainable Economy.

**Increased resource efficiency:** the other side of the scarcity debate is that it is a driver of efficiency. There are moves towards resource reuse, repair and eco-efficiency (as reviewed in Chapters 18 and 19) and an example of this is the development of land in various jurisdictions, as with 'brownfield' land use for house building sites.

**Energy:** the energy sector accounts for the majority of greenhouse gases (GHGs), also aviation now accounts for 50% of total energy-related emissions of GHGs (source: [www.un.orgesa/sustdev/publications/trends2006/index.htm](http://www.un.orgesa/sustdev/publications/trends2006/index.htm)).

Environmental health factors resulting from the production of energy will gain prominence, for example:

- The life expectancy of children can be reduced by up to two years by long-term exposure to particulate matter from power plants, industry, vehicles, household cooking, and construction and waste incinerators. This is mostly from the increased levels of bronchitis and lung problems. More legal actions will be generated as a result of air quality issues (source: [www.un.orgesa/sustdev/publications/trends2006/index.htm](http://www.un.orgesa/sustdev/publications/trends2006/index.htm)); and

- More than 2.4 billion people still rely on traditional biomass, such as wood and dung. There will be an increase in the deaths of children from respiratory infections caused by this of over 2 million per year at present.

**Energy efficiency:** oil amounts to 35% of total primary energy supply, with the largest share going to transport, which also increased four times more than that for industrial use from 1971 to 2003 (source: [www.un.orgesa/sustdev/publications/trends2006/index.htm](http://www.un.orgesa/sustdev/publications/trends2006/index.htm)). This trend is set to continue and efficiency measures and substitutes will gain prominence as risk issues.

### **Product standards:**

- Energy efficiency labels and minimum energy performance standards are common measures taken by countries and will continue with the further development of international labels; and
- Building standards: buildings use a large proportion of a country's energy consumption. For instance, it is estimated that buildings consume around 40% of overall energy in the EU. Energy efficiency standards for dwellings and service sector buildings have been set up in most OECD countries including European countries, Australia, Canada, the USA, Japan, Korea, etc. Some other countries (e.g. Singapore, Philippines, etc.) establish mandatory or voluntary standards for service buildings.

### **Renewable energy:**

- The use and investment in renewable energy will increase – combustible renewables and waste and hydro power account for nearly all the world's renewable energy production. 'New' renewable energy sources such as geothermal, solar, tidal, wave, wind and others will rapidly increase from their small proportion of production;
- China is now the world's leading producer of energy from renewable sources, using it for 7.7% of its total energy supply, and this will increase to 19% of the nation's needs by 2020. China is also the world's leader in passive solar energy (for water and space heating) and it is also the largest source of emissions credits under the Kyoto Protocol's Clean Development Mechanism, and is expected to remain so (source: <http://www.newenergyfinance.com/>); and
- In 2006 the wind power capacity of the US surged 27%.

Some examples of actions to substantiate these trends are:

- BP Solar has unveiled plans for a \$70 million expansion project at its North American headquarters in Frederick, MD;
- China will build the world's largest solar power station of 100 megawatts in the north-western province of Gansu, at an approximate cost of 6.03 billion yuan (US\$766 million);
- Google took steps in a greener direction, announcing it is to make its Silicon Valley headquarters the largest solar-powered office complex in the world. The 1.6 MW of solar power generated will meet about a third of the offices' electricity needs; and

- Technology rival Microsoft has installed 2288 solar panels at its research site in Mountain View, which will produce 480 kW of energy.

**Global warming – international context of climate change:** it is generally accepted within the scientific community that the planet is warming. The role that human activity plays in the warming remains more controversial. An address by Kofi Annan, Secretary General of the United Nations, mentions:

Climate change is not just an environmental issue, as too many people still believe. It is an all-encompassing threat.

It is a threat to health, since a warmer world is one in which infectious diseases such as malaria and yellow fever will spread further and faster.

It could imperil the world's food supply, as rising temperatures and prolonged drought render fertile areas unfit for grazing or crops.

It could endanger the very ground on which nearly half the world's population live – coastal cities such as Lagos or Cape Town, which face inundation from sea levels rising as a result of melting icecaps and glaciers.

All this and more lies ahead. Billion-dollar weather-related calamities. The destruction of vital ecosystems such as forests and coral reefs. Water supplies disappearing or tainted by salt-water intrusion. (At the UN Climate Change conference in Nairobi, Kenya, on 15 November 2006)

Some trends are:

- Weather extremes will increase according to the Intergovernmental Panel on Climate Change (IPCC), drawing on scientific advice from around the world; both drought and floods could be more common due to global warming;
- Global warming is threatening the planet's biodiversity, particularly migratory species like birds and marine animals, and species loss is expected to increase;
- Greenhouse gas (GHG) emissions trading will take on greater importance;
- The planetary climate will warm over the next several decades, resulting in sea-level increases of some unknown magnitude;
- Increase stakeholder activism on the risks – an example is the Carbon Disclosure Project (CDP) which has 225 signatory investors controlling trillions of dollars in assets, with the aim to increase greenhouse gas emission reporting. See the stakeholder analysis below for more details; and
- Increased taxation of GHGs. An example is that France is to push coal and carbon taxes in support of the Kyoto protocol.

### 3. Stakeholder Analysis (tool 3)

To find out what is going on in their marketplaces many companies are taking steps to better communicate their progress and challenges to the stakeholders outlined in the box below and covered in more depth in Chapter 9. They are increasingly demanding that companies be transparent and accountable for their commitments and performance.



To meet these challenges, companies are developing a variety of tools, policies and strategies to increase and demonstrate their accountability. One such practical tool is described in Chapter 9, the *Stakeholder Audit*, whereas in this section we seek to undertake a *Stakeholder Analysis* of the trends taking place. There is a brief overview of general trends and then by stakeholder groups.

Some current general trends include:

#### **The SERM stakeholder template**

- \* Academic and research organisations;
- \* Business partners, suppliers and trade bodies;
- \* Customers and their representatives;
- \* Direct actions groups and NGOs;
- \* Employees and their representatives;
- \* Financial institutions (banking, investor and insurance criteria);
- \* Governmental organisations;
- \* Local and regional governmental organisations;
- \* International governmental organisations;
- \* Journalists and media organisations;
- \* Key competitors;
- \* Local communities.

The level of support for sustainability measures from staff and executives is demonstrated in a recent survey by the Center for Corporate Citizenship & Sustainability. Their survey of companies cites the main drivers and benefits of a sustainability agenda including:

- Stakeholder importance is increasing:
  - Two major internal stakeholder groups are the board of directors and employees as having the most influence on corporate citizenship and sustainability issues.
- Among purely or largely external stakeholder groups, there is a rate of significance of influence on company citizenship and sustainability policies which is recognised by the following percentage ratios of significance:
  - Local communities 70%;
  - Customers and consumers 65%;
  - Shareholders 52%;
  - Governments 51%;
  - Financial institutions and investors 43%;
  - Non-governmental organisations (NGOs) 37%; and
  - Media 27%.
- ‘Recognise that feelings are facts ... Top performers know that what NGOs [non-governmental organisations], employees, customers, communities, and other stakeholders feel about a company’s environmental performance and

reputation can be much more important than the reality’, according to the authors of *Green to Gold*, Daniel Esty, Yale Center for Environmental Policy and Law Director, and Andrew Winston, Director of the Center’s Corporate Environmental Strategy project;

- Increased demand for transparency: in addition to shareholders, a variety of other groups are pressing companies to increase the disclosure of their social and environmental performance:
  - Government regulators, financial analysts, employees, non-profit advocacy organisations, labour unions, community organisations and the news media are among the groups pressing companies to divulge greater amounts of information on decision making, performance and targets; and
  - In addition, many customers, both individual consumers and business-to-business customers, are including social and environmental performance into purchasing decisions.
- Increased stakeholder activism: many stakeholder groups are engaging companies more directly, utilising a wide range of tools, techniques and technologies to bring their interests to companies’ attention. These activists are also working to educate lawmakers, the media and the public about companies that are – or are not – deemed to be accountable. Among the tactics being used by stakeholder groups are public information campaigns, public protests, boycotts and class-action lawsuits seeking action and redress for perceived company misdeeds:
  - Shareholders and board members are pressuring firms to disclose greenhouse gas emissions, set reduction targets and study how stricter regulations could impact the bottom line. Environmentalists and shareholder activists are no longer touting the benefits reductions will produce for the environment, but are focusing their campaigns on the financial risks involved by not reducing greenhouse gases. The resolutions on global warming are part of a significant increase in shareholder actions aimed at influencing large corporations; and
  - Increased shareholder engagement: company shareholders, both individuals and institutions, have become increasingly vocal and aggressive in pressing companies to be more accountable.
- Improved relationships with stakeholders: companies are finding that if they make an effort to be transparent, accountable for their actions and decisions and engage with stakeholders, this can build trust among their stakeholders. This also has the benefits of providing valuable insights into the communities in which they operate, and within society more broadly;
- Lists are playing an increasing role in defining and driving corporate sustainability and responsibility (CSR). For example, *Business Ethics* magazine has released its eighth annual list of the ‘100 Best Corporate Citizens’; and
- The growth of social and environmental reporting standards and guidelines will continue:
  - The number of companies releasing corporate responsibility reports is on an upward trend with non-US and European countries catching up quickly with the depth of reporting by these regions. Corporate environmental

reporting is now becoming compulsory in some European countries, including Denmark and, more recently, France, and this is likely to spread, via the European Commission, to the rest of the EU;

- A variety of organisations and initiatives are attempting to standardise social and environmental reporting procedures to let stakeholders more easily compare companies across facilities, sectors and borders. For example, the Global Reporting Initiative (GRI) was established to ‘help bring together and harmonise the numerous initiatives on corporate environmental reporting that have developed independently around the world, shaping them into one set of coherent, consistent global standards’. The number of companies now participating in this initiative, or reporting to the standard, has reached the 1000 mark. It is now in its third incarnation and is available in eight languages at: <http://www.globalreporting.org/Services/ResearchLibrary/GRIPublications/>
- Accountancy organisations like the ACCA, ICAEW and the US Financial Accounting Board propose companies include more non-financial information in their annual reports, including information on employee turnover, measures of customer loyalty, the numbers of defective products and ethical issues.

A brief overview of some of the main trends affecting organisations from specific stakeholder groups is set out below.

## *A Academic and research organisations*

### **Business schools are adjusting to change:**

- Ethical Corporation and European Academy of Business in Society (EABIS) have produced a report (*Corporate Responsibility and Education 2006*) which shows that:
  - More than half of the world’s leading business schools now feature corporate responsibility-related courses as part of their compulsory syllabuses. [www.ethicalcorp.com/cre/](http://www.ethicalcorp.com/cre/). In Europe this figure rises to two-thirds of courses; and
  - Around a third of MBA and masters degree courses and 9% of undergraduate programmes ran dedicated CSR courses in 2003.
- The overwhelming majority of today’s MBA students believe that businesses should work toward the betterment of society, and managers should take into account social and environmental impacts when making business decisions. Also corporate social responsibility should be integrated into core curricula in MBA programmes, according to a new survey by Liz Maw, executive director of Net Impact, the non-profit association that conducted the survey. Among the findings:
  - 81% agreed with a statement that businesses should work toward the betterment of society, although only 18% believed most corporations are currently working toward that goal;

- 78% agreed that the subject of corporate social responsibility should be integrated into the MBA core curriculum, and 60% said they believed CSR makes good business sense and leads to profits;
- 79% indicated they would seek employment that is socially responsible in the course of their careers, and 59% said they would do so immediately following business school; and
- 89% said business professionals should take social and environmental impacts into account when making business decisions.

#### **Corporate research partnerships will increase and offer larger rewards:**

- With government research bodies – a two-year collaborative study conducted by members of the Truck Manufacturers Association (TMA) and the U.S. Department of Energy (DOE) estimates that if companies adopt their new aerodynamic technologies on trailer truck design this would save America nearly one billion gallons of fuel annually; and
- With design and research bodies – Wal-Mart is using the National Renewable Energy Laboratory and the Oak Ridge National Laboratory to monitor its experimental green stores in the US.

## *B Business partners, suppliers and trade bodies*

Organisations are improving their procedures for increasing the engagement processes with their supply chains. For example:

- US Retailer Wal-Mart Stores Inc. is sending engineers into its chain of suppliers to find ways to help it reduce greenhouse gas emissions. Whereas Wal-Mart emits about 19.5 million tonnes of carbon dioxide equivalent per year, its suppliers generate about 200 million tonnes. The initial results have appeared staggering, at only the first factory they helped cut electricity bills by 60% by installing readily available low emissions lighting and technologies.

## *C Customers and consumers*

**Changing consumer attitudes:** there is a growing awareness from consumers on the availability and benefits of new environmental technologies and products. Recent research findings highlight the changing attitudes of consumers:

- According to a recent survey by Ipsos MORI, 82% of consumers want companies to make more effort to demonstrate the social, environmental and fair trade activities they are engaged in;
- The Co-operative Bank reports that UK ethical consumerism last year was worth £29.3 billion and exceeded the sales of 'over-the-counter' beer and cigarettes. This represents an increase of 11% from 2004 to 2005 compared to a 1.4% increase in general household expenditure;

- A combined US National Consumers League and Fleischman-Hillard International Communications report *Rethinking Corporate Social Responsibility* found that:
  - 76% of the American public polled believe that their purchasing decisions are affected by how a company treats its employees;
  - 58% of US public say that they or people like them can find out more information on the internet about companies' records on sustainability issues than a few years ago; and
  - 41% of those that frequently use the internet say they have sent an email to a company about its products or services and 38% to an official body about an issue. [www.csrreports.com/FINAL\\_Full\\_Report.pdf](http://www.csrreports.com/FINAL_Full_Report.pdf)
- An Environic Millennium Survey of 250 00 individuals internationally indicates that public expectations of large companies acting in a reasonable way are both high and universal:
  - 79% felt companies should be 'completely responsible' for protecting the health and safety of workers;
  - 73% for protecting the environment; and
  - 72% for avoiding child labour.
- A survey conducted in 2005 by POLLARA, one of Canada's largest marketing research firms, found 88% of Canadians would spend more on consumer electronics that were energy efficient, less wasteful, or made of recycled materials. Almost all respondents (96%) stated they prefer products that can be recycled or are manufactured using environmentally friendly processes. Reported in GLOBE-Net, 20 November 2006.

## D Direct actions groups and NGOs

**Cultural dissent as a risk is always with us:** the modern global protest culture has a long history and is a continually evolving and growing aspect of public participation. It migrated from the anti-slavery movement of the 1810s and before, to peace groups at international conferences (Vienna, Geneva) in the 1800s–1900s, to environmental and social justice groups of the 20th and 21st centuries. Over the last century the following examples occurred:

1920s–1940s Gandhi – peaceful resistance  
 1949–1996 Anti-nuclear campaigns led to Comprehensive Test Ban Treaty  
 1950s Emergence of anti-establishment movements  
 1963 King 'I Have a Dream'  
 1965–1973 Anti-Vietnam War  
 1980s Anti-apartheid  
 1989 Tiananmen Square  
 1990s Anti-globalisation facilitated by the internet  
 1993 Transparency International founded  
 1999 WTO Seattle  
 2001 OAS Quebec City  
 2001 G8 Genoa  
 2001 G20 Ottawa

*Engaging stakeholders*, including NGOs, direct action groups, activists and international NGOs (INGOs), can help companies to tailor product and service delivery to meet regional needs, reduce negative media coverage, or enhance existing market presence. For example:

- Nike has partnered with an NGO to help design and implement the company's factory monitoring and community involvement programmes worldwide. The partnership helped Nike gain an awareness of local and global community issues, provided technical expertise in factory monitoring, and showed Nike how the monitoring could be done collaboratively.

## E *Employees*

Employee attraction, retention and motivation levels are all critical to organisational success. Therefore, understanding the new trends that influence these groups of stakeholders' perceptions is important. A survey on employee recognition of corporate responsibility issues by US-based community network Care2 polling nearly 1600 employees found that:

- 73% of workers said it was 'very important' to work for a company they believe is 'socially responsible';
- 35% report they have left a company because they believe it was not socially responsible;
- 48% of employees would work for less income if the company is socially responsible;
- 40% would work longer hours on the same basis; and
- The competition for high calibre employees is increasing as the number of jobs at organisations viewed to be socially responsible is exponentially increasing.

It is also relevant that the treatment of one group of stakeholders affects the perception of the organisation by other groups of stakeholders as well. This is demonstrated by the findings of the University of South Africa's research from their Centre for Corporate Citizenship (in partnership with the Bureau of Market Research [www.unisa.co.za](http://www.unisa.co.za)), which were that:

- 40% of consumers that were participants said that social responsibility will enhance employees' respect for the company, while almost 60% believed that public commitments to socially responsible activities will enhance the employees' respect for their place of work.

## F *Financial institutions*

The financial community is adopting more rigorous investment and lending policies, as mentioned under the value drivers section:

- Investors: asset managers and stock markets are requiring greater disclosure on sustainability risks;

- Banks: are increasingly applying rules to investment lending decisions; and
- Insurers: premiums for sustainability issue cover are increasing as is the levels of research into future claims of these types.

Some additional trends include:

**The continued growth of ethical and socially responsible investments (SRI):** the wide definition of SRI funds within Europe has reached over €1 trillion (of which €781 billion is within the UK) and has grown over 36% in excess of the general market benchmark. The trend for the stricter category of the ‘core’ SRI is stable, at only 1% real market growth above base at €105 billion. These now represent 10–15% of total European funds under management.

The key drivers of SRI are seen as:

- Institutional investors, with pension funds increasingly demanding that their assets managers incorporate sustainability issues;
- The increased credibility of the business case in the financial community;
- Business and financial services regulation that requires more transparency on sustainability issues; and
- Increased activism by the financial community, including strategies such as engagement on these issues and the integration of them into ‘mainstream’ investment decisions.

**Increased investor activism:** there is mounting evidence to support the view that fiduciary duty is not compromised by a socially responsible investment stance which includes sustainability considerations. There are discussions that are taking sustainability issues into account as part of the fiduciary duty of the trustees of investment and pension funds. Relevant findings are that:

- Seven out of 10 global investors wanted improved disclosure of corporate governance information identified. (The 2006 ISS Global Investor Survey [www.issproxy.com/globalinvestorstudy](http://www.issproxy.com/globalinvestorstudy));
- There will be an increase in issue-based activism; an example is the Carbon Disclosure Project (CDP) which has 225 signatory investors controlling trillions of dollars in assets, which has requested information from over 2000 companies on the risks and opportunities relating to climate change and greenhouse gases. The CDP has managed to raise their company response rate from 42% in 2005 to 58% in 2006;
- 71% of global investors in the 2006 ISS Global Investor Survey believe corporate governance has become more important to their firms over the last three years; and
- 63% of global investors in the 2006 ISS Global Investor Survey forecast an increased growth in corporate governance issues in forthcoming years; this figure is 93% for Chinese investors, 61% for Europe but lower for the US.

**Increased attractiveness to investors – improved financial performance:** while it may be difficult to determine a direct causal relationship between increased accountability and financial performance, a variety of studies suggest that such a link exists.

- A 1997 study by Wilshire Associates, a financial information and consulting firm for institutional investors, revealed that the stock prices of financially underperforming companies improved after implementing corporate governance reforms;
- A growing number of investors are including non-financial metrics in their analysis of the quality of their investments. Research suggests that investors may be willing to pay higher prices for the stock of companies considered to be accountable. A 1996 survey of large institutional investors conducted by McKinsey & Co. found that stockholders are willing to pay an 11% premium for the stock of companies deemed well governed;
- Other studies have also linked good stakeholder relations with shareholder value. For example, an analysis of Fortune 500 companies conducted at the Boston College Carroll School of Management found that financial performance was linked to good treatment of stakeholders, including employees, customers and communities. The researchers also found that companies that are judged to treat their stakeholders well are also rated by peers as having superior management. According to UBS Warburg this attracts an average 12% premium;
- 37% of investors in the 2006 ISS Global Investor Survey identified enhanced investor returns as the most significant advantage of engaging in corporate governance;
- *The Emerging Performance of Environmental Funds Relationship between Environmental Performance and Shareholder Wealth* is a report by the Assabet Group, which studied both academic research and nine different environmentally focused investment funds around the world. The report concluded that investing in companies that use environmentally sound business strategies could lead to increased shareholder value. Each of the nine funds examined outpaced their respective benchmarks;
- A study comparing the financial returns of portfolios of highly polluting industry with those of low pollution companies undertaken by IRRC suggested that there was no penalty for investing in a green portfolio. In many cases, such portfolios achieved higher returns both against the high polluters and the S&P 500 Index. (Investor Responsibility Research Centre, *Environmental and Financial Performance: Are they Related?* 1995); and
- During the five years before August 2001 the Dow Jones Sustainability Index (DJSI) clearly outperformed the Dow Jones Global Index (DJGI). While the DJSI had an annualised return of 15.8%, the DJGI increased 12.5% in that period.

Investors – whether shareholders investing in ‘socially responsible’ funds that screen companies for social and environmental attributes, or large institutions – welcome the increased disclosure that comes with corporate accountability. There is an increasing demand for qualitative analysis in an era of increasingly marginal competitive differentiations with regards to technology, communications and access to finance, etc. It is considered that intangibles, such as brand



assets and key personnel, are the new differentiators of long-term value. Key indicators exist:

- The majority of investment banks now publish equity research analysing the financial performance of the carbon markets including Citigroup, J.P. Morgan Chase, Merrill Lynch and Morgan Stanley.

Insurers:

- Insurers, brokers and pollution coverage experts say the purchase of stand-alone pollution liability policies is likely to accelerate among multinationals in and around Europe as the threat of liability increases;
- Among the variables furthering this trend in Europe are the explosion in discovered contaminated properties and new liabilities related to merging European Union (EU) laws that hold polluters and property owners liable for the remediation of contaminated sites; and
- Flood cover for UK properties is under threat as predictions that global warming will cause sea levels to rise are leading insurers to fret over the rising risk of claims.

## G *Governmental organisations*

Examples of governmental, political and legislative actions are covered in more depth in the ‘Environmental Scan’ section above (p. 38) and in Chapter 9. There will be an increase in government action to address risks.

A current example is:

- The Spanish government has sought ways to curb water use after two years of drought, now acknowledging this is not a temporary risk, it requires them to penalise heavy water users.

Governments are also using their vast purchasing power to encourage the ‘greening’ of society:

- China’s central and provincial governments will prioritise their purchasing systems to favour environmentally friendly products and services from 2007, according to the Ministry of Finance and the State Environmental Protection Administration (SEPA).

## H *Local and regional governmental organisations*

Examples of local governments’ actions are covered in more depth in the ‘Environmental Scan’ section above and in Chapter 9. There will be an increase in local and regional government action to address risks. For example:

- The California Air Resources Board approved the Pavley law in 2004 requiring passenger vehicles to reduce emissions by 30%. Two auto industry organisations filed a federal lawsuit against the Pavley law, contending that the federal government regulates fuel economy, not states. In addition, in 2006

California Attorney General Bill Lockyer filed a lawsuit against the Big Six holding them liable for the environmental damages caused by their products' GHG emissions.

## I *International governmental organisations*

Examples of international, political and legislative actions are covered above in the 'Environmental Scan' section and in Chapter 9. The trend is for an increase in collaborative agreements to meet sustainability issues, particularly of a proven environmental risk nature. Examples are:

- The European Union is currently the most regulatory-intensive environment, and EU companies are rapidly realising the benefits of environmentally sustainable policies. This means that competitor nations must find ways of making their products compliant with these stricter environmental policies;
- The European Commission has recently published an outline of how it envisages corporate social responsibility to develop within the EU, encouraging all firms to adopt the 'triple bottom line' of economic, social and environmental responsibility (ED 19/07/01);
- The OECD backs greater corporate responsibility as corporate social responsibility will take on ever greater importance in the coming decades, presenting companies with a set of clear challenges. Close attention to environmental issues is seen as a key element of corporate social responsibility strategies. According to the report, promoting 'a culture of integrity' within firms is the most efficient method of encouraging corporate social responsibility;
- There is a huge increase in calls for more product responsibilities and controls as the European Commission supports moves to tighten vehicle emissions limits further than those foreseen in current proposals after European Union governments and lawmakers called for tougher standards. The Commission proposed 'Euro 5' vehicle standards, which would slash emissions of particulates from diesel cars by 80% and nitrogen oxides (NO<sub>x</sub>) by 20%. They would also cut NO<sub>x</sub> and hydrocarbon emissions from gasoline or petrol-powered cars by 25%; and
- After two decades developing the Declaration on the Rights of Indigenous Peoples, the UN General Assembly is voting on adopting it.

The internationalisation of legislative reach:

- Companies and governments are concerned that the US watchdogs are extending their powers abroad, post-Enron (see also Chapter 22);
- Growing fears of US financial rules are encroaching further into the city and have led UK companies to remove US customers from their books so they do not come into the remit of the SEC Investment Advisors Act of 1940 which calls for companies providing advice to more than 14 US citizens to register with the SEC and make regular reports; and
- Recent interpretations of the US Alien Tort Claims Act have allowed companies to be sued for their actions in foreign countries.

## J *Journalist and media attention*

An organisation's reputation and good brand names are something that is not only vital for sustainability, but is increasingly easy to lose:

The reputation of a thousand years may be determined by the conduct of one hour.  
(Japanese proverb)

Corporate social responsibility and accountability more broadly have become topics of increased media attention and scrutiny, both in the business press and the mainstream media. Examples that have affected reputations and bottom lines include the overseas labour practices of several footwear and apparel manufacturers and retailers that have received significant media attention. The activities of oil companies have also led to high profile consumer boycotts.

The media have been engaging stakeholders in the corporate social responsibility debate, which often focuses on different categories of responsibilities, for example economic, legal, ethical and philanthropic. In managerial reality, however, no natural or distinguishable responsibility categories exist. This has led to a diverse range of reporting on the sustainability issues, possibly even creating confusion in the media and public at large. Furthermore:

- Corporate social responsibility (CSR) is often criticised for being treated as a moral substitute to compensate for harmful corporate activities. The media will view companies more harshly if they find this to be true and if organisations have used CSR to mask harmful activities; and
- The media critics argue for a more comprehensive understanding of corporate responsibility.

## K *Key competitors*

Companies are developing a wide range of management systems to measure, apply, assess and report their efforts to integrate CSR into all aspects of their operations. These systems are designed to build accountability within an organisation and to help to shape a culture that supports and rewards CSR at all levels. As part of this effort, many companies are attaching value to gaining competitive positioning leadership in the field of sustainability.

The corporate competitive landscape:

- Huge discrepancies exist between companies concerning their risk management capabilities;
- As sustainability gains recognition, an increasing number of companies are competing for sector sustainability leadership and differences between leading companies in most sectors are becoming smaller;
- Leaders quantify the value of their brands. Companies care about their brands and invest heavily in brand management, but few report that they are actually able to quantify the values of their brands and the returns on their brand investments;

- The trend towards industry-specific sustainability management continues. Companies are getting increasingly educated about the specific sustainability risks and opportunities in their sector and continuously move beyond general aspects;
- Surveys have found that over a third of companies reviewed lack a formal programme but conduct regular reviews of sustainability activities;
- The majority of the reviewed companies also say they are not active in citizenship and sustainability-related business product developments;
- The top three activities that are the focus of current citizenship and sustainability attention are community and stakeholder involvement (64%), corporate giving to worthy causes (55%) and environmental sustainability/climate change (52%); and
- Climate change continues to attract increased attention. More companies recognise that climate change will have a major impact on their future operations and product offering.

## L *Local communities*

As mentioned in Chapters 9 and 12 this stakeholder group can directly and indirectly affect operations.

### *Useful web links*

- \* EMAS – Eco-Management and Audit Scheme Sites. Regulatory texts and background information, guidance documents and a list of verifiers: <http://europa.eu.int/comm/environment/emas/index.htm>; <http://www.emas.org.uk/>
- \* GRI – Global Reporting Initiative, including a GRI content index and guidelines: <http://www.globalreporting.org/reportsdatabase/>
- \* International Finance Corporation (Part of the World Bank Group) has documents relating to the emerging opportunities with regards to the trends we discuss in this chapter: <http://www.ifc.org/sustainability>
- \* INEM – International Network for Environmental Management. Documents and hyperlinks to other websites of interest, including: EMAS Tool Kit for Small Organisations, Environmental Policy Checklist, and Environmental Statement and/or Environmental Report Checklists: <http://www.inem.org/>
- \* ISO – International Organisation for Standardisation – ISO 14001 Global Overview. This site provides an up-to-date overview of sites certified against ISO 14.001 and sites registered under EMAS: <http://www.ecology.or.jp/isoworld/english/analy14k.htm>
- \* United Nations. Reports on global trends are available from: <http://www.un.org/esa/sustdev/publications/trends2006/index.htm>

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# 4

Background to key aspects of legal risk management

# 4

## Background to key aspects of legal risk management

### CHAPTER OVERVIEW

**The purpose: to achieve compliance with regulatory requirements and licence to operate**

Having regard to what has been said in Chapter 2 regarding Sustainable Enterprise Risk Management (SERM) this chapter is intended to set the scene on business risk management and to highlight certain aspects and principles that affect businesses wherever they operate and regardless of their size. It therefore covers:

- \* Legal risk management:
  - The purpose;
  - The process;
  - Banks and compliance risk management: a case study;
  - Typical transaction risk management and due diligence procedures and documentation; and
  - Formal and informal risk management processes.
- \* Financial risk management;
- \* Risk and insurance; and
- \* Beneficiaries of risk management:
  - Transactional and operational concerns; and
  - Priorities.

### Legal risk management

In today's business climate legal risk management affects virtually every organisation, and in particular highly regulated public businesses, such as banks and healthcare organisations. A solid risk management plan and framework enable the organisation to:

- Improve safety;
- Minimise lawsuits;
- Achieve best practice;

- Make better business decisions;
- Enhance asset management; and
- Meet regulatory compliance standards; which in turn:
  - Protects reputation;
  - Improves the bottom line; and
  - Leads to a more attractive insurance proposition.

It should be emphasised that the cost to implement a risk management plan is always less than the potential costs involved if the organisation does not manage risk. Banks are particularly under the pressure of compliance risk management as a popular management tool. Compliance risk management can be well illustrated in the banking sector which is increasingly under pressure to demonstrate transparency to all stakeholders (see further case studies below). For example, in relation to securities, it enables the board to:

- Achieve a clear picture of a company's corporate hierarchy to better understand their entire securities structure and global exposure;
- Verify the inter-relationship between securities, their issuers, related subsidiaries and affiliates; and
- Determine conflicts of interest relative to their holdings, potential holdings or client inter-relationships.

## Legal risks

Some confusion can arise in the use of the term 'legal risks'. It may be used to indicate the *source* of the risk (such as a change in regulatory environment), or alternatively the *impact* of the risk (such as a legal claim for compensation). Equally, it may indicate a particular course of action to *control* a risk – such as obtaining legal advice to ensure that a key contract meets a company's strategic requirements. In the context of this book the issue lays not in the categorisation or classification adopted, but in the risk that legal issues in terms of the source, impact or controlling of risks may not be properly taken into account. Applying a more consistent process for evaluating legal risks may result in a recognition that risks have been overcontrolled (due perhaps to an excessive weighting of legal issues), as much as a finding that certain legal consequences merit a greater investment in control mechanisms.

### **Analysis of risks: key questions**

Any risk management system should be based on clearly defined risks. These should be aligned to the business objectives of the organisation so that they can be reviewed alongside other business information, such as financial performance, and used to inform decision making. When risk



commentators are analysing risks, they have found it to be useful to ask several key questions:

- \* What information is available regarding historic incidences of the risk?
- \* What additional sources of information could be used to help anticipate the incidence or impact of the risk? (For instance, publicly available financial information about suppliers or contractors.)
- \* When the risk is likely to arise: at what point in time after the relevant activity or event does the risk become less likely?
- \* What factors may affect the likelihood of the risk arising?
- \* What value is lost if the risk does arise?
- \* What would be the costs of remedying the risk if it arises?
- \* How will we know when the risk has arisen and who would have this information?
- \* What indicators or warning factors are there that the risk is more likely to arise?
- \* How is awareness of risk currently reflected in decision making within the relevant area?
- \* Who, either internally or externally, has the most experience of evaluating the way the risk impacts on the organisation, or has the most experience of handling the risk once it has arisen?

In order to be fully effective, the management of risks should be integrated across the business. In other words, the assessment and treatment of individual risks arising in connection with one part of the business should form part of a programme for addressing risks generally across the organisation. This is because the effect of different risks can be multiplied if they occur simultaneously. For example, the effect of the failure of IT systems may be compounded if it coincides with the launch of a new product or service (see also Chapter 11). It has been clearly established that an effective risk management strategy should recognise and address those inter-relationships.

*Best practice compliance guidance*

A best practice information security framework should support the coordination of compliance strategy across multiple channels and guide control responses to multiple threats to all sorts of information assets. While it is clear that no individual information security product is capable of making any user organisation 'compliant', those products and services that reflect best practice guidance will assist organisations to position themselves most effectively to deal with current and emerging regulatory requirements (see also Chapters 19–23).

Similarly, the management of risk must be integrated into the processes and policies for managing the business as a whole. It should be used to inform

decision making alongside more traditional information such as financial performance. The SERM approach found that the impact of risk management techniques will be undermined if they are not consistent with the approaches and policies applied elsewhere in the organisation. For example, a risk-based methodology for pricing projects with potential long-term liabilities may have little effect if it is contradicted by remuneration policies that reward short-term financial performance on the part of particular individuals or units.

As has been indicated in the Handbook Overview and Chapter 2, it should be noted that the ultimate objective is risk management, not necessarily the elimination or reduction of risk. A systematic analysis of risks and how they are currently managed in a business may indeed indicate that particular risks are being overcontrolled. The operation of controls in a disproportionate manner may have disadvantages, not only in terms of the incurring of unnecessary costs, but also the loss of the flexibility to take advantage of opportunities. For instance, this may be especially evident in circumstances such as competitive tenders for new business. For instance, an over-rigid set of controls may inhibit the organisation from responding quickly enough to enable success.

## Risk identification

One recognised approach is to consider the key processes, assets and issues that drive the business and support or threaten the achievement of its business objectives. This is a similar exercise to identifying the drivers for the value of a business when investigating the proposed purchase of that business (see further below).

The table below gives some practical examples:

Processes	Assets	Issues
Recruitment and industrial relations	Know-how	Product liability
Order pricing and processing	Corporate brand and reputation	Regulatory approvals
Waste management	Product branding	Health and safety
Treasury management	Customer connections	Data protection
Negotiation of key contracts	Supplier connections	Corporate manslaughter
Financial reporting	IT systems	Competition law
Marketing	Plant and machinery	
Business acquisitions	Infrastructure/premises	
	Key staff	

Useful acknowledged techniques for identifying risks include brainstorming and SWOT analysis (Strengths, Weaknesses, Opportunities and Threats). Whereas external consultants may be used, the effectiveness of the systems will depend on a comprehensive understanding of how the business operates in practice, and any ‘standard solutions’ should be approached with caution.

As indicated above, risks can operate at different levels of an organisation. A programme of managing risks needs to operate not only a strategic or corporate level (i.e. top-down approach), but also at the level where the risk arises or has its most direct impact (bottom-up). Almost every person within an organisation is involved in managing risks, even if it is not labelled as such. What is obvious to one individual may not be obvious to others. It is therefore always important to involve individuals from a full range of the organisation's functions in order to capture information about risks and allow better decision making. This is very relevant to the SERM approach.

## Risk evaluation

Several acknowledged techniques can be used to help to understand the significance of particular risks, and therefore prioritise action to address them. A common approach of risk experts and commentators is to use a matrix that combines the following factors:

- Likelihood: the perceived probability of the risk occurring; and
- Impact: the expected consequences if the risk actually does arise.

The particular risk is given a rating for each factor (such as very high/high/medium/low/very low), and the combination of those two factors is used to produce an overall risk rating for the particular risk. This is not a scientific or mathematical exercise, and involves a degree of judgement. However, it is important that the evaluation of risks is carried out in a consistent manner which, as far as possible, avoids bias due to perceived commercial or personal interests. This can be achieved by carrying out tests within different levels and functions of the organisation concerned.

The diagram below has been accepted by risk advisors and seeks to set out a possible representation of the assessment of a risk.

Likelihood	VH					
	H					
	M					
	L					
	VL					
		VL	L	M	H	VH
		Impact				

The shading in the diagram represents a possible assessment of overall risk, with risks falling within darker sections carrying a higher priority for action.

In considering the impact of a particular risk if it occurs, it has been recognised that it can be useful to consider the different types of consequences involved, as opposed to the sources of the risk. Bearing in mind also what has been stated about the SERM approach, various methods of categorisation may be possible. The table below describes two possible approaches.

<b>‘Type of impact’ method</b>	<b>‘Site of impact’ method</b>
<ul style="list-style-type: none"> <li>• Financial: e.g. loss of revenue, impairment of cash flow, incorrect pricing</li> <li>• Reputational: e.g. damage to the perceived standing or reputation of the organisation with its stakeholders and the public at large</li> <li>• Operational: e.g. impairment of the organisation’s ability to carry out its day-to-day activities</li> <li>• Strategic: e.g. impairment of the organisation’s ability to meet its strategic objectives</li> <li>• Legal: e.g. potential liability for claims, loss of ability to enforce rights or claims</li> </ul>	<ul style="list-style-type: none"> <li>• Assets: an impact on the assets of the business, whether tangible or intangible</li> <li>• Business processes: an impact affecting effective functioning or performance of particular systems or processes within the organisation</li> <li>• Revenue: loss of earned income or cash receipts</li> <li>• Costs: an increase in cost base or the loss of an opportunity to decrease costs</li> <li>• People: an impact on the human resources or staff of the organisation</li> </ul>

It should always be borne in mind when considering such approaches and classifications that with other forms of categorisation, the classification of types of consequence should not be seen as prescriptive and should be adapted so that it is meaningful for the business concerned.

## Risk management and risk recording

An effective risk management programme requires a systematic approach to recording risks so that they can be addressed and monitored consistently.

In any organisation risk management experts have advised that it is helpful to categorise risks so that procedures can be put in place to monitor and control them. The actual method of classification used is less important than the existence and monitoring of systems to control the risks involved and the consistency with which they are appraised.

The table below sets out an example of the type of generic information which may be recorded in relation to a particular risk, regardless of sector or location.

Information concerning individual risks should be aggregated at the relevant level of the organisation. The overall risk ratings produced using an evaluation matrix or similar tools can be used to prioritise actions to address

<b>Name</b>	<b>The name or reference number for the risk concerned</b>
Description	Description of the circumstances or events in relation to which the risk arises
Category	Identification of the business process, asset or issue to which the risk relates
Risk owner	The individual or group responsible for managing the risk
Risk stakeholders	Description of the stakeholders (internal and external) with an interest in the management of the risk, together with any specific requirements or expectations
Evaluation	Assessment of the likelihood and impact of the risk arising, with an overall risk rating
Target rating	Statement of the desired risk rating, reflecting the organisation's tolerance of that particular risk
Controls	Description of the present controls used to manage the likelihood of the risk arising or its impact
Monitoring	Description of the processes used to monitor the risk and the effectiveness of controls, including key indicators
Corrective action	Description of proposed action to improve the management of the risk

risks. Note, however, that the perception of a particular risk by stakeholders can be as important as the rating produced by considering its impact and likelihood. For example, environmental issues may have particular significance in relation to the public perception of the organisation's activities and may therefore require demonstrable systems to address environmental risks (see Chapters 18 and 19). This should be reflected in a lower tolerance to those risks, and a correspondingly higher prioritisation of relevant controls.

#### *Risk owner*

The identification of the appropriate 'risk owner' is key to the ongoing process of addressing risks. This term is used to indicate the individual or work group who or which is primarily responsible for managing that risk. This will usually be at the level of the activity giving rise to the risk, or alternatively the point where the risk is likely to impact most directly. It is important that the risk owner has the authority to ensure that the necessary actions are taken. Where appropriate, arrangements may be necessary for a risk to be escalated to a higher level in order to ensure an appropriate response.

## Implementing risk management systems

A system for managing risks should be seen by the whole organisation as an ongoing process involving the following basic steps:

- Identifying risks;
- Evaluating risks;

- Prioritising action to controlling risks; and
- Reviewing the effectiveness of controls.

At a strategic or corporate level, the process of reassessing risks and reviewing the appropriate controls should be carried out on a periodic basis, at least annually. However, at this and other levels the process should be triggered by matters such as:

- Implementation of new business activities or new ways of working;
- Preparing for major investment decisions;
- External events which affect the business objectives;
- Changes in external environment, including regulatory constraints or market conditions;
- Changes in the cost of controls; and
- Failure of control mechanisms or occurrence of unexpected risks.

This process may be especially valuable when considering the integration with the legal due diligence process (see below).

There are various possible responses to risks once they have been identified. These include:

- Prevention: by adopting systems to minimise the likelihood of the risk being realised;
- Containment: taking action to reduce the consequences of the risk once it has been realised, e.g. disaster recovery plans, asset protection through corporate structures (see Chapters 8 and 6);
- Spreading: taking action to spread the risk between different operations or units (diversification);
- Transference: e.g. by insurance or contractual arrangements with suppliers; and
- Retention: by accepting that certain potential outcomes are unavoidable costs to be absorbed.

It is important that the responses to the relevant risks are proportionate to the impact and likelihood of the risk. This relates not only to the cost of measures for controlling or mitigating the risk. Particular responses may carry an indirect cost in making the organisation less able to take advantage of opportunities or the potential ‘upside’ of uncertain events. It is therefore a matter of optimising the management of risk, rather than simply attempting to remove or minimise risks.

The process of assessing and managing risks should include a review of the controls currently operated, together with the costs and side effects of those controls as compared to the other responses that are available. However, it should be noted that different responses may address some but not all of the types of impact of a particular risk. For example, product liability insurance may cover the direct financial impact of a claim for compensation, but not the adverse effects on the business’s reputation.

As regards legal risk management it should also be understood that some responses may create new risks of their own. For example, the risks associated with a particular manufacturing process may be transferred by ceasing those

activities and outsourcing the process to another supplier. This will give rise to a separate set of risks in managing the performance of the supplier and the financial relationships involved. Although this may be effective in transferring some liability risks, the impact of adverse incidents on the business will remain.

## Banks and compliance risk management: a case study

Since the debate over risk management and corporate governance has heightened following the introduction of Turnbull and other risk management standards from the 1990s (see Chapters 6 and 21) risk has become a popular and practical management tool. The financial services sector – in particular the banks globally – have evolved important tools to manage risks and to deal with stakeholders. Indeed this sector is under constant scrutiny and must demonstrate enhanced risk management and governance standards. This sector can therefore provide a useful case study that is helpful for other commercial sectors. Indeed, bank auditors currently use risk as a key audit tool. Bank examinations are increasingly based on risk assessment and subject to more and more stringent examination having regard to the many stakeholders. This trend toward risk assessment and risk management is a natural fit for compliance.

For the banking sector in particular regulatory compliance is a crucial form of risk management. In the case of compliance, most of the risk that is being managed is based in or created by laws and regulations rather than by market forces or customer behaviour. However, some of the core elements of compliance risk are shared with many of the same drivers that underlie other risks that are touched upon elsewhere in the book, such as:

- Staff turnover;
- Product complexity;
- Rapid growth of the bank or a bank product;
- Economic forces in the bank's market; and
- Technology.

All of these risk sources affect compliance. As regards this sector the work of the Treadway Commission's Committee of Sponsoring Organisations (COSO) is relevant. COSO identified risk in the following broad, generic categories:

- External factors;
- Internal factors; and
- Risk relating to change.

In the process of identifying risk, determining its extent, and identifying ways to manage it, it has been found that it is useful to divide risk into these general categories. According to the banking community:

- External factors are risk sources over which the organisation has no control but may be able to observe and predict. The experienced risk manager will foresee them coming and have a strategy for responding; and
- Internal factors are risk sources over which the bank (but not necessarily the compliance manager) may have control. The compliance risk manager should

use their knowledge about the bank to identify internal risk factors and take steps to minimise them. Although the bank has some control over internal risk factors, methods to minimise internal risk may often be at the expense of business opportunities. Controlling internal risk therefore involves choosing the optimum balance between risk control and business opportunity.

*The US: OCC approach*

It has been evident that the bank supervisory agencies have moved toward risk assessment as a key element of the bank examination, including the compliance examination. The OCC has identified the following risk categories: credit risk, interest rate risk, liquidity risk, price risk, foreign exchange risk, transaction risk, compliance risk, strategic risk and reputation risk. Although compliance is listed as one of the risk categories, compliance still affects, or is affected by the other categories as well. For example, compliance requirements are part of transaction risk. Credit risk is closely tied to many aspects of compliance ranging from rate disclosures to fair lending decisions. Reputation risk may be affected by compliance requirements including CRA, fair lending and the accuracy and timeliness of disclosures.

To measure risk, the OCC considers: ‘the quantity of risk’; the quality of risk management; aggregate risk; and the direction of risk. For risk controls, the OCC assesses policies, processes, personnel and control systems. These risk controls should be familiar to compliance managers: they outline a compliance programme, as regards the quantity of the risk, and priorities must be determined. Like the US OCC approach, the central COSO question is whether there are reliable controls. The goal is not perfection. The goal is the ability to identify, prevent and minimise problems. The bank that is at risk is the bank with controls that are less than reliable.

- As with other commercial organisations, risk relating to change involves a combination of factors that are within the bank’s control. Change-related risk may be the result of the development of new products that trigger a new analysis of compliance risk. The bank has some control of the choices here.

Change may also occur because of changes in the economy, the bank’s market, or legislation. In this type of change, the bank is in the position of responding rather than driving the change. COSO identified a list of factors of change. These remain useful to study for the ways in which compliance is affected. For instance, included in the factors of change listed by COSO are:

- Changed operating environment;
- New personnel;
- New or redesigned information systems;



- Rapid growth;
- New technology;
- New lines and products;
- Activities and acquisitions; and
- Corporate restructuring.

It is helpful to note that commentators have suggested that basing a compliance management programme on risk management can be an effective communication tool. Bank managers who may be averse to the term ‘compliance’ may respond much more readily to ‘risk’. This approach may therefore provide the organisation with an effective means of getting management to understand and give appropriate attention to compliance priorities.

## Practical hints and tips in compliance risk management

In the face of increased compliance obligations, a dynamic business and IT environment, fragmented risk and compliance projects, and exposure to tort and criminal liability, organisations are seeking a formalised approach to managing risk and compliance. Pertinent questions facing organisations are:

- How do we know if we are meeting compliance requirements?
- Is our compliance and risk management programme effective?
- How do we identify and measure critical risks to the organisation?
- How do we capture what we are doing about them?

More generally certain key hints and tips have been cited as a guide to implementing a legal risk management programme regardless of sector, size, or location.

- Make a list of the laws that affect the organisation;
- To get a quick measurement of risk from these laws, identify what has historically been a problem;
- List the top three sources of compliance risk for the organisation;
- Review the written compliance programme to determine whether it has the elements of a risk management programme. In particular, policies, procedures and controls for the top three risks identified;
- Read the last two reports sent to management or the board of directors. Consider the extent to which they identified risk and used risk terminology. Think about how to rewrite the reports using a risk management approach;
- Study examination procedures based on risk. Look for tools and strategies to incorporate into your compliance programme; and
- Post a reminder for communication to others in terms of risk management.

## Legal risk measurement and control

When considering the SERM case studies it has been found that in an effort to measure and control risk and compliance, organisations are seeking a structured

*Trends in legal risk management*

Accordingly the trends as regards legal risk management in 2006 and beyond are:

- \* Increased interest and adoption of risk management frameworks (particularly COSO);
- \* Managing and measuring compliance as a process as opposed to a project;
- \* Adoption of governance, risk and compliance tools;
- \* The integration of compliance controls into the corporate structure; and
- \* The appointment of a chief risk officer to manage enterprise risk and compliance for large critical infrastructures.

approach that allows them to: quantify risk; establish risk appetite/tolerance; identify and prioritise controls; and establish a system of record to meet a multitude of compliance obligations. The goals in establishing an enterprise risk and compliance management programme are to:

- Improve confidence in operational and financial integrity;
- Maintain accurate and timely information which enhances visibility, measurement, management and sharing of risk;
- Accurately measure risk through a consistent and systematic approach, as opposed to disparate views that are reactively managed;
- Measure risks not only at the system or project level, but from the business process and business unit level, as well as from the organisation-wide view of risk management;
- Provide consistency in terminology, measurement, compliance and risk tolerance; and
- Quantify and justify risk decisions to support accurate response and decision making.

## Key drivers for risk and compliance management

It is evident that there are many different approaches and techniques that can be adopted for managing risks. As the banking case study has indicated, in some fields complex guidelines have been developed – such as the principles for the management of credit risks. In this context one should note the principles published by the Basel Committee on Banking Supervision. What follows represents a methodology which may also be capable of general application and will need to be adapted to reflect the unique characteristics of the relevant organisation.

*Operational risk*

An established or recognised definition of operational risk is: ‘The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.’ (Basel Committee on Banking Supervision)

These risk managers agree that organisations are facing mounting pressures in dealing with compliance management, are driving them toward a structured approach to enterprise risk and compliance management (see also Chapter 5):

- Multiplicity of risk: where organisations have minimised risk and compliance management in the past, the complexity of today’s business, dependency on IT and processes, growth in business partner relationships, and increased liability and regulatory oversight has amplified risk to a point where it demands governance (see also Chapters 21–23). Furthermore, the multiplication of compliance requirements that organisations face increases the risk of non-compliance, which has potential civil and criminal penalties;
- Increased accountability: for companies listed on the US Index Sarbanes-Oxley (SOX) places executives and the board under pressure. While SOX is not specifically aimed at operational risk and compliance, its impact has been felt throughout the organisation. Following the Enron debacle and SOX response executives are faced with stiff penalties regarding the integrity of financials. Therefore they require that risk and compliance be consistently managed within defined levels of risk tolerance to control impact on the financials. The only way to combat potential litigation from one of the major risks requiring management in the US is through increased control and oversight; and
- Fragmentation and duplication of effort: as management grapples to understand how risk and compliance are being managed in the organisation, they often discover an inconsistent approach. Through relevant case studies SERM has also found that risk and compliance management has been fragmented throughout organisational silos, resulting in a duplication of technologies and efforts with inconsistent approaches, measurement and reporting. The lack of central visibility and oversight has resulted in islands of information trapped in documents and individuals throughout the enterprise.

## Legal risk management and due diligence: the purpose

It is well recognised that records and information are at the core of every transaction any organisation undertakes. This is generally true wherever one operates and whatever the sector or even size, bearing in mind supply chain pressures. Accordingly any inadequacy in those records and information – including

non-compliance with regulations such as the Sarbanes-Oxley Act and international privacy laws – can threaten the organisation’s ability to conduct business. This was well illustrated in Enron and its aftermath (see also Chapters 21–23). Despite this logic recent studies indicate that many organisations lack effective policies and procedures for systematic control of recorded information. As a result, they risk:

- Extensive penalties for non-compliance with record-keeping regulations;
- A tarnished reputation; and
- Potential legal liability.

This has meant that record management has become one of the most powerful tools in the compliance and risk management approach. Financial transparency, corporate governance, anti-terrorism and privacy protection are major regulatory themes in the United States and abroad. Recent developments have given corporate directors many reasons to pay attention to enterprise risk; for instance, with \$184 billion in revenue and 59 000 employees in 180 countries, energy giant Chevron Corp. has been highly aware of the need for risk management. When SOX was implemented with its calls for a risk-based approach to assessing internal control over financial reporting, Chevron executives were prepared because they had put in place a risk-based system years ago. Yet evidently less than 25% of corporations are giving their internal audit functions the rigorous external reviews recommended by the Institute for Internal Auditors as a standard of strong corporate governance in the post-SOX economic era. Moreover, companies attempting to comply with the internal control provisions of SOX are finding that they must evaluate the controls not only of their own operations but also those of partners with whom they may form an alliance.

#### *Sarbanes-Oxley*

The emergence of the US Sarbanes-Oxley Act in 2002 brought statutory pressure to bear on US-listed organisations to demonstrate corporate governance compliance. These requirements have had significant impacts on the internal control and risk management approaches of listed companies, and compliance with Section 404 and preparation for the new auditing rules have all been major tasks for many US companies (see Chapter 22). That challenge is now passing to non-US headquartered companies that nevertheless have US listings. Every organisation dealing with Sarbanes-Oxley needs Practical Implementation Guidance. SEC Regulation outside the United States is the authoritative guide for non-US companies trading in the US. Most usefully, the Section 404 Implementation Toolkit can save many organisations many millions in implementation dollars.

The purpose of legal risk management as part of due diligence by a purchaser (buyer) or party entering a joint venture is to ensure that:

- The relevant assets have the value the vendor (seller) has given them;
- The vendor has good title to those assets free from encumbrances, including intellectual property and – in particular – the key assets that are being acquired;
- There are no risks, liabilities or commitments that reduce the value or use of the assets, for example another party having the right to use them; and
- There are no other existing or potential liabilities that may adversely affect the object of the due diligence (the target or candidate).

As a priority, therefore, the purpose of the legal due diligence relates to the verification of the legal affairs and good standing of the target, which, in turn, impact on or verify the consideration being given.

Traditional due diligence usually covers such topics as:

Topic	Examples
Assets	Primarily, assets are considered tangible property, such as buildings, computers, furniture, etc. However, other important assets include people, contractors, business ideas, product relevance in the marketplace.
Contracts	Contracts for work to be done, commitments by others to do work for the company. The contract can be with individuals or companies. Keep in mind that it is not just the contract terms but whether the terms are in fact enforceable. A lot of employment contracts have appropriate terms, but if the individual has a serious accident and is incapacitated, none of the work-related terms may be enforceable.
Customers	Customers for products and services are important elements. Who they are and where they are. When reviewing this topic, consider whether there is a secondary market for the resale of products such as through Amazon or eBay. Customer support may start to come from locations not anticipated.
Employee agreements	This requires appropriate legal support to make sure that the agreement is not so restrictive that the employee could easily break the agreement as being unfair, etc. These agreements may also require consistency which is a process that due diligence can support. (see also Chapter 14)
Employee benefits	This is not just about health insurance. Due diligence requires the comparison of planned benefits with actual received.
Environmental issues	These can form a significant part of any due diligence activities. Environmental impact statements have to be considered a never-ending part of the business operations as well as the business planning. Regulators from government agencies as well as non-governmental organised groups can delay or prevent a specific development project (see also Chapter 18 for further discussion of environmental issues).
Facilities, plant and equipment	Classically, this item is included within the asset category. It is separated here to indicate the requirements for a continuing due

*(Continued)*

Topic	Examples
Financial condition	<p>diligence for the potential retirement or sale of any old facility that is no longer effectively supporting the enterprise business. Examples of this can be old buildings. In the US recently many municipalities have torn down old sports stadiums to construct new ones with 21st century features like adequate bathrooms and enough executive suites.</p> <p>Traditionally the province of the accountant, this topic has expanded to recognise the confluence of cash availability, debt limitations and restrictions, the industry's economic climate, the county's economic climate and the global economy. All of these components can be monitored on a continuing basis as part of the overall financial review of the business.</p>
Foreign operations and activities	<p>Globalisation is the major element of 21st century business. Outsourcing, multiple worldwide locations, different business and governmental regulations, currency conversions, transportation issues, employees, cultural differences all add up to substantial impact on company operations. Some of these issues are addressed in Chapter 13.</p>
Legal factors	<p>Laws never go away. Legal issues country by country, state by state, municipality by municipality all have to be considered, and monitored.</p>
Product issues	<p>Product life cycles need to focus on old products, products about to be launched and products in the development pipeline. Moreover, due diligence includes the need to monitor competitors' products. It is a growing issue considering the expanding global economy.</p>
Supplier issues	<p>Companies are segmenting the manufacture and delivery of products and services. Some companies want to control all aspects of manufacture. As noted, trends in today's economic climate show that more companies are outsourcing parts of all of the development cycle. Due diligence needs to include the viability of the supplier's ability to deliver on time, on budget and within the established quality parameters. If the supplier declares bankruptcy there may be significant issues impacting the completion of company products as well as the financial impact of not receiving value for payments already made.</p>
Tax issues	<p>Tax increases, tax decreases, taxing authorities all need to be monitored. Due diligence needs to include the potential liability of taxes due to a growing number of governments requesting tax dollars. On the other side of this coin is the potential for the impact of economic loss on the tax liability. In some cases, the liability may be greatly reduced and/or turn to a cash refund. In this event, due diligence needs to make sure that this is an accurate calculation and then consider what to do with the returned funds.</p>

These topics are not the only categories of information that an appropriate due diligence exercise will want to assess and analyse. However, they do demonstrate the range of issues that should be addressed in order to fulfil the purpose of due diligence. When establishing due diligence activities, it is

essential that the risk assessments have to expand beyond the most basic levels. This is true wherever the exercise is taking place (for an example of a simple due diligence exercise see later on in this chapter).

From a 21st century perspective, when considering, for example, joint ventures or mergers and acquisitions, the traditional due diligence methods account for 10 to 25% of a complete due diligence process, especially in light of the fact that approximately two-thirds of all mergers and acquisitions fail completely, or fail to deliver the value expected. Further comment on the level of failure is made below. For the present purpose it should be noted that not all failures are due to the lack of data gathering and appropriate due diligence procedures. Quite often, it is the process of due diligence that reveals appropriate information that this merger is not a good deal for one or both parties in terms of their risk management, risk appetite and culture. For example, the cultural due diligence exercise can assist toward more successful outcomes.

#### *Management emphasis*

With enormous emphasis placed on the short term by most firms, especially those in the public markets, a quick increase in price or earnings for the stock market is in many cases the sole reason for an M&A transaction. Easy revenue increases or cost reductions often make management the hero, albeit almost always at the cost of the stakeholders in the long term.

Having regard to the purpose of due diligence, in most places traditional business views are based on a historical perspective. Examples of this type of view are:

- What were the level of earnings?
- What did the CEO do?
- How were sales made in the last quarter?
- More analysis of completed transactions.

Following this model, traditional due diligence looks at the past, not the future, to assess what a company can accomplish from today forward. This analytical method is often performed too quickly and with a too narrow focus on completed transactions that may not be an appropriate predictor of future behaviour, as this book seeks to demonstrate. Clearly there are now other modern tools and resources available that can support a more through analytical process.

### *The transactional process: the role of due diligence*

In most jurisdictions the typical legal traditional due diligence process usually looks at the target or candidate company, its financials, its products, its market and its employees, usually in that order of priority. This may be set against the

risk management approach of the organisation. The process begins with a legal questionnaire and disclosure documents attested by the candidate, and is coupled with a review, compilation, or audit of financial records. Generally, a regulatory agency records search is performed. Most often various public records are searched. Often, research is added in areas such as the industry niche(s) of the candidate, and sometimes the media. Sometimes, additional research is added by contacting various industry and government organisations.

In the course of this process the use of warranties and indemnities has developed to facilitate the transaction. Although the vendor may provide warranties that provide assurances on exposed areas, the purchaser should check them in any event. The verification approach reduces the potential for conflict because problems can then be identified at an early stage. It can happen, for example, that the vendor is unaware of the problems or issues that emerge through the due diligence process.

It is important to note that warranties and indemnities given by vendors often are qualified in certain respects:

- Generally they are subject to time limits and last for only a few years, by operation of law and contract;
- Usually they are limited by amount, including a maximum liability under the warranties and an aggregate level of claims;
- The compensation can be incomplete either because of the inadmissibility of the claim or the restrictive method of calculating the damages, as well as the fact that sometimes it is difficult to evaluate the compensation accurately as in the case of loss of brand reputation (which is discussed in detail in Chapter 9);
- There is usually a *de minimis* limit in respect of individual claims;
- Any claim will only be successful if it is conducted in accordance with the requirements for the conduct of claims;
- Claims can be disputed, thereby causing financial and resource loss;
- Even in the absence of a defence it can be costly and time consuming – as well a distracting – to claim; and
- The terms of the warranties and indemnities can be difficult to enforce.

In the light of the above, in many jurisdictions the due diligence process requires the vendor to disclose all relevant information. Such disclosure enables the purchaser to evaluate the target or candidate properly and to negotiate from the perspective of a more even playing field. Therefore the process of the legal due diligence can be used to provide information on the legal affairs of the target. In this context the organisation's compliance and legal risk management is relevant. Such information can, of course, assist in the decision whether or not to go ahead with the transaction and can clarify:

- The assumptions made by the purchaser or agreed with the vendor, for instance the rate of cancellation of contracts by customers;
- The valuation of the target;
- The operational capability of the target; and
- The identification of any adverse factors.



Once the purchaser has such information the process enables options that include:

- Proceeding with the transaction as agreed;
- Cancelling or ‘walking away’ from the transaction;
- Negotiating specific indemnities; or
- Changing the terms of the transaction.

As indicated, an important benefit of the legal due diligence process is that the information reveals how the target has been managed having regard to sustainable risk management. This is very relevant to the overall discussion in the book. It can take account of the background to the target and candidate and its objectives including its chosen structure in the form of a company, partnership or owner/manager operation. It should be understood that whereas many due diligence exercises involve very large transactions there are also many smaller deals that attract the due diligence process and different organisational vehicles (the alternatives available are considered in Chapter 6. While some of the issues in the process are clearly more suited to the larger transaction, others are equally applicable whatever its size. For example, late or inaccurate returns to the authorities such as the Inland Revenue and corporate registries will reflect upon the management of the business. They may also indicate financial difficulties, such as in financial statements lodged late with the corporate registries. Following the transaction the due diligence information can provide an invaluable tool in the ongoing management of the target.

### *Areas of legal risk management in the due diligence process*

Key topics generally covered in the course of the due diligence process have been indicated above. Many competent due diligence professionals have begun to use a more comprehensive due diligence process. They have established a broad range of topics that have to be monitored and reviewed on a continuous basis which can also be useful in the overall context of risk management and corporate governance.

As can also be seen from the discussion in Chapter 11, 21st century technology is the tool that enables continuous or ongoing due diligence relevant to sustainable risk management. These areas include but are not limited to the following:

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#### **Sample topics to be monitored and reviewed**

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Accounting issues	Competitive analysis
Behaviour	Culture
Business organisation streamlining	Customer defections
Business planning	Distribution channels
Business processes streamlining	Employee retention
Change	Environmental issues

*(Continued)*

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**Sample topics to be monitored and reviewed**


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Executive retention	Post-deal planning and integration
Global business operations	Potential market growth
Global partnering	Potential revenue growth
Health and safety	Problem identification
Human resources	Product distribution
Human rights	Product portfolio expansion
Information systems integration and compatibility	Quality assurance and control
Intellectual capital	R&D expansion
Intellectual property	Revenue losses
Internal auditing	Risk management
Interviewing customers	Security matters
Interviewing former employee	Strategic planning
Joint venture partner and other alliance reviews	Strategic questions
Legal contract reviews	Suppliers
Litigation or claims reviews	Supply chain
Logistics costs	Tax issues
Manufacturing	Technology – internet//intranet/extranet
Marketing practices	Technology planning
Operations	Vendors
	Warehousing

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It should be noted that the traditional due diligence process is largely driven from a legal perspective. The legal practitioner typically delivers numerous documents with the goal of being as legally reliable as possible. The legal professional specifically builds a careful legal paper trail, and gathers as much detail as possible regarding the legal condition of the candidate firm. In this regard legal risk management is of obvious relevance. With the benefit of technology the point should once again be made that the 21st century due diligence should prove to be advantageous through ongoing information gathering that keeps the business abreast of its status in terms of corporate governance.

*Sample UK due diligence*

In the UK the typical legal due diligence exercise will cover some or all of the areas listed. As has been noted in this manual the selected checklists can only exemplify some of the general concerns and provide the basic concerns that should be amended to reflect the individual circumstances of the transaction. Therefore, this list does not purport to be conclusive and will require tailoring according to such factors as:

- \* Whether the transaction is a share purchase or asset purchase;
- \* The target's industrial sector;
- \* The geographic location of its activities; and
- \* The size of the transaction.

The principal selected headings are:

- \* Corporate structure
- \* Company secretarial
- \* Corporate acquisitions and disposals
- \* Compliance programmes
- \* Trading activities
- \* Competition law
- \* Personnel
- \* Health and safety liabilities
- \* Pension schemes
- \* Land and buildings
- \* Environmental management
- \* Plant, equipment and other fixed assets
- \* Computer software
- \* Intellectual property
- \* Investments
- \* Lending to third parties
- \* Banking facilities/borrowing from third parties, financial grants
- \* Guarantees/indemnities/letters of credit
- \* Product liability
- \* Investigations, litigation, disputes
- \* Insurance
- \* Taxation
- \* Non-compliance with agreements/change of control
- \* Voidable transactions/reconstructions
- \* Impending legislative changes
- \* Compliance with special industry sector legislation
- \* The effect of the euro on contracts, including payment arrangements

## Beneficiaries of legal risk management and due diligence

Organisations should be aware that, with the ever-increasing pressure from regulators, security exchanges and stakeholders, there are a growing number of beneficiaries of the risk management and due diligence processes. An overlap in functions can occur, indeed when the parties are establishing the methodologies for legal risk management and due diligence tasks it is important that the user of this information is considered. For example, in many places if it is a government regulator, there are specific forms and formats in which data must be presented. It will be very frustrating and more expensive to have to recast the information multiple times just to conform to the regulator's penchant for specificity.

## Practical issues

In the context of this discussion practical examples of combining internal and external activities are joint deals/transactions/joint ventures and other relationships. As has been seen above, for this work due diligence is actually two-sided. Each company within the relationship will have due diligence to perform. Company 1 will want to investigate and examine Company 2 and vice versa – Company 2 will need to assess Company 1. Mergers are especially the subject of a due diligence exercise by each company, their lawyers, their accountants, government regulators (if public companies), insurance advisors, etc.

Bearing in mind the importance of the quality of data the key is to have each due diligence team determine the level of exposure based on what can or cannot be answered. Many deals or negotiations never get past due diligence because there is not enough documentation about the company operations. As with personal relationships, like marriage, the deal can be filled with risk as there cannot be a total investigation just as there is never a complete investigation of the medical, emotional, financial history for each party to a marriage. There has to be a balance that is part of the risk reward formula for all due diligence activities. For example, in the case of a £50 million deal, not being able to verify a £1000 transaction may not be worth the thousands that it takes to validate the transaction.

This is where the experience and capability of the due diligence team is essential. First, they have to possess training and expertise to be able to recognise the important and the unimportant. Second, they need to have the appropriate tools necessary to perform their tasks. The tools can include, but not be limited to:

- Internet research capability;
- Legal databases – especially for lawyers;
- Tax databases – especially for accountants and lawyers;
- Industry perspective and data;
- Access to company personnel;
- Access to all relevant regulations – securities, government, environment, etc.; and
- Appropriate computer and resource tools that support this work.

The presentation of information is also important. Shareholders, investors and stakeholders can be satisfied with accurate and timely information but typically are less concerned with the precision of the page layout. In fact, most would prefer simpler rather than complex information. They may be making decisions about company compliance with a specific regulation, but also they are concerned with understanding the company's ability to survive and prosper.

As indicated the identification of the risk owner is vital. For instance, it is important to ensure that employees are not forgotten in this process. Clerks, middle managers, management and all other related individuals who receive compensation from the company enjoy hearing about the company. Moreover the due diligence exercise can include preparation of reports, without violating the rules of privacy and government regulations.

As the impact of risk management and due diligence continues to expand, companies will rely on the information gathering that can sustain the enterprise, reduce the risk of business activity and reward the various stakeholders.

## Critical factors for successful risk management

Throughout the book several basic requirements should be borne in mind, factors transcending legal risk management and as pre-requisites for establishing an effective risk management programme. These include the following:

- **Commitment at senior level:** it is essential that there is commitment to the programme at the highest level of the organisation. Without the personal commitment of the members of the board or equivalent body, the programme will not become fully embedded throughout the organisation so as to produce the desired benefits. This is often reflected in the delegation of authority for risk management implementation to a particular officer or committee;
- **Consistency:** it is important that risks are evaluated and monitored consistently across the relevant operations. This requires a clear framework for recording and assessing risks, and clear procedures for reporting and monitoring them. Furthermore, an internal programme will be needed in order to explain the approach to be taken and the responsibilities of individuals and groups within the organisation;
- **Communication and feedback:** the key objectives and features of the risk management strategy must be well understood throughout the organisation. The roles and responsibilities of different individuals should be clear and transparent. Information about risks should be shared both upwards and downwards so as to bring about the maximum benefit;
- **Investment of time and resource:** the implementation of a risk management programme requires a significant investment in terms of management time and resource. External advice may be required on particular issues. These costs need to be recognised and planned for. It is equally important to be realistic about the time which may be required to establish the systems required. This may be a matter of months or years depending on the complexity of the systems involved and the nature of the systems currently in place;
- **Continuous improvement and review:** it is vital that the risk management system should be seen as a continuously evolving programme of refinement and adjustment rather than a static framework. It is also critical that there is an effective process for monitoring progress and reassessing priorities. This requires active feedback on risk issues. From SERM case studies it has also been found that the implementation of any risk management system, even if it is imperfect or incomplete, will usually bring benefits over having no system at all. Effectiveness should improve over time with the experience of the organisation. Similarly, the risk profile of an organisation will be in a state of flux corresponding to internal factors (such as changes in the nature or scope of the business) and external factors (such as regulatory changes or an increased threat of terrorist attack). Any risk management system must be capable of reacting to those changes in order to be successful; and

- Culture: the culture of the organisation must support the aim of managing risks in an open and transparent way (see also Chapter 13). Establishing a ‘no blame’ culture which rewards rather than penalises the identification of risks is helpful in addressing commercial or personal pressures which may otherwise tend to inhibit accurate reporting.

## Cultural aspects

The establishment of risk management mechanisms may require a substantial change in the way that an organisation operates; including a significant change in culture (see also Chapter 13). For this reason, it may be advisable to introduce the approach incrementally, starting with one particular function or business unit before extending it to other units and the business as a whole. This will allow the benefits of the approach to be demonstrated more clearly, and the experience and know-how gained in the pilot phases should help reduce any disruption or uncertainty associated with implementing the systems on a wider basis.

## Trends in risk and compliance management

The drivers referred to above (and discussed further in Chapter 3) result in the following trends as organisations begin to build their approach to risk and compliance management:

- The adoption of an enterprise risk management framework: for risk and compliance to be consistently managed, a framework is necessary. In the US, for instance the response to SOX, most organisations have turned to the COSO Internal Control Framework to model their approach to documenting controls. The COSO Enterprise Risk Management framework extended the Internal Control Framework to establish guidance on how to build an enterprise risk management process. It is likely that the COSO ERM framework is poised to be the de facto standard of enterprise risk management;
- Managed and measured compliance: in the past, organisations approached compliance as a project as opposed to a process. In today’s business environment, this opens up significant risk to the organisation. Dynamic business processes, workforces, partner relationships, and IT systems require that compliance be managed and validated on an ongoing basis. As organisations face an increasing amount of compliance obligations, the mandate will come for a formal compliance management programme;
- Tool consolidation and integration: in order to control costs, as well as to provide a single interface into risk and compliance management, organisations will look toward tools that provide a central repository of risk and compliance management functions. This will cover policies, control documentation, assessments and metric reporting. It should integrate with other technologies that take a more granular view in specific areas of compliance and risk (such as information security, privacy, business partner relationships and financial systems);

- Integration into enterprise architecture: risk and compliance must integrate into the business. The controls and measurement of risk and compliance require that they be integrated into an organisation's enterprise architecture. This involves integration of control into policies, operations and technologies that support business processes; and
- The chief risk officer: where an organisation exceeds \$1 billion in revenue and is a critical infrastructure – finance, energy, healthcare, transportation, utility, telecommunications – it will generally have a chief risk officer (or someone of similar responsibility) aimed at managing enterprise risk and compliance. It has been predicted by experts that 75% of large critical infrastructure organisations will have established a formal enterprise risk management office with a CRO or equivalent role.

## Practical hints and tips

Organisations considering a formalised approach to risk and compliance management should:

- Start with one or two compliance/risk initiatives: taking on too much at once is a recipe for disaster. Identify the key risk and compliance issues and let these form the foundation of the risk management programme;
- Keep the enterprise in mind: a too-narrow focus may limit what can be built on the foundation. Make sure that the enterprise requirements are borne in mind;
- Introduce others over time: as it develops, integrate other areas of risk and compliance management into the programme; and
- Ensure business needs drive initiatives: risk and compliance management needs to be driven by the business, not IT (see Chapter 11). Business managers and information owners are the ones ultimately responsible for risk acceptance and integration of controls – they should be involved and part of the process from the beginning in building frameworks and supporting IT solutions for risk and compliance management.

## Governance and regulatory compliance: IT and risk management

From an IT perspective, governance and regulatory compliance today is primarily about data protection, information security and the organisation's general control environment. It can provide essential benefits in risk management and yet also increase certain risks (see also Chapters 11 and 21–23). In today's complex regulatory environment, organisations must:

- Grapple with the complexities, costs and overlaps of governance requirements (Combined Code, Turnbull, Sarbanes-Oxley, Basel 2, etc.);
- Comply with a wide range of information-related regulation, from: the Data Protection Act; GLBA (the Financial Modernisation Act of 1999, also known

as the ‘Gramm-Leach-Bliley Act’); HIPAA (Health Insurance Portability and Accountability Act); PIPEDA (Personal Information Protection and Electronic Documents Act); and the Computer Misuse Act; and

- Deal with an increasing exposure to rapidly mutating, sophisticated threats to their information and information assets. These threats exploit a diversity of technical vulnerabilities in IT systems as well as loopholes in procedures and the behavioural characteristics of employees.

Whereas regulatory and commercial penalties for failing to secure information and information assets can be severe and value-destroying, regulatory guidance on compliance requirements remains very limited.

*Useful web links*

Risk management professional bodies:

Casualty Actuarial Society

\* [www.CASact.org](http://www.CASact.org)

Global Association of Risk Professionals

\* [www.garp.com](http://www.garp.com)

Institute of Risk Management

\* [www.theirm.org](http://www.theirm.org)

Institute of Internal Auditors

\* [www.theiia.org](http://www.theiia.org)

Professional Risk Managers International Association

\* [www.prmia.org](http://www.prmia.org)

Risk & Insurance Management Society

\* [www.rims.org](http://www.rims.org)

Risk & Management Association

\* [www.rmshq.org](http://www.rmshq.org)

Society of Actuaries

\* [www.soa.org](http://www.soa.org)

Society for Risk Analysis

\* [www.soa.org](http://www.soa.org)

*Further reading*

*IT Governance: Guidelines for Directors* provides advice for boards and senior managers on how to approach compliance issues.



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5

The relevance of due diligence

# 5

## The relevance of due diligence

### CHAPTER OVERVIEW

At this stage it is therefore useful to consider the risk management process in the context of other business issues and the general objective to understand the:

- \* Risks and rewards of sustainable risk management;
- \* Repercussions of mergers and acquisition integration and synergies; and
- \* Interaction with due diligence and corporate governance.

Practitioners emphasise that it is important to understand that risk management must not be restricted to looking only within the company. The external environment in which the company operates, hires personnel, deals with suppliers, etc., is a significant component. In this context the term 'environment' is used to group together the elements that support and impact the company.

### Company goals

The mission of any risk management process is based upon verified corporate goals. The goals have to be prepared and be able to be articulated. A statement such as 'we want to compete in the bicycle market' is much too vague and does not provide any support for people who are trying to implement a business plan. Clarity and specificity are much better than vague assumptions and generalities if the business goals are to be understood and achieved. Another important reason for clarity is to enable the risk management team to be able to recognise when the business is heading off course. Falling asleep at the wheel is not a danger if the car is not moving and the keys are in someone else's pocket. However, if the company is moving ahead, falling asleep is not recommended. The objective is not to find reasons and justifications to keep going. While there are always exceptions to every procedure, the more business operations are guided by consistent principles, the easier it is to identify the exceptions and determine

whether this time such exceptions are justified or not. With enough exceptions, the company operations manual needs to be adjusted to embrace them as it is now a standard procedure, not an exception.

There are several key objectives for company operations to support a SERM environment. Sustainable risk management demonstrates:

- The company's business capabilities;
- The stability of the company, the industry and the overall economy;
- The revenue and expense flows for business operations;
- Company support methods;
- Both tangible and intangible risks – business, personnel, economy, environment, reputation, etc.;
- A clear strengths and weaknesses assessment of the company; and
- Specific business continuity issues (see Chapter 8).

As will be seen in case studies referred to in later chapters the SERM approach helps to create the framework that enables companies to operate effectively. While each company, or business organisation, is different, the objectives are typically the same:

- Achieve business goals and objectives;
- Reduce risk to the company;
- Sustain profitability; and
- Improve the quality of life.

## Drivers for sustainable risk management

Some consideration has been given in Chapter 3 to the drivers for compliance risk management and legal due diligence processes mainly in the context of transactions. Mention has also been made of the growing importance of an ongoing internal process that supports the corporate culture and good corporate governance positively. In view of the concerns raised by the high failure integration rate it is useful to summarise in this chapter some of the key drivers and business issues, thereby setting the scene for the chapters that follow.

### External drivers

External drivers have already been noted in the context of the earlier discussion. These include:

- Regulatory issues;
- Company standards;
- Corporate governance issues and trends;
- Investor/lender/stakeholder confidence;
- Consumer confidence;
- Consumer satisfaction; and
- Government compliance issues.

This list continues to expand: what it is essential to understand is how the environment outside the organisation needs to be included within the elements that the risk management process covers. As indeed, risk owners need to access where this information can be gathered on a continuing basis. SERM has found certain external information to be of practical value. For example, trade associations are a good source for this information. The data collected can be used to compare the company operations with other companies, other industries and other countries.

## Internal drivers

These have also been touched on earlier and include:

- Worker satisfaction;
- Management satisfaction;
- Supplier relationships;
- Operational procedures;
- Operational implementation; and
- Multi-office relationships.

While this list is more bounded than the external list above, it does not mean that any of this information has limits and is exhaustive. As regards internal issues, risk management needs to be attentive to the results of interactions among works and management. Proper implementation requires overall coordination and consistency by the people who are empowered to perform the various tasks. For example, if in a transaction a bookkeeper is allowed to change the data of a sale entry unilaterally without any transaction trail, then chaos could result. There could also be a problem that could lead to fraud and/or the commission of criminal acts. Exposure to such risks is not what business wants and supports the appropriate use of due diligent activities.

## Risks and rewards of risk management: integration value post-merger

One of the most risky activities undertaken by an organisation is a transaction that involves a close relationship with another organisation, such as a merger or joint venture. In this era of heightened pressures for risk management and corporate governance it is important to assess the real value once the deal has been done, having regard to the growing number of stakeholders. Despite the many processes that may be in place and the detailed checklists that have evolved in commercial circles the question is often raised: do organisations try to gain value from acquisitions? This analysis of risks and rewards is relevant to the SERM process. For decades commentators have asserted that the majority of acquisitions and mergers do not deliver shareholder value. Research by McKinsey's in 1998 concluded that around 60% of mergers fail in financial terms. In an earlier study in 1987, Harvard's Michael Porter highlighted that 58% of acquisitions were later divested

due to underperformance. Other commentators have noted that 70% do not deliver intended value. Whatever is the actual figure today there is no doubt that it will also be high.

**Key questions:**

- \* Why is acquisition integration effective – which is the method whereby the paper strategy begins to realise value?
- \* Why are targets chosen wrongly in the first place?
- \* Is the problem that doing the deal is seen as the conclusion to the merger rather than the beginning of the process of integration?

The issue of integration is an important area and key business issue. It is critical as regards ongoing risk management and has implications for risk culture. It is clear that in the deal, the momentum, pressure to close and limited time to assess information can result in decisions that will seriously impact the ability to integrate in the longer term. This can range from operational detail through to more organisational concerns such as the loss of tacit, codified corporate knowledge that lives in the heads of key personnel that have been lost. A further example is in IT where often only the most basic inventory of physical hardware is undertaken, when programming skills and long-term single-source service deals may in fact be the critical factors to consider.

## Need for synergy

In all these areas advice and assurance are required to enable the ability to retain and modify key assets post-merger. One significant issue is to anticipate the effect on integration that contractual financial arrangements, remuneration practice and other obligations will have.

In the 1970s and 1980s, acquisitions were generally typified by the conglomerate approach: acquired companies were viewed as assets to be financially engineered to improve profits, and often a diverse set of companies was brought under one corporation to achieve a diversified portfolio. As such, acquired targets were often only integrated to the extent of a financial reporting manual. Today, such an approach actually attracts a ‘conglomerate discount’ from analysts evaluating the share price of firms – shareholders can create a diversified portfolio of companies themselves. In the 1990s, the concept of related diversification by acquisition has been touted as a more effective route to wealth creation. That is, for effective acquisition, acquirers should bring a synergy to target firms that will create more value than the previous entities when they were not combined. Such synergy may be brand image, manufacturing know-how, physical asset overlap, R&D skills or just pure economies of scale. The merger of Mercedes-Benz and Chrysler in the automotive

industry is an example of an attempt to achieve synergy in terms of global presence, range of vehicles offered and manufacturing and purchasing know-how.

In reality, accessing true synergy in acquisitions means that:

- The acquirer is fully aware of the depth and breadth of its core skills;
- It is similarly aware of the target's; and
- There is always a clear and focused set of acquisition objectives for integration post-merger that will create new wealth from an optimised combination of assets whether intellectual, physical or informational.

The objective of synergy can lead to a potentially vast and complex web of practical detail that ongoing sustainable risk management can assist with.

## Successful acquisitions and competitive advantage

In the earlier times of conglomerate acquisition financial control was often the only overlap that had to be managed. However, when a 'synergistic' acquisition takes place marketing, manufacturing and IT functions may also have to be combined. Thus the risk and complexity of the acquisition is much higher.

Yet, as is clear from the chapters that follow, this risk and complexity, however daunting, is a vital area of corporate life that has to be managed effectively. There are a number of reasons for this. At the strategic level it is likely that the ability to achieve successful acquisition will become a competitive advantage as corporations look more and more to this method of accessing growth and differentiation.

## Tactics and price

When considering sustainable risk management at the tactical level in any transaction, the actual price paid for a target firm should reflect the proposed synergies to be achieved. One acknowledged method of looking at the price of any target is:

- The fair market value of the firm;
- Add or subtract any applicable premia or discounts; and
- Add the perceived operational synergies created by the merger.

If such synergies are not a major factor, then the process is merely asset capture – the purchase of an ongoing business's revenue stream – and the price paid should reflect this. If synergies are a major factor in price determination, then the realisation of post-merger synergies should be a priority for business managers. It is important not to pay a premium for intended synergy and then not integrate properly to get the value and the benefits paid for in advance. In a sense this is a double blow for shareholders and other parties involved. A premium is paid for the target firm above true market value – if integration does not then follow, the price paid has been too high, and the intended synergies have not materialised: investors lose both ways. Organisational and strategic

research has led to the conclusion that unsuccessful or piecemeal integration often leads to M&A failure.

## Integration options

When considering risk management the question is whether organisations find that acquisitions become too difficult, and that asset capture remains the easiest and most worthwhile route – irrespective of whether or not this affects the overall success of the acquisition. There has been extensive research carried out in various jurisdictions. For instance, some answers are available from work that studied all UK acquisitions in the period 1991–1994. The study ('The acquisition challenge – realising the potential of your purchase, D. Angwin and R. Wensley, Warwick Business School Paper, Vol. 1, Number 4, 1997) used a framework which usefully highlighted the different types of integration undertaken by acquiring corporations, as follows:

- Absorption: full integration of the acquisition by the buyer;
- Preservation: where the acquisition is not integrated at all and held at arm's length;
- Symbiotic: where there is mutual dependence (but not integration) between the two companies; and
- A fourth option – holding – is also discussed which indicates that the acquired company is held to be (possibly) traded at a later date.

It has been argued that the simplest way to view these four alternatives is to note that they are separated along two dimensions: the amount of resource transferred and the degree to which the acquired company is left independent or not. Data has shown that over three-quarters of the companies studied had not attempted to integrate resources significantly. It was concluded that this was due to the inherently difficult nature of integration – and hence risk – and in terms of acquiring good performing assets the instinct was not to 'contaminate' the good work for risk of harming performance. The stark conclusion is that in the 1990s in the UK most acquisitions were of a 'purchasing asset' variety involving little or no transfer of resources between buyer and target.

## The best option

Although evidence has revealed that only in a minority of cases does extensive integration appear to occur, and several key changes do happen in all acquisition types. The most common changes are ones that are symbolically important, signalling progress to staff and the market. Management changes, financial reporting changes and communication changes are all quick to occur. Changes that are relatively easy to accomplish, and have high impact such as senior staff movement, will be pursued first. Longer term (if at all), the more complex areas, such as site rationalisations and IT systems, will be tackled. Accordingly, given the focus on share price and City evaluation that drives much business strategy, for instance, in the UK – not least because of the share options link between



senior management and company stock price – acquisition integration tends to focus on early indications of success which is a less risky and preferable approach to a longer-term – and more costly – involved integration which may take time to signal success.

As regards sustainable risk management, in the long run, the early win approach may be detrimental to value. If the acquired target is not brought into the wider corporate structure and is left to continue much as before, it is unlikely that the acquirer will have accessed that premium that was paid for in the deal. This may well be part of the reason for the number of divestments that have to be undertaken.

The fact that the above study was conducted in the UK means that the stock market impact on managerial action will inevitably be a major factor, as it will be in the US as well – that is jurisdictions with highly active and liquid stock markets. It has been suggested by risk and market commentators that it may be that in European or Asian countries, with more conservative bourses, the focus on short-term delivery is less intrusive. Indeed this may facilitate more measured analysis and implementation of integration. Some comparative analysis would be useful. True value creation from acquisitions therefore appears to be only pursued in a minority of actual instances – a clear opportunity for genuine wealth creation therefore remains.

## Priorities

Many texts exist on how to integrate successfully with descriptive guidance along the following lines:

- Communicate thoroughly with all employees;
- Set clear objectives and initiate appropriate organisational change;
- Have clear milestones;
- Ensure normal business is not hampered; and
- Act quickly to avoid losing momentum and enthusiasm.

There is evidence to suggest that post-merger synergy may not be a primary objective at all – competitive reaction, revenue capture for growth or other strategic issues may actually dominate, and require that resource is only expended on specific areas.

Whatever the case, merger activity in the UK has indicated that the integration issue is receiving more attention. For example, when interviewed about the merger of Price Waterhouse and Coopers & Lybrand, the integration manager noted a simple but insightful point about the ‘grubby details’: ‘The two firms bill their clients and do their time sheets differently. It will probably take two years to sort all that out, and it’s going to take a huge investment.’ This is a realistic assessment of the kind of effort required and highlights the reality that even with best intentions it is often very difficult in the short term to make significant progress in certain areas – a realistic and flexible evaluation of these areas could ensure expectation about progress is managed.

## Cultural integration

Integrating the culture of two combining firms (often given high profile in merging episodes both in the literature and by management) is very likely not to occur much beneath the surface in the timescale of integration – irrespective of what literature best practice advises. In many instances even after several years a parent culture tends to linger with many individuals. It might be better to realise that the cultures will continue to have a certain flavour, and that this is either acceptable, or if it is not a change-out of key staff may have to occur. In any event, a fundamental review as to how important this is actually going to be should be undertaken. If it seems manageable but resource consuming, this fact should be reflected in the purchase price. Cultural issues are worthy of a separate debate (preferably in a separate manual) and are considered to an extent in Chapter 13.

It is clear that, if attempted, extensive post-merger integration will often be a difficult and time-consuming task. It therefore would seem to make sense that as part of a negotiated target price this investment in resource and time be used to counterinflationary premia for the target firm. This addresses in part the problem of shareholder value return – and in fact may be a salutary action to undertake in terms of assessing how viable the wider acquisition or merger will actually be.

### *Role of lawyers*

In-house lawyers are often key players in determining the strategy and implementation of acquisitions and so it is important that they can provide guidance to their colleagues on the importance of effective integration. Furthermore, when advising on a transaction, both in-house and private practice lawyers need to be aware of the buyer's purpose for making the acquisition, and integration will be a factor in this. This will influence the due diligence, the transactional documentation and the negotiations. For instance, the purchase of a service sector business, such as an insurance brokerage, will involve a different set of legal analyses and transactions if the personnel are not being acquired.

The experience and capability of the due diligence team is essential. First, they have to possess training and expertise to be able to recognise the important and the unimportant. Second, they need to have the appropriate tools necessary to perform their tasks. The tools can include, but not be limited to:

- Internet research capability;
- Legal databases – especially for lawyers;
- Tax databases – especially for accountants and lawyers;
- Industry perspective and data;
- Access to company personnel;

- Access to all relevant regulations – securities, government, environment; and
- Appropriate computer and resource tools that support this work.

As legal risk management and ongoing due diligence continues to expand, companies will rely on the information gathering that can sustain the enterprise, reduce the risk of business activity and reward the various stakeholders.

The plain facts are, however, that often mergers and acquisitions provide such a strong momentum of their own that it tends to sweep aside all but the most obvious of post-merger integration considerations. In order to realise the objectives of good corporate governance and to achieve realistic purchase prices, and fully access post-merger value, these aspects should be prioritised before rather than after the event.



# 6

Risk and corporate organisational  
areas: an overview

# 6

## Risk and corporate organisational areas: an overview

### CHAPTER OVERVIEW

This chapter considers the issues of choice of organisational vehicle bearing in mind the trends and drivers that have been discussed in previous chapters. In recent years there has been greater flexibility in the available options, these depend upon the priorities and objectives of those setting up an organisation. This is a vast subject that could be discussed in very great detail and there are many texts covering the risks and opportunities that are involved in setting up, for example, a company, which remains the more likely choice for commercial projects or entering into a partnership.

Moreover the factors can vary depending upon the choice of location. Therefore in this chapter the circumstances in the UK are selected as a case study, having regard to the topical debate that has developed over the extent of directors' duties in the context of the Bill dealing with company reform (see also Chapter 21). This area has also been considered in the handbook *Due Diligence and Corporate Governance* (2004/2005) by L. Spedding.

### The choice of vehicle and structure and liability in business

It has been noted that in order to be fully effective, the management of risks should be integrated across the business. In other words, the assessment and treatment of individual risks arising in connection with one part of the business should form part of a programme for addressing risks generally across the organisation. This is because the effect of different risks can be multiplied if they occur simultaneously. For example, the effect of the failure of IT systems may be compounded if it coincides with the launch of a new product or service. An effective risk management strategy should recognise and address those inter-relationships.

Similarly, the management of risk must be integrated into the processes and policies for managing the business as a whole. It should be used to inform decision making alongside more traditional information such as financial

performance. The impact of risk management techniques will be undermined if they are not consistent with the approaches and policies applied elsewhere in the organisation. For example, a risk-based methodology for pricing projects with potential long-term liabilities may have little effect if it is contradicted by remuneration policies which reward short-term financial performance on the part of particular individuals or units.

It should be emphasised once again, that the ultimate objective is risk management, not necessarily the elimination or reduction of risks. A systematic analysis of risks and how they are currently managed in a business may indeed indicate that risks are being overcontrolled. The operation of controls in a disproportionate manner may have disadvantages, not only in terms of the incurring of unnecessary costs, but also the loss of the flexibility to take advantage of opportunities. This may be particularly relevant in situations such as competitive tenders for new business, where an over-rigid set of controls may inhibit the organisation from responding quickly enough to allow success.

Whereas certain aspects of this discussion assume that the reader is a larger and more advanced business entity that has been in operation for some time it is as well to recognise also the core decisions that must be made in the business environment in order to establish a vehicle that suits the choice of operations. Moreover, as is seen in other chapters, such as Chapter 11 regarding e-commerce, it is important to recognise the legal status of any party that the business deals with. A brief analysis of the advantages and disadvantages of the available business vehicles is therefore useful at this stage of the book. This decision can be one of the most important management decisions that can be made. The discussion focuses on the circumstances in the UK largely in the context of a comparison that can be made under other jurisdictions. As a case study it should be noted that practical issues, such as the appointment of a finance director at an increasingly early stage and the appointment of non-executive directors (NEDs), should also be considered as early as is practicable bearing in mind recent trends and requirements. While the choices and decisions made may not remove risk or liability (see below) they can mitigate repercussions.

#### *Governance and the balance of interests*

Regardless of the choice of vehicle and whether or not the organisation operates in the profit or not-for-profit sector (see further below), as has been mentioned earlier, one of the main drivers for risk management is the trend toward increased regulation and operating standards. Indeed, it is interesting to note that as the business world shrinks and the speed and amount of information grows, transparency is the keynote of the day. This is true of all businesses, whatever their size or place of operation. Moreover the number of interested parties is on the increase as the use of technology enables access to information in a much more cost-effective manner. As this book emphasises it is advisable for small businesses also

to take appropriate steps in risk management (see also concluding section below). They must also bear the impacts of such matters as:

- \* Data protection laws;
- \* Product liability legislation;
- \* Health and safety regulations;
- \* Environmental requirements; and
- \* Comprehensive EU developments (increasingly important with the EU enlargement programme that has meant a union of 25 countries since May 2004 and 27 since January 2007).

## Risk management

As is discussed elsewhere in this book in more detail (see also Chapter 21) in the UK a great deal of guidance has been prepared over the past 20 years or so to encourage boards to take accountability seriously. The final guidance prepared by the Internal Control Working Party of the Institute of Chartered Accountants in England and Wales, chaired by Nigel Turnbull, entitled 'Internal Control: Guidance for Directors on the Combined Code' and produced in September 1999 (available from [www.icaew.co.uk](http://www.icaew.co.uk)) has notable impact for risk management. This final guidance suggested that when determining policies relating to internal control, the members of the board should take into account the following factors (taken from paragraph 17):

- the nature and extent of the risks facing the company;
- the extent and categories of risk which it regards as acceptable for the company to bear;
- the likelihood of the risks concerned materialising;
- the company's ability to reduce the incidence and impact on the business of risks that do materialise; and
- the costs of operating particular controls relative to the benefit thereby obtained in managing related risks.

The board therefore faces two key issues. These are:

- To ensure all employees have some responsibility for internal control; and
- The system of internal control is such that it forms part of the operation and culture of the company.

Once these controls are in place, it is then the responsibility of the board to review the effectiveness of the internal control system. In reporting on this issue by way of the annual assessment, the board should avoid paying scant regard to this duty by merely adapting statements used by other companies. List checking is not sufficient. Although the guidance may not always be mandatory for a board to observe, nevertheless it does serve a function in a legal context. The guidance, while not as such having legal status, will normally be

considered as evidence of what is considered to be best practice. Whether a board of directors fulfil their collective and individual responsibilities will be determined by a standard of care set by a judge, who will in turn take into account best industry practice, which will include the type and quality of guidance that is available. As a result, directors cannot and should not ignore the guidance that is widely accessible. Moreover listed companies are now facing more and more mandatory requirements, supported by guidance, as is mentioned in other chapters.

## Evolving board responsibilities

As the above section demonstrates the business world in which we live does not remain static. In addition to the debate over financial transparency some other earlier examples relevant to due diligence and corporate governance also demonstrate how the complex regulatory framework has developed. For instance, in England the Victorians adjusted to the rapid developments that occurred in business structures during the nineteenth century by providing for the incorporation of companies. This meant that the company became a separate legal entity, and the concept of limited liability developed (mentioned in Chapter 4). These early developments were adjusted over time by Parliament, as politicians reacted to the scandals and criminal acts perpetrated by various individuals within companies periodically, as well as the perceived deficiencies in the protection of investors or attempting to prevent fraudulent activities occurring. Major Acts of Parliament and piecemeal amendments relating to companies have been adopted from time to time over the past 150 years.

It is important to bear in mind that, whatever the legal environment that boards have to work within, directors are required to provide leadership and guidance to the company. In this capacity, as has been seen in other chapters in this book, it is always incumbent upon directors to be aware and to take stock of the operating risks to ensure the company is prepared for the future.

### *Role of regulation and best practice*

In terms of managing a business, it has been seen that the sticks and carrots operate on a continuum: politicians provide for legal structures on the one hand, which companies either ignore or are ignorant of, while best practice operates at the other end of the continuum. Best practice is encouraged through guidance from various bodies, and is used by some boards when discharging the majority of their responsibilities.

## The English legal framework

In March 1998, the British government set out, in the paper ‘Modern Company Law for a Competitive Economy’, its intentions of taking a broad approach to



review the framework of company law. A consultation document was subsequently issued in March 2000, entitled ‘Modern Company Law for a Competitive Economy: Developing the Framework’ by the Company Law Review Steering Group (which was available from [www.dti.gov.uk/cld/modco-law.htm](http://www.dti.gov.uk/cld/modco-law.htm)). The trial draft statutory statement of directors’ duties comprised the following:

- Compliance and loyalty;
- Independence of judgement;
- Conflict of interest;
- Fairness; and
- Care, skill and diligence.

This section is particularly concerned with the last item on the list, and the consultation document went on, at page 31, to propose that:

A director must exercise the care, skill and diligence which would be exercised by a reasonably diligent person with both the knowledge, skill and experience which may be reasonably expected of a director in his position and any additional knowledge, skill and experience which he has.

While this consultation document was open to discussion, the Home Secretary decided to take separate action with the introduction of new legislation relating to involuntary manslaughter. While this aspect of the law need not worry the majority of directors, nevertheless, for those directors with responsibilities that are inherently dangerous (shipping: *Herald of Free Enterprise* 187 deaths; *Marchioness-Bowbelle* 51 deaths; railways: King’s Cross 31 deaths, Clapham 35 deaths, Southall 7 deaths, as well as Paddington and Hatfield; oil fields: Piper Alpha 167 deaths), it is a factor to keep in the forefront of thinking when directing the affairs of the company.

Bearing in mind the book’s discussion of sustainable risk management the debate over responsibility and corporate manslaughter provides a useful case study for the present chapter.

## Corporate manslaughter: a case study in risk

The area of corporate manslaughter has been very controversial as regards the future of risk management. The paper, published in May 2000, and entitled ‘Reforming the Law on Involuntary Manslaughter: The Government’s Proposals’ (available from [www.homeoffice.gov.uk/index.htm](http://www.homeoffice.gov.uk/index.htm)) set out the government’s intention to clarify the law on corporate manslaughter. The proposed legislation was based on the Law Commission’s Report No. 237, *Involuntary Manslaughter*, published in 1996. The Law Commission recommended the:

- Abolition of the offence of involuntary manslaughter;
- Replacement by two new offences of ‘reckless killing’ and ‘killing by gross carelessness’; and
- Creation of a special offence of ‘corporate killing’, broadly similar to the individual offence of killing by gross carelessness.

In introducing the offence of corporate killing, the government intended to cover a wide range of circumstances in which deaths occur, including those on building sites and in factories. Examples of the few companies that have been prosecuted for manslaughter under English law are: OLL Limited, Jackson Transport (Ossett) Limited and Roy Bowles Transport Limited. All of these were small companies, and in the Dorset canoe tragedy, the company comprised a single director. The government's aim was to provide a legal basis for ensuring that prosecutions were more successful than they have been in the past. It is therefore incumbent on directors to ensure they take appropriate action to manage the risks their company face in order to avoid possible culpability in the future. They should be aware that the responsibility is both personal and collective. The legislative area is clearly an issue that directly concerns corporate governance and requiring proper monitoring.

## The business vehicle

It is easier to set up a business organisation in Britain than in most industrial nations. Whether or not the business prospers is another matter, but it is unusual for bureaucracy to be the cause of failure. Getting the structure in place can be remarkably simple. In this section we consider briefly which business structure is most appropriate for the contemplated or existing business, with particular emphasis on how to limit or reduce personal liability for business mistakes or business insolvency.

At the outset we should consider the sort of circumstances that might lead to personal liability on the part of the trader and place his or her personal assets at risk. It probably goes without saying that dishonest or reckless conduct by the trader in the course of his business, whether or not as a sole trader, partner in a firm or company director, may well lead to a personal liability for losses suffered by others as a result. Being honest and conscientious, however, is no guarantee that personal liability will not arise. As is well known, experienced, skilled and careful drivers are likely at some time to make an error of judgement or suffer a temporary suspension of concentration. The consequences can be fatal and expensive. An otherwise unblemished driving record might persuade the magistrates to be lenient, but it is unlikely to reduce civil liability for death, injury and physical damage resulting from driver error. It is no different in business. The one-man financial advisor who unwittingly gives what turns out to be bad advice, the restaurateur whose suppliers supply sound looking but contaminated food that is served to a customer and the international auditing practice who failed to uncover a fraud buried deep in the accounts may all be at risk.

As regards listed companies, the primary exercise by shareholders of their right to participate in the governance of their corporation or organisation is in connection with election of the board of directors. Specific information is required in connection with the election of directors. This includes, for each person nominated for election by the shareholders:

- Their age;
- Business experience over the last five years;

- Directorships of other listed companies;
- Any position they have had with the company;
- Any understandings with others related to their selection as a nominee;
- Legal proceedings where the director's interests are adverse to the company's;
- Any bankruptcies of companies they were executives or partners of;
- Various types of legal proceedings they have been involved in; and
- Indebtedness, financial transactions or other relationships with the company.

Bearing in mind the Higgs Review in the UK regarding the role of non-executive directors (NEDs) the appointment of NEDs is becoming more sensitive as the level of responsibility and integrity is raised. Moreover, whereas the review was aimed at large businesses, advisors have noted that, as with other regulations and standards relevant to ongoing due diligence and good corporate governance, there are impacts also on small business. The increased risks and the growing vigilance of shareholders, as well as other stakeholders, means that a proactive approach can assist business performance, whatever the size of the organisation. Being careful is advisable, but it is not enough. How risk can be reduced will depend to some extent on how the business entity is organised. The more common alternatives are considered briefly below.

## The limited liability company

Unlike setting up as a sole practitioner or as a partner in a firm, establishing a limited liability company requires a certain formality. It has become a common business vehicle in the UK. In essence the nature of a limited liability company is that:

- It is a legal 'person' and is regarded in law as existing entirely separately to its shareholders and directors. It is the company that carries on the business not its directors, officers or owners;
- It is owned by its shareholders. The business of the company is under the control of its directors, who may or may not be its shareholders, and who are appointed by the shareholders;
- The personal liability of the owners of the company (the shareholders) to those with whom the company comes into contact is (with few exceptions) limited to what is owed by the shareholders for shares in the company which they have taken up but for which they have not yet paid; and
- Although the shareholders appoint the directors, they have very limited control over the day-to-day running of the company (subject to the comments above).

If the company incurs liabilities which it cannot meet from its own resources, the circumstances in which the shareholders or directors will be called upon to make up any shortfall are very limited provided the loss has not been brought about through the dishonest activity of the shareholders or directors. There are exceptions to this rule. For example, directors may be personally liable for unpaid income tax and National Insurance contributions which have been collected

from employees but not paid over to the authorities. The tendency over the years has been to increase the circumstances in which directors' personal liabilities may be involved by increasing legislation intended to ensure good corporate management (see also Chapter 21). Compared to partners in traditional partnerships, company directors and shareholders are much less exposed. Directors' liability insurance is generally available.

A limited company is a vehicle born of statute. It owes its existence to the due observation of procedures required by the Companies Acts. Its formation and constitution is a matter of public record. Companies are required to keep and file up-to-date information concerning the shareholders, directors, location of registered office, etc. Companies are also required to file accounts each year showing turnover, profit and loss, etc. All this information becomes a matter of public record and can be obtained by any member of the public making a search at Companies House or via the internet where information can be downloaded or faxed to the applicant on payment of the appropriate fee.

The structure and operation of the company will be determined by its Memorandum and Articles of Association (its charter), by the Companies Acts and by the great body of law that has come into being over the years since the concept arose of a business organisation existing independently of its members.

Despite the due solemnity which necessarily accompanies the formation of a company, a new company can be purchased for something like the cost of a colour printer for a PC. Company formation 'agents' will sell you a 'ready made' company 'off the shelf' that is a company which has already been incorporated with temporary shareholders and directors and is available for instant transfer to its new owners. They will arrange for the temporary directors and shareholders to withdraw so that the new directors and shareholders can take over. You can walk in, buy the company over the counter and start trading immediately. You can also arrange to change the company's name to something more to your liking which will usually take a few days. Alternatively, if you are not in a desperate hurry, the formation agent will make a 'bespoke' company according to your requirements and with the name of your choice if that name is available. Solicitors and accountants also use the services of company formation agents. You can of course buy a company elsewhere that has already traded and may already have an ongoing business.

Private companies (identified by the word 'Limited' or abbreviation 'Ltd' or its Welsh equivalent 'Cyfyngedig' or abbreviation 'Cyf' at the end of its name) are not allowed to offer their shares to the public. If the business of the company succeeds and outside capital is required, it may be appropriate to transfer the business of the company to a public limited company (whose name will end in 'Public Limited Company' or 'PLC') but that is beyond the scope of this chapter.

Limited companies also have their less obvious uses. Leaseholders in a block of flats who decide to exercise their collective right to acquire the freehold may arrange for the freehold to be held by a limited company in which each leaseholder becomes a shareholder. Ownership of the freehold by a limited liability company provides a democratic structure with all the protection that is provided by company law. Charities or clubs may also be incorporated

into a company although a variant form is usually used – the company limited by guarantee. Such a company has no share capital and therefore no shareholders. It has a board of directors (or trustees) who operate the company and whose personal liability is limited to a predetermined (and perhaps nominal) sum, which is the extent of contribution that can be called up in the event of the company being unable to meet its liabilities.

The company can limit its own liability and the risk of liability in the same way as a partnership, but the owners' and directors' personal liability for the debts of the company are already limited. Shareholders should take care who they appoint as directors, and the directors should police each other.

## The Limited Liability Partnerships Act

As a result of recent UK legislation there is a further alternative: this is known as the limited liability partnership. It is important that small business representatives and their advisors should be aware of the alternatives in practice having regard to today's climate of proper transparency and corporate governance.

The Limited Liability Partnerships Act 2000, which became law on 6 April 2001, created the business entity called the limited liability partnership or LLP. The Act is much more accessible than many other legislative instruments. It is unusually short, consisting of 19 sections and a schedule. These cover the core characteristics of the LLP, including:

- The requirements for incorporation;
- Membership issues (including, becoming and ceasing to be a member);
- The LLP agreement;
- Taxation;
- Regulation and definitions;
- Commencement; and
- Application.

The implementing regulations are the Limited Liability Partnership Regulations 2001.

## Main characteristics of the LLP

The LLP is a body corporate with separate legal personality. It has unlimited capacity. It is the LLP which carries on the business and which is the subject of the duties and liabilities of the business. On the winding-up or dissolution of the LLP the liability of its members to contribute will be limited to whatever has been agreed in this respect. Every member of an LLP stands as an agent of the LLP, subject to some exceptions. The individual members of the LLP are protected by the LLP from personal liability for both their own acts and those of their fellow members.

In order to incorporate an LLP there must be two or more persons associated for carrying on a lawful business with a view to profit, and they must subscribe their names to an incorporation document. The two persons may be

natural persons, bodies incorporate, trustees or partnerships and they may reside anywhere in the world. In order to incorporate there must be at least two designated members or provision that every member is to be a designated member (see further below). The incorporation document is delivered or submitted in paper form to the Registrar of Companies. The approved form of incorporation document is Form LLP2, which sets out a clear format for disclosing the information prescribed by the Limited Liability Partnerships Act at the time of incorporation. The LLP2 must provide:

- The name of the LLP which must end with ‘Limited Liability Partnership’, ‘llp’ or ‘LLP’;
- The legal domicile of the LLP, such as England and Wales or Scotland;
- The address of the registered office of the LLP;
- The name and address of each member of the LLP; and
- The details of the designated members.

A well-drafted written LLP private agreement should also be formulated which, unlike the memorandum and articles of a company, is not a public document (see further below).

## Designated members

The designated members have the duty or responsibility to ensure that the LLP should meet its disclosure obligations under the Limited Liability Partnership Act. As it is a vehicle with limited liability the LLP is also subject to the compliance regime or requirements of the Companies Act 1985. Therefore, like a private limited company, the LLP must file an annual return and statutory accounts with the Registrar of Companies at Companies House. In addition an LLP is similarly subject to the provisions of the Insolvency Act and the Company Directors Disqualification Act. Accordingly members of an LLP are subject to potential personal liability under the provisions of the Insolvency Act relating to ‘wrongful trading’. They are also subject to disqualification under the Company Directors Disqualification Act in the same way as company directors.

## Comparison with UK private limited company

The LLP differs from the UK private limited company in three important ways:

- An LLP can establish the decision making and profit distribution arrangements more or less as the members wish. Whereas certain other provisions of the Companies Act 1985 apply, the LLP is not subject to the strict rules concerning share capital, the management of companies, as well as the meetings and resolutions that govern companies;
- Unlike a company there is no distinction built into the structure of an LLP between the roles of proprietors and management. In effect this means that the decision making and profit distribution arrangements are a matter for private agreement. These should be set out in a written LLP agreement that is a

private agreement and not a matter of public record. It is important to understand that in the absence of a properly drafted agreement the default provisions that are contained in the LLP Regulations 2001 apply and lead to unforeseen and unwelcome repercussions; and

- Unlike a company, which is a separate fiscal entity, a UK LLP is what has become known as a fiscal transparency.

## Fiscal transparency

Essentially Section 10 of the LLP Act 2000 provides that a trade, profession or business carried on by an LLP shall be treated as though carried on in partnership by its members. This means that the members of an LLP are taxed under the self-assessment rules as if they were partners in a partnership. Therefore, like a partnership under UK law, the LLP is fiscally transparent. There is no taxation at the entity level. Profits and losses flow through the members themselves, subject to the important caveat that such transparency is lost if the LLP goes into insolvent liquidation or is wound up for a tax avoidance reason, that is avoidance of UK taxation. This fiscal transparency is very important in the context of tax planning. It means that, in view of the fact that the LLP is not required by law to have UK resident members (whether individuals or companies) the LLP has significant application for cross-border trading arrangements.

It should be noted that in the case of a UK LLP with non-UK resident members UK taxation is only chargeable on profits derived by such a member if either the profits are derived from a trade subsisting in the UK or if the profits otherwise have a UK source. There is no single test to establish whether or not a trade is exercised in the UK and this aspect can be examined in more detail in another article. Moreover the examples of UK source income can similarly be considered in a separate article. For the purpose of this discussion it is, however, important to bear in mind the principle of fiscal transparency in the context of risk management and sustainability.

## Investment activities

One question that is pertinent is whether a UK LLP can function as an investment vehicle. This could happen, for instance, in the case of shares held in a non-UK company with a view to receiving dividend income or realising capital gains. The tax transparent nature of the LLP is based upon the LLP carrying on business with a view to profit. The issue is whether the conduct of a pure investment holding function is the carrying on of a business. This can also be considered on another occasion, along with consideration of the LLP as a potential tax planning vehicle.

## Comparison with limited partnerships

The limited partnership is a long established alternative structure as compared with the LLP. It was created by the Limited Partnership Act 1907. Like an LLP

a limited partnership is fiscally transparent. However, the characteristics can vary to a small or large degree depending on a particular case and the needs of the founders. As with LLPs the limited partnership can be subject to English or Scottish law. It should be noted that under English law the limited partnership has no separate legal personality whereas under Scottish law it does.

Important distinctions arise relating to the principal place of business and the filing of accounts. However, to discuss these in further detail is beyond the scope of this chapter, but the fact that such distinctions exist should be noted. In an age of increasing disclosure requirements the transparency of the LLP may prove to be a useful advantage.

There is some evident value in understanding the nature of the LLP as an alternative to other more traditional vehicles. Its existence may provide a commercial and tax efficient opportunity for small business depending upon the objectives of the members. Having regard to today's highly sensitive regulatory and business requirements relating to corporate governance the LLP may enable a viable choice for small business representatives to consider subject to, of course, any professional advice taken and their individual needs and circumstances.

## The partnership (firm)

It is still more usual to find that when two or more traders decide to combine operations and share assets they may form a partnership which lawyers, but not everyone else, know as a firm. Alternatively, they may (for example) like doctors in a group practice or barristers in chambers work together only in the sense of sharing accommodation and overheads while continuing to trade or practise as individuals. In the latter case, they remain sole traders. A partnership is rather like a marriage. It can be easily formed. It can quickly and easily be dissolved, but the consequences of dissolution can be far-reaching. The distinguishing feature of a partnership is that each partner, no matter what his or her personal share of the partnership assets and business is personally liable for the whole debts of the partnership. Again, that means personal assets, not just partnership or business assets. This means that if Mark and Jane set up a partnership together and Mark runs off with a client's money, or gives bad advice as a result of which the client suffers recoverable loss, the disgruntled client may look to Jane for the whole of his loss. This applies even when the client had never previously had any business dealings with Jane within the partnership and when it is clear that the cause of his misfortune is Mark. If Jane has to foot the partnership bill she will have recourse against her partner (according to how the partnership is set up) but if he has disappeared or is penniless, that will be of little comfort. Perhaps then the first rule of risk management in a partnership is, like a contemplated marriage, to choose one's partner (or partners) carefully.

## Key features of a partnership

A partnership can be created at will. While it is advisable to have a partnership deed spelling out the structure of the partnership and, in particular, the



personal liabilities of the partners towards each other in the event of partnership insolvency, the partnership can come into being without any formality whatsoever. Each partner places his personal assets at risk in entering into a partnership. In these circumstances one wonders why this form of business entity should ever be adopted. It has the advantage of great simplicity and that is perhaps its primary attraction. However, some professions (for example, solicitors) have for many years been obliged to conduct their business either as sole traders or partners. The theory behind not allowing some professions to limit liability by incorporation is that it keeps the practitioners 'on their toes' and by preventing 'outsiders' from participating in the profits, keeps the practice in the hands of the professionals. With compulsory insurance to compensate for losses, this obstacle to incorporation has increasingly been regarded as outmoded and now one often sees professional partnerships that are in fact LLPs.

Partnerships can be very useful for occasional as opposed to full-time business or (for example) when friends or members of a family pool their resources to purchase a property to let for investment purposes.

Generally speaking, professional rules, regulations and restrictions aside, most or many partnerships could probably operate satisfactorily as limited liability companies. Some traders, however, prefer to remain in partnership rather than become directors of their own limited company and then be treated by the Inland Revenue as employees and taxed accordingly. Another attraction may be that partnerships are not (unlike limited companies) required to file (for public record) partnership accounts. A self-employed partner in a business may conclude that the personal tax advantages he may enjoy as such outweigh the peace of mind of being a director and/or shareholder of a limited liability company. Perhaps we will see a more rapid development of the limited liability partnership that lies somewhere between a partnership and a limited liability company.

Personal liability, or the risk of it, can be reduced in the same ways as the sole trader, added to which list must be the caution to choose one's partners carefully. Partners should also recognise the need to diplomatically 'police' each other's activities.

What often happens is that the sole trader progresses to a partnership. The partners then conclude that it is cheaper and therefore preferable to run the business as a limited liability company than to pay high liability insurance premiums. They may also prefer not to lie awake at night worrying about keeping the home safe from the business or worrying about having placed the home in the sole ownership of the spouse with that in mind.

## The sole trader (the one man band)

This is the simplest form of business ‘organisation’. With a few exceptions, the trader will be free to set up and run his business without prior registration, licence or formality. Like everyone else, the trader will have to keep business records so that he may properly account to the Inland Revenue. Depending on annual turnover, the trader may have to register for VAT purposes (at risk of being personally liable for uncollected VAT if he fails to do so). For some businesses (for example, where public health may be involved), it may be necessary to first obtain formal registration or a permit to trade. In the case of most professions, it will be necessary to comply with professional rules and restrictions. For the majority of businesses, however, no such obstacles or restrictions apply.

The business may be carried on in the name of the trader or the trader may use a ‘business name’. If the business name is not offensive and does not suggest that the business is (for example) a limited company, or connected with government, the trader may generally adopt whatever name he pleases without the need to obtain permission or register it.

### *Registration of business names*

The now repealed Registration of Business Names Act 1916 required any individual, partnership or company using a business name other than their own name to register it, declaring details of its proprietors. The real but undeclared purpose of that legislation was apparently to flush out the German shopkeepers and businessmen in Britain who were hiding behind non-German business names at a time of intense nationalistic feeling. Fortunately the world has changed.

If the sole trader incurs a liability in the course of his business his personal assets will be at risk. When that happens, there is no differentiation between the assets employed in the business and personal assets outside the business. All the sole trader can really do is:

- Trade honestly and carefully;
- Choose and supervise employees, agents and contractors carefully (he may be liable for their mistakes);
- If appropriate in the business, trade only on the terms of the written trading terms and conditions limiting the extent of responsibility. This option is not generally available to the professions;
- Insure against loss and liability;
- Operate good financial and credit controls; and
- Consider transferring personal assets to someone else (before liability arises).

Paying lawyers to draft a tailor-made set of trading terms and conditions is likely to be expensive, but should be cost effective in the long term. Sometimes

membership of a trade association enables the member to use the association's own standard trading terms and conditions designed to protect its members. One-off liability insurance policies can be expensive. Sometimes a better insurance deal is also available through membership of a trade association.

The sole trader may consider forming a limited liability company (of which more below) through which to operate his business. He can do this and still be a 'one man band' in reality. He should then be careful to make it clear to those with whom 'he' trades that he is not the person with whom they do business (particularly if his clients/customers have become used to dealing with him as a sole trader). He is merely the agent (as a director) of the company.

These days many companies, including major companies, engage consultants to work on a regular basis but without the consultants becoming employees of the company. Sometimes, to avoid it being said that the consultant has in reality (and in the eyes of the Inland Revenue) become an employee or part-time employee of the company, the company insists that each individual consultant must render his services as a limited company. This is an example of how a sole trader, otherwise content to trade as such, may decide to conduct his business through a company even though, when one looks behind the company, there is no one there except that former sole trader. The limited liability company option has been considered further above.

## Charities: issues of transparency

### *Governance of charities*

Just as business is now operating in an era of exacting requirements of corporate governance, as has been touched upon earlier, charities are similarly impacted. Moreover those companies that donate to charities should ensure that the non-profit organisations that they support are following correct procedures.

## Trustees duties: governance for non-profits in the US

Meanwhile the corporate governance debate in the United States is spreading from the for-profit to the non-profit world. Well-publicised controversies at organisations such as The Nature Conservancy, the American Red Cross and the James Irvine Foundation have even caused observers such as Eliot Spitzer, the Attorney General of New York State, to suggest that the Sarbanes-Oxley Act should be applied to non-profit boards. To be sure, those boards operate under unusual constraints, for example directors:

- Volunteer their time;
- Play an important role in raising funds; and
- In some cases are so numerous that board meetings resemble conferences rather than deliberative assemblies.

They also answer to a wide range of stakeholders who may lack a single common goal, such as increasing shareholder value. Thus it comes as no surprise that a recent McKinsey survey of executives and directors of not-for-profit social service organisations found that only 17% of the respondents felt that their boards were as effective as possible.

To improve the governance of non-profits, their boards must venture beyond the traditional focus on raising funds, selecting CEOs and setting high-level policy. McKinsey's research indicates that the best boards also:

- Provide professional expertise;
- Represent the interests of their non-profits to community leaders;
- Recruit new talent to the organisation; and
- Provide the more rigorous management and performance oversight that funders increasingly demand.

In the US over the longer haul, however, not-for-profit organisations have no choice but to rethink the way they replace and recruit directors. Regular evaluations can help by:

- Setting out expectation;
- Indicating when a change of behaviour is needed; and
- Motivating underperforming directors to leave.

As for the recruitment of new directors, a standing nominating committee should have the responsibility for creating a board on which each member brings not only the all-important fundraising capabilities but also necessary skills or relationships with community leaders, politicians or regulators. The committee should recruit candidates from as wide a range of channels as possible and recognise that sustained cultivation may be needed to get the best possible directors. This should be compared with the Higgs Review in the UK.

## The Tyson Report

In view of the finding from the Third Sector Survey that charities are moving away from short-term financial agreements with companies to look for longer-term relationships and real partnerships the Tyson Report is particularly relevant.

The Tyson Report called for more diversity on company boards so that they included more NEDs from non-traditional backgrounds, such as the voluntary sector. It is evident that, compared with the voluntary sector, listed companies are very rigid about appointments. The voluntary sector is more flexible while commercial organisations are awaiting more guidance in order to implement the Tyson Report. Tyson's remit was to develop the ideas raised in the Higgs Report on corporate governance. The role of NEDs is regarded as increasingly important given the high profile corporate failures at companies such as Enron. Tyson argued that companies would benefit from recruiting a more diverse board and that the non-commercial sector was a fertile source of NED talent for UK companies.

The Tyson Report also led to hopes that companies would take advantage of specialist registers that include top people from non-commercial sectors. Companies need to decide not only whether they want a more diverse board but also whether they would recruit other than by word of mouth or other traditional methods, thereby changing the culture.

## Reporting requirements

Since the introduction of the SORP accounting framework in England in the 1990s charities have had to comply with increasingly rigorous requirements in accordance with the Charities Acts. SORP has been updated to cover the need for charities to explain their activities and their achievements. This has of course increased the pressure on charities to be transparent in their objectives and operations.

More recently a new tool has been introduced: this is known as the Standard Information Return (SIR). The SIR was proposed in 2002 by the Strategy Unit in its report on charities with a view to raising transparency and accountability in the voluntary sector. It has been agreed that SIR will be added to the reporting requirements for charities that have an income in excess of one million pounds (£1 000 000). Therefore where small business representatives make a decision to invest in such charities they should ensure that the beneficiary organisation is following the procedure and fulfilling the requirements once the SIR is implemented.

The SIR is intended to be a two page statement that includes a range of topics, such as:

- The charity's achievements over the reporting period;
- Its aims that it intends to achieve in the forthcoming year;
- Information on the sources of support; and
- Information on the charity's spending.

### *Purpose of SIR*

The intention of the SIR is that donors, funding organisations and other stakeholders will be able to appreciate quickly:

- \* What a charity does;
- \* The financial base of the charity; and
- \* Whether it is fulfilling its objectives.

The Charity Commission will run SIR and the information will also feed into the Guidestar online charity information website. The main idea is that donors, funders and stakeholders will be able to understand clearly and quickly:

- \* What a charity does; and
- \* How it is doing.

## Considerations of the Strategy Unit

The Strategy Unit proposed the SIR essentially on the basis that many of the reports and accounts of charities submitted to the Charity Commission were ‘inaccessible and often ill-suited to the public’s needs’. The Commission has added that it was especially difficult to find credible information about performance or outcomes. It has also expressed concerns that it has been hard to make any meaningful comparisons between similar charitable organisations.

## Accountability and corporate giving

When discussing risk and organisational concerns a sensitive area relates to corporate giving and issues over donations and the legal bodies involved. On the one hand the not-for-profit sector is being encouraged and support for good work recommended, and on the other hand the need to ensure that the use of funds is clear and above board is paramount. In the UK the Charity Commission has been widening the not-for-profit sector into a now more accessible area and has been reviewing hybrid legal bodies to encourage creativity in the sector such as charitable companies. As a general principle in this age of growing accountability, wherever a charity operates clarity over donations is at issue since corporate support is vital to several key areas of the voluntary sector, such as the art world and other non-profit-making ventures. The giving is highly influential as well as tax efficient. While this has been true for some time in the US, for instance, the tax implications have become increasingly important in the UK. Therefore as far as concerns both the donor and the donee, transparency is most important. As in the US, in general since the collapse of the stock market, charities are finding that there is greater public interest from both taxpayers and shareholders in who is giving to charity and why. Moreover there has been a heightened state of interest as a result of the global concerns regarding terrorism.

One noteworthy example illustrating the increasing connections between charities and corporate giving in the US is the connection between Enron and the foundation associated with Kenneth Lay, the company’s disgraced former chairman. The full extent to which charities favoured by Enron directors benefited from Lay and his company’s patronage is unknown, due to the complexity of the arrangements and lack of information (see also Chapter 22). What is clear is that much of corporate philanthropy is strategic. It is giving that ultimately affects a company’s bottom line. It is not just about being a good corporate citizen. Bearing in mind the significance of governance both for corporations and charities even small business should ensure that it is clear about donations. Many companies simply do not know exactly how much they give to charity and from where because the giving is diverse – from small donations to local community groups to charity functions used as marketing events. There should be clarity from both sides to ensure the trend in favour of greater transparency, such as that demonstrated by SIR, is followed.

*The SIR*

The SIR is another indication of the growing importance of transparency and governance. While stakeholders have generally welcomed the introduction of SIR in principle, they have indicated that there are issues to be dealt with regarding the use of the SIR as a tool for comparison. It is to be hoped that in time the SIR can be implemented to the positive satisfaction of donors and donees alike. Meanwhile this is a matter of interest to organisations, including small business, and should be monitored carefully.

## Concerns over SIR

Accountants and some charities in England have, nevertheless, raised concerns over the new tool. Their argument is that it will be very hard to define and accurately set out the work of a charity in the small space available. This could mean rough rankings of charity performance. This could in turn bring about the possibility of league tables that the regulator might also use as a tool in its armoury. The consultation process with key groups of charities and donors has therefore focused on the format of SIR and the extent to which the topics covered can be dealt with in the two page statement. There is no doubt that this will be a real challenge in practice. The Strategy Unit proposed nine categories of information, including:

- Achieving against objectives;
- Stakeholder involvement;
- Governance;
- Fundraising;
- Trading; and
- Reserves and investment.

However, there remain real concerns, demonstrated by the consultation process that a two page statement cannot represent the correct position of the charity, thereby going against the objective of transparency.

Another concern is whether the SIR should be audited like the charity's accounts. This has yet to be resolved. The Strategy Unit has stated that: 'in order to confer some external scrutiny, the information provided should be professionally audited and where possible should make use of accredited processes (such as use of accredited quality tools)'. However, the Charity Commission's head of policy, Rosie Chapman, has said that the SIR will be certified rather than externally audited. The lack of audit could mean that there is a risk that SIRs will lack credibility among the public, again rather defeating the object of transparency. There is a risk that the SIR could be considered to be a marketing exercise unless charities are able to support their statements in the SIR with credible evidence.

As regards the future, some accountants believe that there will be a compulsory audit. This is largely because of the issues mentioned above and because

funders are increasingly requiring detailed reports from charity applicants with verification by accountants.

## Closing remarks

In any event it is clear that the independence of the voluntary sector should not be jeopardised. If involved in company boards any representatives should ensure that they keep their independence. This should not affect the ability to scrutinise companies, nor the corporate sector generally, on social and ethical issues.

## Chapter summary

- Sole traders remain personally liable for the debts of their business. Turnover, profit and loss are not a matter of public record;
- Partners in a partnership (firm) are each personally liable for the debts of the partnership. Turnover, profit and loss are not a matter of public record. The partners may or may not be treated as employees, according to their status within the partnership;
- Partnerships are an easy way to get started and may eventually lead to a transfer of the business to a limited company;
- Limited liability companies including public limited companies provide limited liability for their shareholders, directors and officers. Ownership, turnover, profit and loss are all a matter of public record as is the identity of the board of directors;
- Big business (requiring the employment of outside capital) tends to be conducted through public limited companies. Private limited companies are ideal for small businesses (including the ‘one man band’) as well as major family owned businesses; and
- At the end of the day, a well-tailored liability insurance policy will take care of liabilities that arise when good and honest business practices and trusted colleagues are not enough to prevent losses arising. It should be noted, nevertheless, that many of the trends in the business environment are creating major ramifications for today’s insurance industry.

### *Useful web links*

‘Internal Control: Guidance for Directors on the Combined Code’ and produced in September 1999 (available from [www.icaew.co.uk](http://www.icaew.co.uk)).



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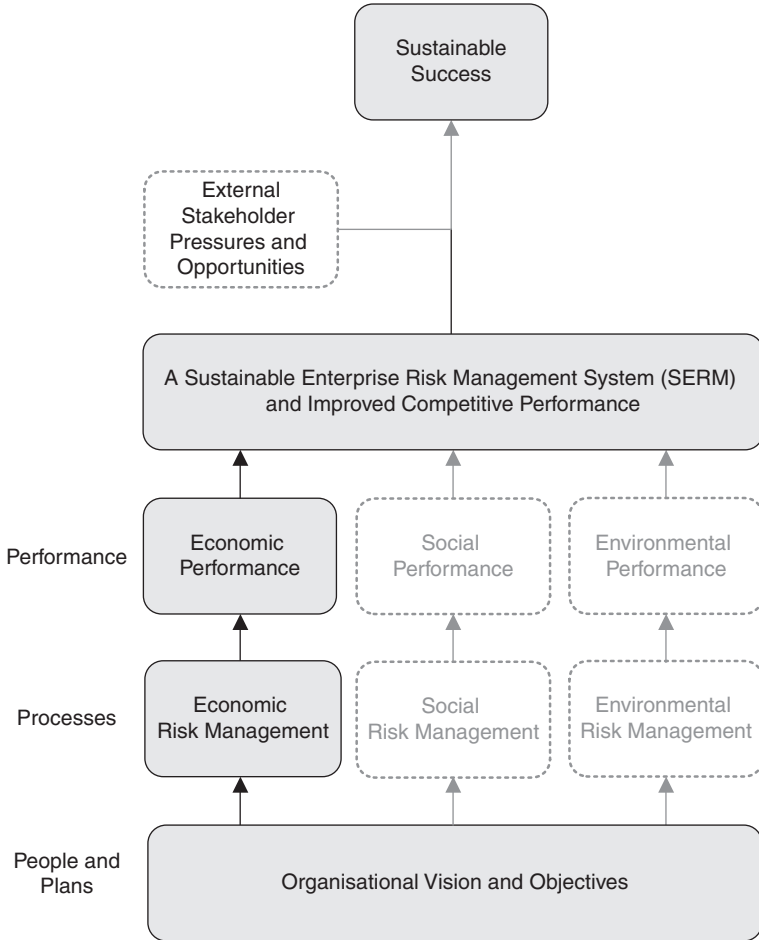


# PART B

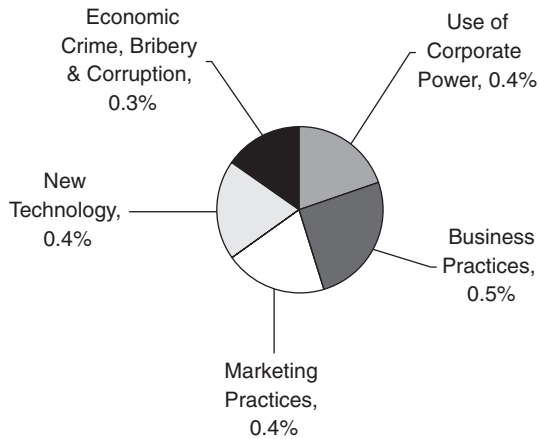
## Overview of the Economic Aspects of Business Risks

We cover the key emerging economic aspects of the risk; these currently represent an average of 2% risk to market value of organisations. This risk level will increase as research is completed. At present the main issues include:

- Economic crime, bribery and corruption (Chapter 7);
- Business interruption and disaster planning risk with crisis management (Chapter 8);
- Stakeholder and reputation risk management (Chapter 9);
- Business, marketing and fraud (Chapter 10); and
- New technology-related risks (Chapter 11).



The net risk to market value from these issues is outlined in the pie chart below.





7

Economic crime, bribery and  
corruption

# 7

## Economic crime, bribery and corruption

### CHAPTER OVERVIEW

Having considered the main forms of vehicle that are available in the UK, particularly in terms of sustainable risk management, it is intended to examine one of the key risks facing any organisation in this era of globalisation. This chapter therefore places the risk of economic crime as a prime concern that requires careful management from the perspective of both inside and outside the organisation. It is truly a global issue that crosses borders as a result of the breakdown of technological barriers and it can affect any type of organisation operating in any sector in any location. Moreover it can impact an organisation in the context of:

- \* Specific transactions; or
- \* Ongoing operations.

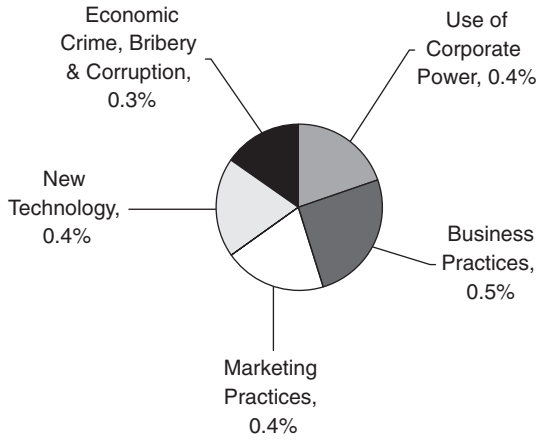
Much of the international regulation governing economic crime is referred to in the publication *Due Diligence and Corporate Governance* (Spedding, 2004/2005). Therefore it is intended here to set the scene having regard to the risks involved in global trade and operations. In this chapter the main discussion is based upon the consideration of case studies, with some emphasis on activities involved in the development of trade between the UK and India, as well as key trade concerns that should be borne in mind in this context. This is an excellent case study when considering the SWOT analysis involved in deciding to do business with and/or in a vital emerging jurisdiction.

We also consider the practical initiatives undertaken in London. At the end of the chapter we provide a risk management section to illustrate and make practical recommendations for steps that can be taken to reduce your risk levels from these issues, having regard also to company codes.

Research on economic crime, bribery and corruption risks indicates that:

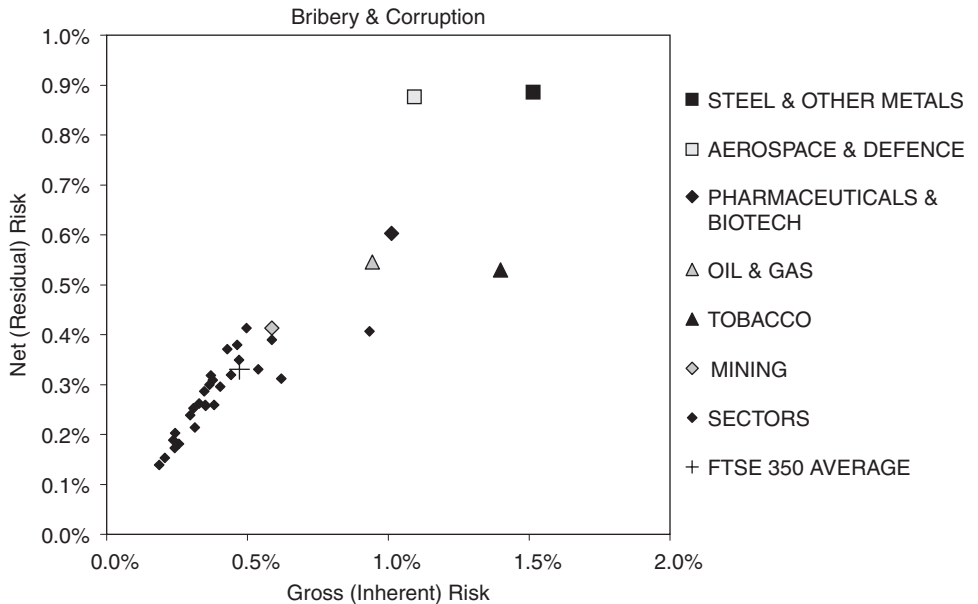
- Bribery and corruption risks are an average of 0.3% of all organisations' market value, and the estimates for economic crime are rising as new research comes to light; and
- This risk exposure has been reduced from 0.5% of market value by good risk management techniques (the risk reduction/management factor).

The chart below shows the economic risk categories by (net) risk to market value for the top 500 companies in the EU and US.



Chapter number	Economic and socio-economic risk	Net (residual) risk to value	Economic risk ranking
Chapter 7	Economic crime, bribery and corruption	0.3%	5th
Chapter 10	Use of corporate power	0.4%	1st
Chapter 10	Business practices	0.5%	2nd
Chapter 10	Marketing practices	0.4%	3rd
Chapter 11	New technology	0.4%	4th
	<b>Total</b>	<b>2.0%</b>	

The following graph shows the bribery and corruption risks, by sector.



There may be some surprises in the findings of the high risk sectors. It is to be remembered that this is ‘net’ risk and there may be sectors with very high ‘gross’ risk profiles but they are seen to be doing a lot more to improve their record with regards to these issues than other sectors who may start with a much lower ‘gross’ risk figures like the metal and pharmaceutical sectors. It is clear to see that this is a key issue for the resource extraction industries where their operations are usually in locations and of such a scale as to warrant particular attention.

While the oil and gas sector for some time has seemed to be directly and indirectly addressing these types of risks ...

- Oil and mining sectors: George Soros has launched a more specific campaign to clean up oil and mining companies’ impacts upon emerging markets governments; and
- Oil sector: BP is sacking over 200 people a year to root out economic crime, bribery and corrupt practices or work conduct. Shell also suspends staff for unacceptable work practices, following on from a crackdown last year when they suspended seven staff globally for either soliciting or accepting bribes (*The Guardian*, 19 June 2001);

... the defence industry seems to be in disarray after a range of global scandals. There have been:

- Growing concerns about the credibility of the defence acquisitions processes, as the US Department of Defense reviews over \$33bn worth of contracts in the light of the Boeing scandal. The Pentagon talked about reopening the bidding for the aircraft refuelling contract, which could mean the loss of a US\$21 billion deal;
- The UK Ministry of Defence has had a strained relationship with their main contractor after a range of stories came to light, including allegations of: giving Pinochet money; BAE’s alleged secret vault in Geneva; a Serious Fraud Office investigation into ‘suspected false accounting’ over gifts; and accusations of staff blocking attempts to investigate allegations of fraud in contracts. This last issue coincided with a 1.7% fall in share price on one day in 2004; and
- The awarding of contracts in the reconstruction of Iraq and the prison abuse scandal in Abu Ghraib has also raised a lot of issues concerning integrity.

### **Relevant definitions**

Economic crime is a term used to describe:

- \* Asset misappropriation;
- \* Bribery;
- \* Cheque and credit card fraud;
- \* Corruption;
- \* Cyber crime;
- \* Identity theft;

- \* Insurance fraud;
- \* Money laundering;
- \* Procurement fraud;
- \* Product counterfeiting; and
- \* Revenue and VAT fraud.

(RSM Robson Rhodes LLP Report on Economic Crime, 18.10.2004)

*What is corruption?*

- \* The abuse of entrusted power for private or public gain. It can hurt everyone whose life, livelihood or happiness depends on the integrity of people in positions of authority.

Economic crime and corruption can have some devastating impacts on organisations:

- Corporate bribes to the local and national government official and inspectors cut severely into cash flows;
- Corrupt leadership can systematically siphon off a nation's riches;
- Competing corporations can secure contracts through illegal kickbacks to corrupt government officials, at the expense of honest companies, thus buying an unfair advantage in a competitive market;
- Internally, fraud and corruption can divert organisational funds and assets into the hands of criminals; and
- Unsound or faulty buildings, built to lower safety standards because a bribe passed under the table in the construction process, can collapse in an earthquake or hurricane, causing life threatening loss or damage.

Internationally crime and corruption can have very adverse effects upon the market environment as they can:

- Distort national and international trade;
- Undermine the rule of law and democratic values and can compound political exclusion;
- Jeopardise the ethics and sound governance of the public and private sectors;
- Threaten the domestic and international security and the sustainability of natural resources;
- Have dire global consequences, such as trapping millions in poverty and misery and raising social, economic and political unrest;
- Be one of the most serious obstacles to reducing poverty. Corruption denies poor people the basic means of survival, forcing them to spend more of their income on bribes; and
- Deny human rights where corruption is rife, because a fair trial comes with a hefty price tag where courts are corrupted.



## The international framework

The primary document asserting the desired level of behaviour by organisations with respect to national laws is the *UN Norms on the Responsibilities of Transnational Corporations* (the UN ‘Norms’ – <http://www.unhchr.ch/>). The main rights with regards to an organisation’s sustainable risk management system with regards to economic crime are outlined below.

These are that organisations and business enterprises should have respect for national laws and process, including the avoidance of bribery and corruption measures and shall:

- ‘recognise and respect applicable norms of international law, national laws and regulations, as well as administrative practices, the rule of law, the public interest, development objectives, social, economic and cultural policies including transparency, accountability and prohibition of corruption, and authority of the countries in which the enterprises operate’ (UN Norms 10);
- ‘not offer, promise, give, accept, condone, knowingly benefit from, or demand a bribe or other improper advantage, nor shall they be solicited or expected to give a bribe or other improper advantage to any Government, public official, candidate for elective post, any member of the armed forces or security forces, or any other individual or organisation’ (UN Norms 11); and
- ‘respect economic, social and cultural rights as well as civil and political rights and contribute to their realisation, in particular the rights to development, adequate food and drinking water, the highest attainable standard of physical and mental health, adequate housing, privacy, education, freedom of thought, conscience, and religion and freedom of opinion and expression, and shall refrain from actions which obstruct or impede the realisation of those rights’ (UN Norms 12).

This is quite a lot and almost puts business organisations on a parity with governmental bodies in terms of the actions recommended (UN Norms 12).

## An introduction to the business risks

As has been seen in highly reported scandals such as Andersen, Boeing, Enron, Halliburton, Tyco, Mars and WorldCom, there has been a deluge of news items to fill up the newspapers over several years.

This is a global problem which often means that the effect of individual countries to reduce these types of activities normally means their ‘competitiveness’ suffers and their resident businesses lose contracts. The 1999 Organisation for Economic Cooperation and Development (OECD) Convention against bribe-paying has sought to remedy this market imperfection and introduce a more ‘level’ market environment.

The OECD Convention was a major step forward in addressing the supply side of transnational commercial bribery, thus reducing the competitive pressures that lead to bribery. It has made it possible to prosecute business people

accused of corruption in their home countries as well as in the jurisdiction where the offence took place. This convention – and other international initiatives (see below) – does have a significant impact in this area of business risk. However, the problem is that the pace of change remains uneven: the ‘rules’ often change at different speeds in different countries and sectors. The challenge is for directors of international companies or organisations to find ways of implementing effective internal anti-corruption programmes while still winning business in an imperfect world. For instance, in some countries the party and the government are virtually synonymous and some individual governments are unwilling to undertake prosecutions – often because of the difficulty and expense of gathering evidence abroad.

Drivers for change have, however, become stronger since the OECD Convention came into force on 15 February 1999, largely through media interest and NGO activist pressure, such as Transparency International (TI) (see further below) working with the United Nations in a global compact.

#### **Perennial problem?**

The first recorded anti-bribery law was enacted by an Egyptian pharaoh in the 14th century BC; he imposed the death penalty on judges who took bribes during legal dispute handling.

Other global initiatives also exist. The oil sector has been an initial target for activists to try and standardise some sort of code of behaviour between all participants in tenders for contracts. As indicated, meanwhile, large investors like George Soros have made this a central element of their activist investor campaigns. Moreover there is a corruption ranking system in use to view which countries are perceived to have the least corruption. The Transparency International (TI) index focuses on the public sector, and how far there is an abuse of office is for private benefit. Two-thirds of the countries assessed are seen to have serious levels of corruption. The greatest declines in corruption seem to have occurred in the already least corrupt state, in that it may be a self-perpetuating social trend (<http://www.transparency.org/> – see also further discussion below). There are concerns that such league tables could unfairly hinder investment in the lower ranked countries. Once again these factors need to be integrated into a Sustainable ERM system that incorporates such external risk factors. Indeed, with reference to numerous senior executives having to resign at German blue chip companies, Peter von Blomberg of Transparency International, Germany, says:

Each corruption case that comes to light leads to more companies realising they have to take preventative measures against corruption. (*Financial Times*, 28 July 2005 ‘Germany ponders extent of corruption as heads roll’)

National governments are starting to act in the wake of scandals which reflect poorly on their management of the business environment. Meanwhile international bodies like the European Commission (EC) have strengthened their pursuit of cartel members. These can escape prosecution in exchange for information on their agreements with other parties.

It should be noted that the reported view of the UK Confederation of Business Industry (CBI) is that the UK's adherence to anti-bribery and corruption measures would 'endanger a number of valuable contracts' (*Financial Times*, 14 January 2005). However, these types of considerations did not prevent the Anti-Terrorism, Crime and Security Act 2001 from being a powerful piece of legislation with a number of provisions to address the problem of bribery and corruption abroad; it also enables criminal prosecutions to be brought within the UK against a company and its officers.

## Surveys and case studies

SERM has found that there seems to be a gulf between organisations' overall processes in this respect and the feelings of the staff that are involved with the systems. Numerous surveys show most employees in Europe would be willing to report evidence of fraud in their workplaces, yet fewer than one in 10 feels that they could go to the police with evidence.

The risks have increased as executives are losing their jobs and being sent to jail more regularly:

- Three former Ahold executives received suspended sentences and fines of \$860 000 for their part in a 2003 accountancy scandal that almost bankrupted the Dutch food retailer;
- Boeing sacked its finance director, Mike Sears, stating that he violated company policy by discussing a potential job offer with a US government official while working on matters affecting the company. Another senior Boeing employee faced up to five years in jail and a fine of up to \$250 000;
- Ex-Tyco chief Dennis Kozlowski faced up to 25 years in jail after the New York jury convicted him of grand larceny and securities fraud. Mark Swartz, the ex-CFO, was also found guilty;
- Four Mars UK staff were jailed for up to six and a half years for their respective parts in an elaborate scam involving bribes and fraudulent invoices that is estimated to have cost Mars millions (*Financial Times*, 6 May 2006);
- UK oil major BP sacked 252 staff in an anti-corruption drive in 2004, being 50% higher than the previous year;
- Total, the French oil company, detained several of their staff for investigation in relation to suspected bribes paid to foreign government officials (*Financial Times*, 4 October 2004);
- Martha Stewart served five months for obstruction of justice and false statements relating to her selling of ImClone stock; and

- The conviction of WorldCom's Bernie Ebbers demonstrated that age is not a barrier to proceedings.

#### Key corporate examples:

- BHP, the Anglo-Australian mining giant, is also alleged to be implicated in the Iraq oil for food scandal and whether an A\$8m wheat shipment may have contravened the UN sanctions in Iraq;
- Weir, one of Britain's largest engineering groups, admitted to making payments to Saddam Hussein's regime in Iraq that amounted to \$8m to supply industrial parts under the UN's oil for food programme;
- A UK water company tried to silence their whistleblowing finance manager by sending him a letter through a law firm stating that the company no longer considered him protected by the Employment Act, Section 43, known as the 'whistleblower's charter';
- Germany's two largest utilities, Eon and RWE, were embroiled in an investigation by state prosecutors into whether they bribed municipal politicians with opulent journeys abroad (*Financial Times*, 24 January 2006);
- The UK's Financial Services Authority (FSA) fined the Capita Group – the company that implemented the London traffic congestion charge and collects television licence fees – £300 000 for anti-fraud control failure;
- The Nigerian government attacked Halliburton and its partners for their alleged failure to cooperate with a hearing into an alleged \$170m bribery case (*Financial Times*, 22 October 2004);
- The US Securities and Exchange Commission (SEC) is investigating five companies for allegedly entering into joint ventures with companies partly or wholly owned by members of the oil rich regime of Equatorial Guinea. Companies cited include ExxonMobil and ChevronTexaco (*Financial Times*, 31 August 2004); and
- The South Korean firm Hyundai Motors has pledged US\$1bn of its own money to South Korean charities to stem the public relations damage over an alleged bribery scandal (*Financial Times*, 20 April 2006).

#### Reported country examples:

- Transparency International's (TI) Russian office says that corruption is growing there. Russia's deputy prosecutor general says that corrupt bureaucrats cost Russia £125bn a year (*The Guardian*, 8 November 2006);
- Bribery in Russia is up tenfold to \$316bn in four years according to Indem, the independent think-tank; their methodology involved interviewing 1000 businesses and 3000 individuals at random and extrapolating the figures; and
- US Republican lobbyist Jack Abramoff admitted fraud and bribe plots, and the Democratic Party hopes to use this admission to their advantage by exploiting the perception of the existence of 'a culture of corruption' (*Financial Times*, 4 January 2006).

## Current trends

Companies and directors are being pursued by governments and other organisations internationally. Moreover advisors are generally being more rigorous. For example:

- The World Bank (WB) is reinvigorating its anti-graft role but has been urged to integrate more ‘corruption risk analysis’ into WB project developments;
- The UN’s internal investigation arm has produced a report regarding procurement operations that cover 31% of the value of all commercial UN contracts over \$5m. The report states that the UN may have lost \$298m in contract irregularities in respect of the value of \$1bn of contracts investigated;
- Corporate governance legislation and more active public prosecutors are having an effect on bringing these matters to the public attention;
- PwC’s Japanese business unit Chuo Aoyama PwC had to suspend its operations for two months as a result of investigations into allegations of failing to detect and prevent accountancy fraud at the Kanebo cosmetics group;
- Compass, a large UK-based caterer, has been hit by a second US lawsuit from an international competitor (Es-Ko) claiming \$369m in damages for lost business through Compass’ alleged corruption at the UN;
- In Bolivia, Repsol’s top two executives in Bolivia went into hiding when the government there ordered their arrest on charges of oil smuggling and tax evasion (*Financial Times*, 11 March 2006);
- Columbia has sued Diageo, the UK drinks company, alleging that the company threatened national security by dealing with known terrorists, money launderers and drug traffickers (*Financial Mail on Sunday*, 7 November 2004);
- After four big scandals in Germany involving blue chip companies Commerzbank, DaimlerChrysler, Infineon and Volkswagen the German regulators have become much stricter; and
- In Thailand the Thai prime minister threatened to scrap a contract for the provision of baggage scanning equipment unless US-based GE InVision publicly denied that government officials may have been offered inducements to accept the deal (*Financial Times*, 5 May 2005).

Indirect risk may affect you:

- Financing projects which have come under suspicion may have a negative affect upon your reputation. For example, a report on India’s power sector revealed that a UK bank had a loan guaranteed to the Nathpa Jharki power project, which was said to be a ‘first-rate scandal’ after being investigated for corruption and suspensions of building works by the Ministry of the Environment and Forestry (MOEF) for violations of the Forest (Conservation) Act 1980 (with Amendments made in 1988), and the Environment Act 2002.

## Company codes

Bearing in mind the above it must be recognised that – regardless of the legal and moral drivers – corruption represents a significant business risk. Companies

that pay bribes typically win some short-term advantage, but pay a severe long-term price:

- They cannot complain if they do not receive what they had paid for;
- Paying any bribe leads to further demands, from petty ‘grease payments’ to major bribes to secure contracts;
- By breaking the law they become vulnerable to blackmail, particularly if there is a change of regime; and
- Ending a corrupt relationship may lead to various threats, including violence.

Nevertheless bribery and corruption still continue often because:

- Companies believe that bribes are part of ‘local custom’;
- They think – usually wrongly – that there is no choice when faced with what often appears to be official extortion; and
- Executives often claim that – though they dislike the practice – they need to arrange kickbacks to secure business to avoid unscrupulous competitors from winning the contracts.

It is advisable not only to be aware of the legal and regulatory framework but also to develop and have in place a corporate code (see further below) in the interests of sustainable risk management whatever area, size or operational location.

## International case study

The impact of international economic crime on doing business in today’s marketplace can be well illustrated by the trade link between the UK and India. This is a topical example especially bearing in mind the importance of India as an emerging market. The impacts affect a variety of different sized organisations.

## UK and Indian economies

The UK’s economy is one of the world’s most regulated economies. London is a hub of world trade and finance, and has world-class status in financial management and probity. The UK is not historically a corrupt marketplace. The South Asian population in the UK accounts for 2% of the GDP, and 10% of the UK’s financial turnover. There are over 300 South Asian millionaires with personal assets of over £4m, and the spread of such wealth in the southeast of the UK amounts to some £8bn alone (Ethnic Media Group Rich List 2005). The UK provides many opportunities for new economies such as India and China and it is recognised that there is significant potential for investment from India in particular.

India has the second fastest growing economy in the world, and may soon have the world’s largest population. Furthermore, it is estimated that within the next two decades, India will have the third largest economy in the world. In terms of growth sectors, it is a world leader in telecommunications and the pharmaceutical industry. India’s drawback is that it is a historically corrupt

marketplace, both in public and private sectors of the economy. By way of putting this into perspective, in 2003, for instance, the National Crime Records Bureau of India reported 2058 cases of corruption under investigation by the Central Bureau of Investigation (CBI).

## Off-shoring: UK and India

There is tangible evidence, not just a perception, that problems are emanating from India that impact on confidence in India/UK trade. The Forrester Asia Pacific Research Report 2005, for instance, raised fears regarding the security of customer data at offshore centres. John McCarthy, vice president at Forrester Research Asia Pacific, told reporters in Australia that thefts could result in a 30% reduction in the amount of call centre work Western companies offshore to firms in India.

Case study (April 2005): three former employees of Indian BPO firm Mphasis have been arrested for allegedly siphoning off \$300 000 from Citibank customers after stealing account details while working at an offshore call centre in India.

Case study: in 2004 BPO firm Wipro lost a telemarketing contract with US card issuer Capital One after an internal audit found that staff at its call centre deliberately misled customers during sales calls.

Over half of UK consumers have been reported to be unhappy about banks outsourcing customer contact centres to cheap offshore locations, according to research conducted by Fujitsu Services (2005). The survey of 1000 consumers from regions across the UK found that 62% were 'concerned' about the off-shoring of call centres: issues around data security were a main issue. The popular media have been keen to exploit such stories, which culminated in the *Sun* newspaper report of June 2005 concerning the HSBC call centre in Delhi.

## The effects of globalisation

There is now a global economy, which transcends national and regional borders, with major global companies operating in every corner of the globe. The consequences of huge advances in technology, the growth of e-commerce, and the availability of cheaper modes of transportation have meant that we now live in a shrinking world. It has facilitated the growth of trade, the movement of goods, and the migration of the world's population, generally from poorer economies to richer ones. In the era of globalisation, borders are porous, information technology speeds financial flows around the globe and trade barriers have broken. With today's situation, the movements of funds through illegal means have become easier.

## Organised criminal networks: the UK case study

The unprecedented movement of people for economic reasons has led in the UK to a tremendous rise in the growth of unregulated cash rich businesses,

which can be a front for organised criminal operations. Money laundering has seen an immense growth in the last decade or so, in the UK in particular. By way of example, mention should be made of the hawala banking system. It is legal in the UK, and although hawala is illegal in India, it is still a very big area of operation there, because of tight fiscal controls surrounding the movement of money. Historically, an alternative banking system such as hawala offers cheap solutions to the movement of money, and therefore competes with normal trade and business. For example, in the UK there are about 1000 registered hawaladars, who are given only scant supervision by HM Revenue & Excise, thereby giving immense opportunities for organised criminals to dispose of money (NCIS South Asian Organised Crime Threat Assessment 2004). In India, according to Mumbai police records, hawala (money laundering) transactions averaged more than Rs30 000 crores (US\$6.25bn) a year in the 1990s (Institute of Peace & Conflict Studies: Article 974 of 7.3.03).

#### **Growth of organised crime**

Organised crime, which is defined by NCIS UK (2003) as ‘those involved, normally working with others, in continuous criminal activities for substantial profit, whether based in the UK or elsewhere’, has seen unprecedented growth in the last decade or so. It is estimated that in the UK it is now worth upwards of £150bn (NCIS UK Threat Assessment 2005) while in India it is a commercially accepted statistic that the amount of illegal money (i.e. that which is based upon tax evaded income) is thought to exceed 40% of India’s total GDP (Institute of Peace & Conflict Studies: Article 398 of 5.8.2000).

Given that the UK is not historically corrupt, it is significant that the cost of fraud in the UK is currently running at £40bn pa (£28bn in London alone) and the cost of cyber crime here is £2.8bn (NCIS UK Threat Assessment & RSM Robson Rhodes LLP Report 18.10.04) and rising. There is a gap in our intelligence with regard to the actual cost of fraud within India, but with large global companies, including banks, establishing large-scale business there, it is likely to be significant.

It should be noted that organised crime groups within the UK and India have become increasingly sophisticated in terms of logistics, technical skill, and the scale and diversity of operation. It is often a multi-dimensional business, with a spread of investment across all sectors of criminality. It is also global business, imitating legitimate business in having stakeholdings across international borders, often with a head office in one country and many branch offices across a region or continents.



**Criminal networks in India**

In India the depth of penetration of organised criminal networks is likely to be significant. For example, there are reportedly 700 legislators, including 40 Members of Parliament, with criminal antecedents. More than 47% of the representatives in local self-governments in Maharashtra have criminal backgrounds; in states like Uttar Pradesh and Bihar, this is as high as 70–80%. This reveals that organised criminal activities are no longer limited to urban centres but have percolated down to the grassroots (Institute of Peace & Conflict Studies: Article 974 of 7.3.03).

Such crime groups often have an SMT, middle management structure and ground floor sales team just like their legitimate counterparts. The South Asian crime groups in the UK account for about 15% of operations against the UK's 900 criminal organisations (NCIS South Asian Threat Assessment 2004) and about 20% of London's 142 such groups (MPS SCD Criminal Networks Prioritisation Matrix).

As regards India and the UK, most communities in India have representation in the UK not only because of the historical connections but also because of globalisation. Many members of the newer communities from the subcontinent in the UK do not have their status confirmed within this country, and are therefore vulnerable from organised criminals living within their own communities, often coercing them into committing serious crime ranging from fraud, money laundering, drugs trafficking and human smuggling.

**Impact on fraud in London**

In terms of serious economic crime committed by South Asian crime groups within London alone, it is clear that they play a very significant part of the total fraud committed there. By way of evidence, in 2004/5 they accounted for some 25% of the detections for serious fraud and public sector corruption, investigated by the MPS's SCD6 (Specialist and Economic Crime Unit), and in 2003/4 some 38% (MPS PIB 2005).

When considering specific crimes, kidnapping within India also has an impact on trade between the two countries. In 2003 the Histox Insurance Group indicated the top 10 countries with regard to the frequency of kidnappings – India was ranked sixth. In 2003, for instance, there were over 20 000 people kidnapped across India (National Crime Records Bureau, India). The effect of this on risk to companies is significant when one considers the deployment of staff to countries such as India, as well as the potential for coercion of employees to commit economic crime. The fear of kidnap on British Asian business people visiting India is also significant, as well as bad treatment by the Indian Police

Service when they become victims of crime. Clearly this too has an impact on the issue of confidence for UK/India trade, as the South Asian business community in the UK is so significant. Clearly any business considering international business opportunities should be aware of such issues when developing its risk management strategy.

#### **Key economic crime offences**

- \* Identity theft/fraud (accounts for 40% of fraud offences in the UK alone);
- \* Infiltration of companies and finance houses;
- \* Corruption;
- \* Company fraud/theft;
- \* Investment fraud;
- \* Cyber crime; and
- \* Money laundering.

## The effects on trade and business between UK and India

### *The risk assessment: UK and India*

Overall, risks to trade from threat are generally low (but see reference above to Forrester Asia Pacific Report 2005). However, it should be understood that the:

- Risk of damage to global business will nearly always be low – business and trade will go on globally whatever the threat;
- Risk of damage to the national reputations of the UK and India, however, could be high if no action is taken;
- Impact on communities is medium to high if no action taken against organised criminal networks; and
- Impact on SMEs is higher because they are more at risk, particularly of infiltration, cyber crime and fraud – SMEs in the UK employ 95% of the workforce, so there is an impact on employment, and cost of trade could be adversely affected.

### *UK – confidence building*

Emerging issues:

- Some of the most deprived communities in Britain exist alongside most affluent areas (City of London, for instance) – but there is little in the way of engagement or interface between the corporate world and UK communities (e.g. employment, partnership, education);
- New communities and their vulnerabilities from organised criminals;
- In the index of multiple deprivation, three of the top 15 wards in London have the largest South Asian communities (Mayor of London's Index of Deprivation 2005); and
- UK consumers have concerns about off-shoring of fiscal call centres (see above).

## *Practical confidence building – India*

Emerging issues:

- Need for bilateral agreements (police/police or police/industry);
- Long value chains;
- British Indians have bad experience of treatment when victims of crime;
- Potential of attacks on British companies by organised criminals (e.g. call centres, infiltration);
- Speed at which criminal networks operate is very significant; and
- Kidnap plays a significant part in current risk assessment.

## *Lack of concerted cooperation: affects risk exposure*

- Multi-jurisdictional issues cause complications;
- Concealment of losses can exacerbate problems;
- Commercial confidentialities compound risk vulnerability;
- Myriad of different intelligence databases being developed in isolation;
- Reluctance to acknowledge ownership of a problem;
- Business emphasis is not holistic enough; and
- Lack of willingness to assist police continues.

## *Key company vulnerabilities*

- Lack of transparency;
- Low business standards;
- Complacency and intransigence;
- Lack of robust HR policies;
- Communities that are not engaged; and
- SME vulnerability.

## **The current situation: tackling international fraud and money laundering**

Compliance has been the main issue when considering global effects to tackle global economic crime. There are many multi-lateral agreements in existence, particularly in the fight to tackle terrorist funding. However, many countries do not actually comply with such agreements when one examines their national legislation with regard to such crime. Jurisdictional issues become an encumbrance to the investigation of economic crime because of a lack of will to tackle the problem once and for all.

The Financial Action Task Force (FATF) was set up as a global network of countries to try to tackle money laundering across international borders. Not all countries in the world are members because there are strict minimum standards for membership. India is not a member but is a member of the Asia-Pacific

Group (APG), which shares some of the philosophy of FATF. India's problem is one of standards, and efforts are being made, particularly by the UK, to encourage India to raise those standards with regard to economic crime.

## Some solutions relevant to risk management

### *Building bi-lateral relationships*

- Law enforcement Memorandum of Understanding with Indian Police Service/CBI;
- Reducing value chain to cut down bureaucracy;
- Speed up communication;
- Share intelligence and information;
- Development of technology to support, e.g. fraud alert websites;
- One stop shop for police and industry;
- Capacity building to achieve membership of FATF; and
- Building fraud alert websites.

### *Indian companies*

Companies investing in London must be prepared to:

- Be transparent in their trading;
- Engage with local communities (employment, investment through partnership, education); and
- Work with MPS by information sharing, entering into partnerships under Operations Sterling (Fraud in Business), Grafton (Organised Crime around Heathrow) and Quadrant (South Asian Organised Crime).

### *UK companies*

- The MPS is committed to making a significant impact on these high losses;
- This cannot be achieved by reactive enforcement alone; they need the support of partners in sharing intelligence and taking preventive action; and
- Those partners need to come from the business communities who see this as their risk management strategy.

### *Hawala banking*

- Better regulation and supervision of the hawala banking system in the UK.

## Practical initiatives

Business organisations are seeking to help trade and mitigate bilateral investment threats using economic crime initiatives (MPS, DTI (UK) and corporate

partners). The priority step is to raise the profile of the threat along with some promise of action at ministerial level. For example, the MPS is seeking to develop linkages between the UK and India, in order to reduce the numbers of UK victims of economic crimes perpetrated in India, and also to reduce the numbers of South Asians arrested in the UK for serious economic crime. The formation of a partnership between government and industry could bring a number of business benefits. These can be summarised in the following points by way of example:

- Business should establish an ongoing initiative to combat global economic crime, where there is a gap in the marketplace at the moment;
- Fundraising for partnership and research work should extend to academic institutions;
- EU and WB money should be available for the priorities being highlighted;
- Keynote speaking on economic crime internationally with case studies will raise awareness of the key players, including big companies as well as governments;
- There should be a cyber crime platform to the work of MPS, as well as developing and extending networks not previously accessible;
- Long-term personal contacts and champions in big business; and
- These are high profile projects that will play well to the business community, and bring long-term benefits to the diverse communities in London, through sponsorship of projects that enable similar projects globally and greater cooperation to improve risk management.

## Rising economic crime: practical business concerns and the need to be organised

Almost daily there are reports of criminal activity that is causing problems for both private and corporate citizens alike wherever they operate. For example, crimes against businesses cost the UK a staggering amount last year. Therefore, increasingly companies are finding that developing a more positive relationship with public agencies, particularly the police, can offer a healthy way forward if business is to become really organised in its fight against organised crime. Business should indeed be more innovative in dealing with these concerns and keep abreast of developments as far as possible.

Running a business in today's economy can prove to be a complex matter that requires an alert and multi-disciplinary approach to issues that were traditionally not relevant or were handled by others. Moreover those running a non-profit organisation must consider the risks involved since there have been reported cases of charities being used as vehicles of economic crime. In this chapter the circumstances in the UK are examined in particular. However, most of the issues are relevant to the business world generally.

**‘Victimless’ crime**

It has been calculated that crimes such as embezzlement, money laundering, fraud and dishonesty cost British businesses more than £40bn last year, the equivalent of £110m a day or some 4% of the UK’s domestic product. Indeed, some £32bn was lost to the criminals, while £8bn was spent on prevention. It is largely because crimes against businesses are often construed as ‘victimless’ that industry groups have had to campaign for many years to press the authorities to take the problem seriously.

## Survey case study

A recent survey by RSM Robson Rhodes has also found the following:

- There is a stigma attached to crime that prevents companies from reporting it to external auditors or industry regulators;
- For this reason, just 14% of respondents said they shared information on criminal activities with local firms;
- Six in 10 respondents expected the problem to get worse in the next three years; and
- While nearly all respondents agreed that responsibility for tackling the problem should be held at board level, only 57% claimed to have extensive knowledge of the problem.

As with other areas of emerging risk it has been found that businesses must also take the risks posed more seriously. While there is no set time for how long boards should spend tackling the issue, in order to achieve a proper understanding and response to the concerns they need to research the level of economic crime in their industry sector. They then have to put in place effective systems and controls to:

- Prevent economic crime;
- Identify material losses; and
- Take action to recover those losses.

## Sector issues: financial services

Clearly there are certain key sectors that are particularly vulnerable to economic crime. By way of example in the UK the Financial Services Authority (FSA) has warned that organised crime groups are attempting to place staff in financial services firms to commit fraud and steal customers’ identities. The FSA has advised that:

- Firms must vet the background and identity of their staff more carefully before confirming their appointment;

- They also should be aware that devices such as personal digital assistants (PDAs), USB pens and smart phones can be used to steal corporate information or act as sources of virus infection;
- Firms could do more to address the potential risks rather than responding to attacks once they have occurred; and
- In particular, senior management needs to take on responsibility for information security which includes the need for firms' defences to be continuously reviewed and updated to keep on top of the increasingly sophisticated methods used by criminals.

The warnings come in a recent report by the FSA that demonstrated how financial firms are managing their information security in the fight against fraud and other financial crime. Some findings have indicated that while some major firms, particularly in the banking sector, have built some practical defence in response to potential targeting by hackers and fraudsters, other sectors and small and medium-sized firms are less well prepared.

#### **London police initiatives**

In London the Metropolitan Police Service at new Scotland Yard has prioritised the issue of global economic crime and the impact on the UK, particularly in the context of its Operation Sterling. London is viewed as a centre for economic crime. Yet there is an identifiable concern over the sharing and partnership regarding intelligence. In general, business does not like to share information. Accordingly the police are re-engaging with business to enable a single office to consider the trends and tackle the concerns. Since there has been a migration across sectors there needs to be an expanding partnership with business that crosses traditional boundaries and sectors to enable more proactive and dynamic intelligence. This has meant a more proactive prevention team. By way of example, in 2006 the police in London warned that gangs of organised criminals were infiltrating Britain's banking industry and blackmailing employees to obtain customer account details. The problem was exacerbated by the use of unvetted temporary staff. Firms should follow a preventive approach rather than reacting to a situation once it has happened, which can be costly and damaging to reputation according to the police. Having been the target of criminals in recent times, as noted, via the internet and other such technologies, the major banks tend to have strong defences in place. However, there is no room for complacency and criminals will seek to exploit vulnerable points where they can find them, including other sectors or smaller firms.

## Small business

It has been reported that nearly 60% of small and medium-sized businesses or SMEs in the UK become the victims of crime every year. A Federation of Small Businesses (FSB) survey of 18 000 firms has revealed that while 58% of small businesses experience criminal acts, less than half of these are reported. The

report highlighted the crucial fact that businesses are twice as likely to fall victim to criminal acts as households, and criticised the Home Office for failing to prioritise business crime. According to reports David Croucher of the FSB has said, ‘There is a perception among business owners that the UK is experiencing a crime epidemic and that no one cares. Sentences are lower for commercial burglaries than domestic burglaries, and criminal damage and theft from commercial premises have effectively been de-criminalised.’ Evidently, the business group is calling for a number of measures to be put in place to help tackle the problem, several of which highlight again the need for a partnership approach with the police, including the following:

- Business crime to be recorded as a distinct category from domestic crime;
- Crime against business to be made a key performance indicator by the Home Office;
- Businesses to report all crimes to the police;
- Sentencing guidelines to be revised, to ensure that crimes of a similar nature are treated equally; and
- A business crime compensation scheme to be established, to prevent otherwise viable businesses from closing down (see also Chapter 8).

## Corporate identity theft: the approach in the UK

The Metropolitan Police Service (MPS) has also launched a major initiative to advice businesses how they can take simple preventive measures to minimise the risk of their company’s identity being hijacked. Again the statistics cause concern. The crime works in much the same way as personal identity theft. Criminals change the details of UK registered firms by filing fake documents with Companies House. Having done that, the criminals can then impersonate the companies and use their credit lines to obtain goods. The police have said that criminals are so well organised that they have even diverted lorries when they are mid-transit to a new address. Meanwhile Companies House has warned that it could not check every one of the seven million or more documents it receives every year relating to changes of company details. Yet statistics show the rising crime figures: fraudsters who steal the identity and then trade under a legitimate company’s credit and name are thought to cost industry in excess of £50 million a year.

The Metropolitan Police’s ‘Sterling’ initiative is a long-term partnership strategy which takes a proactive partnership approach to reducing opportunities for, and combating, economic crime. Part of its aim is to dispel the myth that fraud is a ‘victimless’ crime. Therefore, working together with Companies House under the ‘Sterling’ initiative, the MPS has warned or advised companies to take four simple steps, which will protect their company from being cloned by a fraudster including:

- First, checking your company’s registered details are correct at Companies House and that they have not been fraudulently changed;
- Second, for companies to sign up for Companies House electronic filing, by which information is filed online with an electronic password – registration



details can only be changed electronically with correct security codes. Companies House electronic customers can then subscribe to 'PROOF', the protected online filing service that reduces the possibility of fraud even further. PROOF customers tell Companies House that they will only file electronically, and that paper that claims to come from them should be rejected;

- Third, to sign up to Companies House 'Monitor', an email alert system, which will warn the password-holder when any future changes to your company details are made. The alert system sends an email every time someone tries to change a firm's registered details; and
- Fourth, to take the precautionary measure not to rely solely on Companies House records in determining whether to lend goods or offer services on credit. Companies House is a public record registry and not a credit reference agency or crime prevention service. It is therefore recommended that you satisfy yourself that your customer is legitimate through additional means.

For more details see <http://www.met.police.uk/fraudalert> and for more details on how you can protect your company's identity, see [www.companieshouse.gov.uk](http://www.companieshouse.gov.uk) as such an initiative that supports proactive risk management deserves recognition in other jurisdictions.

## A comparison: Ireland

It has been widely reported that economic crime is also rising in Ireland and cost Irish businesses over €2bn in 2005, which is equivalent to approximately €1000 a year for every tax payer. Moreover the problem is getting worse, according to a report launched recently by RSM Robson Rhodes LLP in association with Dublin Chamber of Commerce. Evidently in total, Irish companies lost the estimated €2bn in 2004 through acts such as fraud, embezzlement, cheque and credit card fraud and corruption and spent a further €500m seeking to prevent and combat the problem. Despite these findings the survey showed that only 51% of Irish companies discussed the matter of economic crime at board meetings more than once a year, indicating that Irish boards are not doing enough to tackle a potential 'business killer'.

It has further been reported that the true cost of economic crime could be even higher as the report only highlights known losses to businesses. It is also a growing problem – 44% of respondents believe the threat of economic crime to their business will worsen over the next three years. The research also showed that 34% of respondents took disciplinary action against perpetrators in 2005.

As regards the need to have an organised response to the threat, the findings have shown that directors are beginning to acknowledge the severity of economic crime. Eighty-one per cent of respondents were concerned about the effect a disclosed financial fraud could have on supplier relationships, three-quarters about the effect on shareholder equity and 74% stated that it could have a serious impact on brand image. Meanwhile it is interesting to note that 47% of companies have no specific insurance to recover fraud losses should they arise. The report also highlighted that respondents agree that the board has

ultimate responsibility. It has been reported that ‘corporate denial’ is rife with only 54% of Irish boards believing they have an adequate understanding of the financial cost of economic crime. It is, however, reassuring to find that 62% of businesses have invested in new risk management systems and that almost half (46%) of the sample invested more in 2006 than in 2005. That said 57% of respondents felt they would like to see more advice being made available to companies on the problem and indicated that more involvement should occur between government, law enforcement and industry associations.

Key findings from the report include:

- \* Nearly 43% of respondents did not inform their external auditors of instances of economic crime and on average only 31% informed their industry regulators of instances of economic crime;
- \* Only 31% of company boards have had formal training in how to recognise economic crime and only 35% of respondents had trained staff in aspects of economic crime;
- \* Only 9% share information with local businesses – acknowledged as a key method to understand and overcome the threats of economic crime; and
- \* 10% of respondents have been a victim of corporate identity fraud, over the last year, with criminals masquerading as well-known brands.

In Ireland the prime areas of corporate concern are – as in the UK – asset misappropriation (embezzlement), cheque and credit card fraud and employee collusion with fraudsters. Other ‘employee perpetrated’ crimes such as bribery and corruption and procurement fraud also ranked highly.

## Survey findings: remarks and suggestions

The findings of the surveys and the initiatives mentioned above show that economic crime is a growing area of concern that extends beyond the business community to the general public who suffer its negative effects. The belief that white-collar crime is a victimless crime must be overcome; the negative affects of economic crime are actually suffered by all. The statistics are striking and reinforce the need for further collaboration between state and industry bodies and consumer groups. Furthermore, as seen above, economic crime is not confined to specific industries or regions and knows no limits or geographical boundaries. In an age of technological advancement, it is vital the issue of economic crime is discussed within industry forums and closer collaboration between industry bodies and consumers occurs to raise general awareness of the problem. In most cases, the trust that businesses place in their staff is rewarded by hard work and loyalty but since employee disaffection by one

member of staff alone can cause a great deal of harm this must be considered a priority. For instance, software piracy and music piracy are huge concerns. Moreover, while educating employees and management in methods of prevention are crucial, they need to be combined with strong and effective regulation.

In view of the rising trend in economic crime globally, there is no doubt that the cost of crime and of crime prevention is substantial to business. Firms see the cost of crime directly, for example, in terms of goods that are stolen, but also indirectly through increased security and higher insurance costs. In order to become more organised in the face of organised economic crime improved risk management is paramount for all businesses, regardless of size and location. There is no doubt that greater cooperation is needed among all interested parties and that this is an area that should be monitored and on which professional advice should be sought.

## **Economic crime, transparency, openness and ethics and small business**

In previous chapters there has been considerable consideration of the need for improved risk management and governance by all business representatives. It has been noted that while standards may be aimed principally at larger organisations impacts occur for the small business sector in practice due to, for instance: enhanced stakeholder interest and awareness; supply chain pressures; and other competitive drivers. This is even more the case bearing in mind that small business and small and medium-sized enterprises (SMEs) are increasingly involved in international operations and activities and, as a result, exposed to differing regulatory and non-regulatory business standards.

In this section the intention is to consider certain aspects of transparency, openness and ethics from different perspectives, bearing in mind both the risks and the opportunities presented by the ethics debate. The growing concern over economic crime and other instances of commercial or business theft are referred to only briefly as they are covered more fully above.

## **International considerations**

As noted above for some time both international public and private organisations have demonstrated an increased interest in ethical issues involving business – principally in the fields of economic crime and corruption, in particular the OECD (as mentioned above as well) and the International Chamber of Commerce (ICC) are two well-known organisations that have been working to combat extortion and bribery within the global marketplace. Their initiatives also demonstrate and highlight the gradual agreement on some common, worldwide standards for global business operations, as well as the need to be proactive in dealing with such risks. One way forward, it is submitted, is through the evolution and implementation of sound ethical corporate policies.

As has been indicated, an awareness of ‘stakeholder relations’ further promotes the practice of good business ethics. Since improved governance has been the trend companies are recognising:

- The impact of decisions outside their control; and
- How these decisions could damage the reputation of the company from the public’s perspective.

Just as the number of ethical issues appears to have grown with increased public understanding and advanced technology and media coverage business has to consider reputational issues more and more and avoid moral confrontations that might result in their stakeholders’ disapproval. Moreover, it is often a matter of sound risk management to consider ethical issues as a priority regardless of the location of the business and the sector in which it operates.

## The small business challenge

Bearing in mind the above, the comparative lack of attention given to the ethical concerns of small and medium-sized businesses is a significant area of trepidation. It has been noted by various business advisors that there is too much research on business ethics that assumes that all private sector commercial organisations behave in similar ways or have similar problems. In fact, this is not so, over 95% of organisations in most national economies are composed of fewer than 50 people, and they provide the majority of employment. Commentators have noted that it is, therefore, surprising that this distinction between large and small companies, which function in different ways, has not been more widely recognised with regard to ethical behaviour. Moreover it is surprising that simple behavioural codes of conduct are not in place more often, which can enhance the transparency, integrity and performance of the organisation as a whole.

One clear and simple illustration relates to commercial dishonesty. By way of example, business leaders anxious to discourage skiving, pilfering and scamming at work should first examine their own behaviour and ethics. They should, of course, set an example and this example is important for staff morale and conduct in practice. According to the survey entitled *Ethics at Work* from the Institute for Business Ethics (IBE), only personal telephone calls find favour with more than half the workforce – all the other ‘minor’ misdemeanours received disapproval by the majority. Yet practical guidelines reflecting modern day business practice are often missing: for instance, it should be mentioned that in a world where people work from home, it is not clear that the pen should be checked in as they leave the office anyway.

In another recent survey reported by *The Times* it has been indicated that more than half the workforce think a ‘bit of fiddling on expenses’ is not as bad as fraud and an even larger number think most people lie to their boss on occasions. This is according to the first comprehensive survey of workplace attitudes

towards ethical conduct. The survey was carried out by Mori for the IBE. It also found that evidently the vast majority frowned on:

- Taking software home;
- Going sick the day after a party at work;
- Favouring family or friends with contracts; and
- Charging personal entertainment to an employer's account.

Moreover this does not only apply to commercial organisations. Just as business is now operating in an era of exacting requirements of corporate governance, as has been discussed in Chapter 6, it should also be noted that charities today are also similarly impacted. Furthermore those companies that donate to charities should ensure that the non-profit organisations that they support are following correct procedures and are responsive to change. The interaction and influence between the commercial and non-commercial sectors can be witnessed globally. As has been emphasised previously, issues of transparency and governance include both macro and micro concerns. Developments and comments can therefore extend from the larger organisations to very small organisations in this vast global marketplace. This highlights the value of company codes in terms of risk management (see below).

## A case study: transparency certification of the private sector (enterprises)

As has been indicated above there has been research and other related practical projects undertaken by respected organisations over ethical business practices for a considerable period. For instance, the initiatives undertaken by Transparency International (TI), which has for some time been working toward more openness, accountability and ethical behaviour – as well as transparency – can be considered as regards the debate over the suggested idea of ‘transparency certification’.

### TI business principles

Transparency International and Social Accountability International have facilitated the initiative for the *Business Principles for Countering Bribery*. These were developed in a partnership project undertaken with a Steering Committee drawn from companies, academia, trade unions and other non-governmental bodies.

It is important to note that the Business Principles have been designed for use by large, medium and small enterprises. It is understood that they apply to bribery of public officials and to private-to-private transactions.

The purpose of the document is to provide practical guidance for:

- Countering bribery;
- Creating a level playing field; and
- Providing a long-term business advantage.

According to TI this offers an innovative and practical tool to which companies can look for a comprehensive reference to good practice to counter bribery. The hope is that the Business Principles will become an essential tool for businesses and encourage them to consider using them as a starting point for developing their own anti-bribery systems or as a benchmark. It is further understood that the Business Principles have been aimed at a good practice level to attract the widest possible acceptance. Moreover, as a ‘living document’, the Business Principles are expected to evolve over time to reflect changes in anti-bribery practice as well as the lessons learned from their use and application by business according to TI.

## The objectives and impacts of the TI project: a summary

It is useful to highlight the key objectives of the TI approach, which are to:

- Promote a more ethical approach to business as a management tool;
- Build mechanisms to promote organisational excellence and to improve corporate ethics;
- Discourage corrupt practices at private SMEs;
- Improve relations between private enterprises and the interest groups they work with in order to raise productivity and enhance the overall business environment;
- Raise the awareness of business people about ethical practices in management;
- Encourage business to make concrete commitments to social responsibility and the development of better ethical practices;
- Promote the consideration of ethical principles in corporate decision making; and
- Develop management models for implementing more ethical practices.

This approach is very useful when considering and comparing initiatives and projects of other leading bodies in this field, such as the IBE.

## Ethics and comparative governance issues: the UK and the US

In the UK ethical issues and governance generally in the profit and not-for-profit sectors have been under scrutiny for some time. As with the commercial sector, the voluntary sector is under pressure from all sides to consider a code or framework to bridge the gap between law and good practice. As is explained in other chapters, the Enron and WorldCom scandals and the subsequent Higgs Review of the role of NEDs in the UK private sector gave the debate an air of urgency (see also Chapter 21). Although the review considered corporate boardrooms the ICSA has stated that the issues raised are also relevant to charities. Clearly as regards ethical issues, whatever the sector, this should not entail

a box ticking exercise: there should be practical solutions as a result of a code of practice that provides guidance on:

- Best practice;
- Recruitment; and
- Professional development.

There should be a set of expectations in both sectors which effectively says comply or explain. As has been discussed previously the corporate governance debate in the United States has also spread from the for-profit to the not-for-profit world. Indeed observers such as Eliot Spitzer, the Attorney General of New York State, have suggested that the Sarbanes-Oxley Act should be applied to non-profit boards.

As regards ethical behaviour there has been a proposal relating to the relief from personal liability for trustees. Just as is the case as regards non-executive directors, the matter of personal liability has discouraged many from being trustees. The intention is that if a trustee acts honestly and reasonably they will not be personally liable. Nevertheless, as mentioned in Chapter 6, the voluntary sector is generally under pressure to improve governance and, in particular, the role of trustees. There has been some debate regarding the need for a trustee code of practice. This type of analogy is relevant to the whole debate of risk management.

## **Governance and CSR: an ethical business opportunity for SMEs**

As indicated above for most organisations the concern over economic crime and fraudulent activities is becoming more and more relevant. However, practical arguments are still needed in order to engage the small business sector in this debate in a truly meaningful manner that links the concepts of transparency, openness and ethics with bottom-line issues that:

- Go beyond the figures for business theft; and
- Impact upon the behaviour of the organisation as a whole.

A clear example is in the area of corporate social responsibility (CSR) which has attracted those businesses whose activities identify with CSR, such as the recycling business, or where there are enlightened owners who have a particular interest. This can lead to more enlightened business practice throughout the workforce and reduce the risk of economic crime.

For SMEs in fact, a procedure can be followed that not only can assist in improving the ethical behaviour of the organisation but also adds value having regard to its price/earnings (P/E) ratio. It is straightforward to establish the company earnings, and most executive teams will have a working estimate of the value of their company. It is therefore relatively easy to estimate a P/E ratio, which can be compared with similar companies that are publicly quoted as a rough benchmark. Companies can similarly establish their relative CSR/CR

position since the executive team will have a good understanding of what is going on within the company. Benchmarking this against the competition may not be easy, especially if little information is available publicly. However, a quick comparison with one or two publicly listed companies within the sector, who generally publish fuller accounts of their internal activities, will provide a qualitative insight. For an SME this is all that is likely to be required in view of the need to economise in resources.

As a matter of business practice and in order to see the benefits of improved business behaviour it should also be mentioned that reporting, where it is necessary for an SME, should follow the principle of ‘Minimum and Adequate’, since deploying any more than the minimum level of resource on this task may not be cost beneficial. This can change as confidence in the real value of an ethical business policy grows.

For SMEs the supply chain pressures related to CSR/CR can also be very relevant. Frequently SMEs are part of the supply chain to larger quoted companies who themselves are seeking to align their suppliers with their CSR/CR standards, policies and practices. For this reason SMEs are advised to use an analysis of their cover of social, ethical and environmental matters and to examine the CSR/CR position of their business-to-business customers, and assess what the implications for the SME might be. It has been demonstrated that those having a superior coverage of CSR/CR matters will generally have a higher market value in comparison with others in their sector.

## The opportunity for ethical business strategies

The opportunity for business ethics to demonstrate its practical – even bottom-line – value and use is growing in this risk-laden economic climate. The increased awareness of the public and stakeholders should again be mentioned as major drivers for improved business openness and responsible corporate citizenship. It has been argued by many commentators that:

- Enhanced educational opportunities, coupled with the availability of world-wide information at minimum cost, have provided the public with a greater desire to be involved in decisions affecting their lives;
- Governments and shareholder groups are demanding transparency and accountability on the part of multinational corporations in particular (which extends to the supply chain), given the potential high profile incidents that poor corporate behaviour can lead to; and
- Furthermore, campaigning groups are raising a variety of concerns with corporations, which need to be addressed.

In the US, regulatory imperatives had also been driving change in business practice in order to reduce corruption, well before the corporate scandals referred to above (see also Chapter 22). By way of example, the promulgation of the Federal Sentencing Guidelines (1991), together with the stringency of the US Foreign Corrupt Practices Act (FCPA) (1977), provided a strong impetus to



corporate ethical programmes in the United States. The FCPA made it possible to prosecute corrupt business people in their home country, as well as in the jurisdiction where the offence took place (prior to the OECD convention). Meanwhile calls for the accountability of issues – other than financial – have been responded to through CSR programmes that have encouraged companies and charities to become more proactive on such issues as human rights and the environment. It is clear that opportunities for business ethics can be found in the willingness of companies to adopt these CSR and ethical policies and approaches that sustain respectable relations with their stakeholders.

## Practical concerns

Despite the period over which this debate has been taking place there remains the problem – as with the environmental or health and safety policies in the recent past and that can still exist – that there can be a lack of integration of ethics with corporate policy. Generally speaking, insufficient effort is being made to familiarise employees and human resources as a whole with business dilemmas and how to exert moral initiative. To be taken seriously, ethics within the business place must be seen to be of significant value. In addition to bottom-line arguments, therefore, this can only be achieved if employees recognise the distinction between right and wrong and are given guidance in the matter. More and more statistics demonstrate, for example, that economic crime commences with dissatisfaction in the workforce. There again an appropriate company code is important as a tool for sustainable business risk management (see below).

## Risk management

Senior people within a company should be responsible for enforcing company policy; targets, integrity of processes and performance measurement should all be in place. The following are examples of good risk management:

- Have a company-wide code of conduct and adhere to it. Ensure it contains elements forcing staff to disclose gifts above a nominal value and very clear rules on the business rules of how to deal with suppliers, governments and other stakeholders. There should then be enforcement of this plan and disciplinary action against non-adherents;
- The end of the freebie: there needs to be an internal review of what is seen as acceptable generosity and the darker world of bribery, inducement and corruption as the dividing barrier has become ever closer in the eyes of stakeholders. An example is that the UK airport operator BAA even reviewed the ending of its scheme to offer free airport parking for members of the European parliament, House of Commons and Lords. This happened after shareholders gained 17.3% of a vote to stop the practice, against the board's recommendation for this practice to continue (*Financial Times*, 28 July 2004);

- Make provisions for internal fraud systems of investigation. Financial institutions have been bankrupted by internal systems failures; BCCI, Barings Bank and others have experienced severe losses:
  - The UK financial watchdog said companies must work harder to cut down fraud as losses were close to £1bn in 2005, a trebling from the previous year's figures;
  - A UK banking employee was sentenced to two years in prison after defrauding the bank of £280 000;
  - A UK postal worker was also jailed for six and a half years after gaining £20m from a chequebook and credit card fraud; and
  - A large UK-based caterer admitted to spending over £5m on an internal investigation into allegations that a subsidiary that feeds UN peacekeepers had been involved in corrupt buying practices.
- Working with anti-bribery agencies can pay dividends, as the Kenyan government has found in their moves to clean up their country and make it a more investment friendly zone;
- Avoid paying bribes, apart from the obvious illegality in many nations and damage to reputation when they surface, there is the practical side that once started it is difficult to stop paying them; and
- Strive for sound ethical standards in carrying out business activities and, together with whistleblowing procedures, endeavour to create the climate in which employees may voice genuinely held concerns about behaviour or decisions which they perceive to be contrary to the terms or the spirit of the policy. The intention is to install a philosophy whereby everyone seeks to protect the business principles, reputation, values and therefore long-term value in the organisation (see also Chapter 9).

## Company codes

When considering risk management, regardless of the precise legal framework, companies should put their own ethical position in order (see also Chapter 13). Most company codes have expressly forbidden bribery since the OECD convention. For example, several years ago Rio Tinto published a statement of business practice entitled 'The Way We Work', which stated that 'the direct offer, payment or soliciting of bribes is not permitted'. In terms of risk management such codes can provide a form of protection: if it is generally known that employees are forbidden to pay bribes they are less likely to receive demands. However, SERM's experience has shown that codes are not enough and attention is now focusing more on the issue of enforcement (see Chapters 21 and 22) following so many corporate scandals.

As regards the vulnerability of management to corruption SERM has found middle management can often be more exposed than senior management and junior staff. This can be because they believe that the code is a theoretical exercise or lip service and that senior executives give mixed management messages. Those deployed overseas particularly often think that corporate headquarters does not understand local problems and is only interested in financial returns.

This bottom-line profit is what can bring promotion: moreover personal security can be at risk if local corrupt practices are not followed. To overcome some of the middle management problems it is essential to:

- Involve them in drafting the code;
- Train expatriate managers prior to deployment; and
- Maintain clear lines of communication with superiors.

It is always helpful to be proactive and survey the more complex and corrupt environments for opportunities to operate more honestly and effectively. Generally this means:

- Obtaining detailed local knowledge;
- Carrying out detailed due diligence investigations of potential partners;
- Building up, confidentially and sensitively, a broad network of relationships with a variety of local representatives, both in the formal political and administrative system and beyond;
- Not relying on one single patron or sponsor, thereby reducing exposure to political risk;
- Generously demonstrating benefits to the local community (see Chapter 12); and
- Operating transparently in the wider region to draw on a range of others against any type of corrupt demand.

It should be emphasised that high standards of integrity form the only reliable basis for robust risk management and long-term commercial sustainability (see also Chapter 12).

## Chapter summary

As has been mentioned in other chapters (see Chapter 9) a sound business reputation is critical to successful business sustainability. As part of their risk management strategy organisations should ensure that a sound approach to economic crime and ethical issues is part and parcel of corporate strategy, regardless of size and location and indeed whether commercial or non-commercial. Moreover there is no doubt that the overall lack of ethics topics in corporate training programmes in many business sectors poses another concern in the quest to achieve and maintain high moral business standards. In order to maintain an enlightened workforce the organisation should invest in sound ethical strategies that can mitigate exposure to related risks.

From all of the above it is clear that the role of human resources is paramount and that a happy healthy workforce with good communication flow can make a huge difference in practice to the health of the organisation. One recommendation that may be made by way of best practice is to include in all training programmes from top to bottom and vice versa – ranging from those for directors to new employees programmes – some ethics awareness element. This could be in the form of a mini-case study. Additionally, training employees to fully understand business ethics relies on competent and qualified

instructors. The shortage of these instructors, coupled with the continuing competition between philosophy and management teachers concerned with business ethics, provides another concern when considering the long-term sustainability of responsible business. Creative solutions are possible and it is in the interest of small business to be part of the solution finding debate.

**Hints and tips**

Key message: 'transparency'

Best standards: will sustain lasting partnerships in global trade as well as with law enforcement agencies.

Communication: companies need to propound their transparency internally to their employees as well as globally, to business as well as communities.

Complacency: the enemy of transparency ... do not let it happen!

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8

Business interruption and risk  
management

# 8

## Business interruption and risk management

### CHAPTER OVERVIEW

In this chapter the practical issues of business interruption and risk management are considered. Despite the fact that such matters are of course paramount in the context of sustainable risk management it emerges from many practical incidents or case studies and surveys (see below) that organisations often fail to prepare themselves sufficiently. Indeed even when they have experienced business interruption managers they often still do not adequately manage these risks.

### Business interruption and recovery

Clear examples of the approach to business interruption and recovery occurred when the London Chambers of Commerce (LCC) studied the impacts on business behaviour one year on following the 7 July 2005 terrorist attack in London. This report has summed up many of the key issues regarding business interruption and recovery and its findings are most valuable in terms of sustainable risk management. It is therefore cited in detail here.

The LCC found in particular that business continuity management is about more than just surviving a direct terrorist attack on a company's business premises. Business survival can also be threatened by failures in other critical business areas such as power outages, failures in IT or telecommunications systems, loss of transport networks, or supply chain disruption – all of which may result from natural disasters or random 'acts of God' rather than terrorism. The current UK government's only legislation on preparedness, the Civil Contingencies Act 2004, for example, owed its genesis not to the 9/11 terror attacks in 2001 but to the period from September 2000 to Summer 2001 when the UK was beset by a fuel crisis, severe flooding and an outbreak of foot and mouth disease.

*Financial help for business*

In 2001 the New York City Investment Fund created the Financial Recovery Fund to help small businesses in Lower Manhattan that were affected by the World Trade Center attacks. By early 2003, grants to the amount of \$113 million were distributed to 88 small businesses and 34 seat holders of the New York Board of Trade (New York City Investment Fund, 'Lessons learned', September 2003).

The variety and unpredictability of disasters that can affect communities and businesses was further demonstrated by events in 2005, when the world witnessed the full spectrum of disasters that could befall communities and businesses, starting with the Asian tsunami and then moving on to include the Pakistan earthquake, hurricanes in the US, the London bombings and even the Buncefield oil refinery explosion. It has been reported that respondents to the London Chamber of Commerce and Industry *CMI Business Continuity Management Survey 2006* rated 'terrorist damage' as only the seventh most significant threat to their finances, alongside fire but behind utility outage (sixth), loss of telecoms (second) and loss of IT (first) (see also Chapter 11). Also, the seventh-placed ranking was actually down slightly on the year before, when 'terrorist damage' was rated as the sixth most significant threat. The full table of results is included below.

Source of threat to costs and revenues	Percentage of respondents identifying this threat (2006)	Ranking (2006)	Previous ranking (2005)	Percentage of organisations' contingency plans which include this (2006)
Loss of IT	67	1	1	67
Loss of telecoms	56	2	2	63
Loss of people	56	2	5	51
Loss of access to site	54	4	6	61
Loss of skills	49	5	3	40
Utility outages	45	6	8	51
Fire	44	7	3	55
Terrorist damage	44	7	6	45
Damage to brand or corporate reputation	39	9	9	26
Negative publicity	34	10	10	28
Employee health and safety incident	30	11	11	41
Supply chain disruption	28	12	11	27
Environmental incident	27	13	11	42
Flood/high winds	26	14	14	42
Customer health/product safety	26	14	15	22
Industrial action	22	16	15	20
Pressure group protest	16	17	17	16

(Source: *CMI Business Continuity Management Survey 2006*)



More importantly, when asked to rank these factors in terms of those which had actually had an impact on their organisation during the previous year, managers placed direct ‘terrorist damage’ at the bottom of the list, impacting on just 3% of respondents. Loss of IT topped the poll with 38%, followed by loss of people (29%) and loss of telecoms (24%).

Nonetheless, although managers said that their business had not suffered direct damage from terrorism, many reported knock-on effects from the 7/7 bombings in London. Some 10% of survey respondents said the bombings had caused ‘significant disruption’ while 26% said it had caused ‘minor disruption’ and 24% said there had been a negligible effect. Thirty-six per cent of managers said their organisation had seen ‘no impact’ from the terror attacks. In contrast, 70% of managers said the Asian tsunami had no effect on their business and 77% said they had seen no effect from the Pakistani earthquakes.

Several other potential threats to businesses have raised in prominence recently, most notably a possible avian flu pandemic. However, despite the significant media attention the threat of a flu pandemic received, businesses evidently remain unprepared. An LCCI London Business Leaders’ Panel survey in February 2006 found that just 19% of firms had a contingency plan in place to deal with an avian flu pandemic. Some 10% of London firms had updated their existing contingency plan to deal with avian flu and only 6% had tested their plans in the context of a pandemic.

In view of increased public interest in climate change, concern over environmental disasters and extreme weather conditions has also gained in priority. A sustained heatwave in France during August 2003 did not just result in the deaths of an estimated 11 000 citizens but also threatened national power supplies and caused IT systems and data centres to shut down or overheat. An AXA Insurance survey found that SMEs cited severe weather patterns as a bigger threat to their business than poor management or competition (Axa Insurance, April 2006).

The Hurricane Katrina disaster in the US is estimated to have caused insured losses of \$25 billion, making it the costliest storm in US history. Lost tourist revenues in New Orleans alone are said to have topped \$5 billion and the Mississippi River’s gaming industry was all but wiped out with the state’s 12 floating casinos either severely damaged or destroyed. As a result of the storms and flooding 91% of oil production and 83% of gas production in the Gulf of Mexico was shut down, forcing petrol prices and energy costs to rise sharply across the US. Freight transport companies lost \$3–4 million a day while the region’s 12 ports were closed (‘Counting the cost of Katrina’, BBC News, September 2005). In the state of Louisiana alone an estimated 18 750 businesses were destroyed, wiping out 240 000 jobs (Acadania Regional Development District, *Louisiana Hurricane Statistics 2005* (2005)).

## Buncefield: a lesson in contingency planning for business

As is again explained in the LCC report, one useful example of the need for contingency planning is the Buncefield oil refinery fire in the UK in December 2005. This example is cited from the report by the Business Continuity Institute

(BCI) and described the Buncefield disaster as ‘what business continuity management is all about’. According to Lyndon Bird, technical director at the BCI: ‘It provides more messages and lessons than all of the other annual incidents put together. Firstly, it just happened “out of the blue”, with no obvious reason, warning or prior experience to suggest it might ... Secondly, it happened at the most inconvenient time, two weeks before Christmas when demand for oil products was at its peak and many organisations were working at full capacity. Thirdly, it was the things that many had not planned for that caused the most concern, for example police and other emergency service access restrictions. Lack of access to their own business premises (even if not damaged) caused anger, conflict and major frustration’ (‘Buncefield – What BCM is really all about?’ *Continuity magazine*, [www.thebci.org](http://www.thebci.org)).

The Buncefield disaster had a heavy impact on surrounding businesses. Internet retailer ASOS suspended trading on their shares, the headquarters of software firm Northgate Information Solutions was severely damaged and had to initiate its contingency plan, and DSG International, the firm that owned Dixons and Currys, had to close its head office (‘Fuel blasts close neighbouring firms’, *The Guardian*, 12 December 2005). According to Geoff Howard, director of The Continuity Shop: ‘After the Buncefield disaster, several companies went bankrupt which weren’t even damaged by the explosion, but were just in the exclusion zone. One wholesaler of Christmas supplies was caught in the exclusion zone for a week, and due to the nature of his product, was unable to deliver to his suppliers in time for the deadlines. Clearly due to the investment made in the stock he could not wait another year, and hence went bankrupt. This illustrates the importance to SMEs especially of having some kind of business continuity plan in place, as well as some kind of insurance which covers such eventualities.’

These sentiments were echoed by Professor Jean-Noel Ezingard of the Henley Management College, who said: ‘Something like Buncefield, where businesses three miles away were affected, should bring it into focus. Every business owner should be looking at the effect an incident could have ... They need to prepare for the impact on trade, turnover and stock.’

Following the Buncefield disaster, data management software designers Version One conducted research which found that 30% of finance directors did not believe that their business would survive the loss of all paper records and business documents in the event of a disaster. Some 32% would take 12 months to recover and 38% estimated a recovery period of approximately six months. In terms of the financial cost of losing paper records, 45% of firms estimated the cost to be at least £50 000, 32% of firms said the cost would be between £100 000 and £800 000 and 15% of finance directors said the cost to their business would be more than £1 million (Version One, *Financial Directors say 30% of Companies at Risk*, January 2006).

## Barriers to developing contingency plans

The LCC has found – as SERM case studies have also discovered – that a lack of adequate contingency planning is a major issue for SMEs in particular. It is

likely that the scenario in the UK would be similar in other parts of the world. While the latest LCCI survey found that 41% of firms had a contingency plan, the figure fell to just 29% among firms with fewer than 20 employees. Comparatively, among firms with 20 staff or more, the proportion with contingency plans is 57% (LCCI, *London Business Leaders' Panel*, May 2006).

The LCC considered research by Axa Insurance and Henley Management College which found that 76% of SMEs had not 'reviewed business approaches' since the July terrorist attacks. The report concluded: 'Despite growing awareness of the problem, UK SMEs appear to have failed to be stimulated into action ... With fewer resources to withstand the business impact of a major incident than larger firms, under-prepared SMEs expose a significant vulnerability in terms of their own survival, and the consequential impact on their employees, their customers and their suppliers' (Axa Insurance/Henley Management College, December 2005). According to Professor Jean-Noel Ezingard of the Henley Management College: 'Too many of Britain's SME managers bury their heads in the sand when it comes to continuity planning. The fact that 40 per cent of businesses suffer a terminal failure as a result of an incident proves that more needs to be done. Continuity planning can be a simple, practical measure whereby senior managers ask a series of "What if" questions, and for most businesses, the only cost to the business will be their time. A lot of SMEs tend to focus on the day-to-day aspects of the business but never look at risk control ... Firms can have robust contingency plans with only a small amount of carefully directed effort.'

In addition to the size barrier, the LCCI's research found that there are also differences in business continuity management take-up rates between sectors. Some 52% of professional services firms, 50% of transport operators and 49% of 'other services' firms have contingency plans but just 34% of manufacturers and only 21% of retailers said they had a contingency plan.

In the UK another critical barrier to adopting contingency plans is that government advice is provided through government agencies which are not the points of contact or sources of advice that SME company directors tend to utilise. Accurate and timely information from government is a vital aspect of effective business resilience. If the government's civil contingencies messages are only being communicated to a small section of the business community then this could have very serious ramifications for the resilience of UK plc.

A recent survey by the Federation of Small Businesses found that only 4.4% of SME company directors take business advice from government-funded business support organisations and just 1.1% seek advice from central government bodies (such as the DTI or the HSE). By comparison, directors were much more likely to take business advice from their accountant (53.7%), their solicitor (28.4%) or their bank (8.7%). In fact, company directors were almost six times as likely to take advice from a trade association, and twice as likely to seek the opinion of their local tourist board, than from the DTI.

In the UK the LCC has found that another barrier is the nature of the advice itself. While guidance from policy experts in Whitehall may be thorough and comprehensive it tends to lack grounding in the realities and constraints of

running a business. For example, the Cabinet Office's *Pandemic Influenza Checklist for Businesses*, 2006 recommends businesses assess their preparedness for a flu pandemic with reference to 30 tasks or activities. However, 21 of these tasks require a significant input of time and a further seven, such as more frequent cleaning of business premises or enhancing mail ordering facilities, represent considerable extra costs to businesses. Three of the tasks – finding up-to-date pandemic advice, reviewing a communications plan and testing contingency plans – must be regularly repeated and revised, representing ongoing obligation upon businesses. The Cabinet Office should also ask itself how practical or realistic it is to ask SMEs to 'establish policies for reducing the spread of influenza at the worksite [by] promoting respiratory hygiene and cough etiquette' or to always 'ensure that communications are culturally and linguistically appropriate' (Cabinet Office, *Pandemic Influenza Checklist for Businesses*, 2006).

In order to engage business proactively the LCC has stated that it is important to ensure that communication with business is practical and fit for purpose. Departments and agencies should make advice focused and relevant and avoid trying to use contingency advice to meet other policy objectives, not least because to do so suggests that the government has failed to grasp the seriousness and scale of the threat to business.

Efforts to increase levels of business continuity management must also be targeted at the right audience. Research has shown that – as with most areas of risk management – contingency planning within firms is a direct result of commitment from the highest levels of management. According to the Henley Management Institute,

Without backing from the managing director or chief executive, business continuity management does not happen. (Axa Insurance/Henley Management College, December 2005)

## Survey on business interruption and security

Bearing in mind the LCC report, it is useful to note that The Conference Board published a report *Navigating Risk: The Business Case for Security* based on a year survey of 213 senior corporate executives. Those responsible for security and chief information officers were excluded from the survey to enable it to gauge the role and influence of business security managers among general senior executives. The surveyed companies most concerned with security are companies in critical infrastructure industries (including energy and utilities, chemicals and transportation), large corporations, multinationals with global operations, and publicly traded companies.

'Security directors appear to be politically isolated within their companies,' says Thomas Cavanagh, senior research associate in Global Corporate Citizenship at The Conference Board and author of the report. 'They face a challenging search for allies when they need to gain support from upper management for new security initiatives.'

The survey found that experts from security directors themselves, the executives most supportive of security matters are those in risk-oriented positions, such as CIOs, risk managers and compliance officers. It also found little linkage

between the level of support for security initiatives and the level of influence over security policy within the companies surveyed. In general, the most supportive executives were not the most influential, and the most influential executives were not the most supportive. In addition, most senior executives surveyed reported that they have little direct responsibility for most aspects of security. Moreover senior executives are often heavily involved in specific security decisions even though they are not directly accountable for them.

## Alignment with business objectives

In the survey executives were asked how effectively their company's security was aligned with their company's business objectives – in other words, to what extent their own company's security operation contributed to accomplishing the firm's overall mission in the marketplace. The most effective alignment was found on issues of operational risk, such as complying with government regulations (cited by 79%), protecting confidential information (74%), meeting certification standards (72%), and maintaining business continuity and ensuring customer safety (both 71%). Limiting financial risk (62%) and defending against litigation (60%) are also viewed as areas in which security was effectively aligned with corporate functions.

However, in the survey companies reported less alignment of security with long-range strategic objectives of the firm. For example, among senior executives, 56% see their company's security operation as effectively aligned with the need to keep pace with competitors, and half of the sample believes security had been effective in reducing insurance premiums. Much lower proportions saw security as contributing toward enhancing the value of the brand (44%), managing the supply chain (36%), or pursuing new business opportunities (35%).

'At one level, these results are perhaps surprising and a bit disappointing, since they suggest that security remains a function that is mired in operations in the eyes of senior executives', says Cavanagh. 'But if security executives could successfully relate security initiatives to the competitive posture of the firm – for example, enhancing the appeal of the brand – they might be able to bolster the case for such initiatives as part of a long-range strategy, giving them more prominence in the thinking of the board and the firm's senior management.'

In critical infrastructure industries, evidently 87% of the executives surveyed saw effective alignment of security with compliance needs, compared with 70% in the non-critical industries. Similar gaps were seen with regard to protecting confidential information (77% effective alignment in the critical industries vs 69% in the non-critical industries), meeting certification standards (77% vs 65%), maintaining business continuity (75% vs 68%), and keeping pace with competitors (60% vs 54%).

## Value of security programmes?

As SERM has found, the search for effective measurement of risk has become an essential part of the management process in security as in other aspects of

corporate life. Increasingly, security directors are asked to establish a business case for undertaking security expenditures.

Survey participants said that the most useful approach for determining the appropriate level of security spending in their companies were those that enable executives to determine how much a security problem would cost the firm in terms of liabilities or lost business. The most helpful values found in the survey were the cost of business interruption, cited by 64% of executives; vulnerability assessments (60%); and benchmarking against industry standards (49%). Another group of values was explicitly related to insurance costs, such as the value of facilities (44%), the level of insurance premiums (39%) and the cost of previous security incidents (34%).

‘Unfortunately, the measures available for analysing the effectiveness of corporate security tend to be much less sophisticated than those that have been developed for other corporate functions such as finance, human resources, and information technology’, says Cavanagh.

## Insolvency and meaning

One of the main repercussions of business interruptions is insolvency. Moreover insolvency can lead to business continuity problems. This can be a complex area approached differently in various countries. In this section the current focus is on the UK and US, bearing in mind also the discussions in Chapters 21 and 22.

### *The insolvency debate*

Key areas of concern are the:

- \* Role of the banks;
- \* Appointment of an insolvency practitioner (IP);
- \* Priority of debts;
- \* Costs of insolvency; and
- \* Problem of cash flow and causation of insolvency.

There has also been extensive debate regarding the appropriateness of the UK’s regulatory framework relating to insolvency and business failure. It is not intended to go into the present laws of insolvency (which is a vast subject) but rather to consider the meaning of insolvency. What, then, is usually meant by insolvency? Generally:

- The inability to pay debts as they mature;
- Under the American Bankruptcy Act (1898) the insufficiency of assets at a fair valuation to pay debts; or

- Under other laws the insufficiency of assets at a fair saleable valuation to pay debts (see James A. Machachlan, *Handbook of the Law of Bankruptcy*).

The second meaning is sometimes referred to as the balance sheet insolvency test and is the predominant meaning in civil law jurisdictions. Non-lawyers are accustomed to using the term ‘insolvent’ as an adjective, such as an insolvent debtor whereas lawyers sometimes use the term attributively as a noun, that is ‘an insolvent’.

Also relevant is the concept of bankruptcy, which generally refers to the:

- Fact of being financially unable to carry out one’s business and meet one’s engagements, especially to pay one’s debts;
- Fact of having declared bankruptcy or having been adjudicated bankrupt under a bankruptcy statute; or
- Field of law dealing with those who are unable or unwilling to pay their debts.

In this respect the relevance of the American approach has been widely debated in the UK. In the US the phrase Bankruptcy Act refers to the law of 1898, which governed bankruptcy cases filed before 1 October 1979. The phrase Bankruptcy Code refers to the Bankruptcy Reform Act of 1978 (frequently amended since then), which governs all cases filed since 1 October 1979. What is well known in American law – and increasingly understood here – is what is called Chapter 11. In American legal usage Chapter 11 has become synonymous with corporate reorganisation for the purpose of handling debts in a structured way, under the protection of a federal bankruptcy court. The phrase is often used attributively. By way of example it has been noted that, ‘The purpose of a Chapter 11 filing is to give a chief executive an opportunity to reorganise a financially troubled business by putting its creditors on hold. When the money problems have been straightened out and the company restored to health it emerges from the protection of the bankruptcy courts and picks up where it left off’ (John Taylor, ‘Bankruptcy was a disappointment’, *New York Times*, 10 December 1989, paragraph 7 at page 11). Therefore a common colloquialism that has evolved is to go Chapter 11. By way of example in a review of John Rothschild’s work *Going for Broke* (1991) it was also noted: ‘Of course Campeau’s badly overextended retailing Empire would soon go Chapter 11 anyway, throwing thousands out of work and rippling damage through the US economy’ (Book note, *American Way*, January 1992 at page 78).

Although to go Chapter 11 does not appear to have the stigma often attached to insolvency and bankruptcy evident here, certainly the consequences for business – as well as personal consequences – may in practice be devastating. This has been witnessed in many very recent cases, such as Kmart and Global Crossing as well as the controversial Enron case study that has been so publicised and analysed (see also Chapters 21 and 22). This led to calls to make US directors more accountable and to require a new team of managers under Chapter 11 rather than leaving the existing management in place. In some ways

the US is moving closer to UK thinking, to make it more difficult for bankrupts to be forgiven their debts and to be rehabilitated without sanction. It is recognised that insolvency may be a result of mismanagement, rather than purely misfeasance or fraud.

Nevertheless it must be appreciated that the stigma that attaches in the UK, together with the ongoing practical repercussions of business interruption and failure – insolvency or liquidation – often means that a valuable contribution to the business economy is damaged. This can happen, for example in circumstances that are often beyond the control of the small business at risk and are disproportionate in effect. Solutions remain imperfect when considering sustainable risk management and different jurisdictions look to each other. For instance, in some ways the UK is moving closer to the US by attempting to make it easier for companies to be rescued and make it less of a crime for an individual to go bankrupt. This is where there is no blame involved. It can be appropriate in circumstances in which small business often finds itself, that is with cash flow problems in circumstances beyond its control through the late or non-payment of debtors.

## **Business continuity and operational risk management**

Bearing in mind the earlier chapters, it is also appropriate to consider business continuity and operational risk management at this stage. Since business continuity can be affected for an array of reasons management should be prepared as part of its risk strategy. One preliminary issue is whether a business does in fact consider operational risk management and business continuity as being entwined. The basis for this discussion is the experience of many organisations where operational risk management and continuity planning are considered to be two entirely separate disciplines. This has also been borne out by the surveys cited above. So often, according to risk practitioners, the two departments never really work together to any significant extent. Yet according to many risk advisors they are one and the same. Continuity planning is simply one of the opportunities – and an increasingly important one – available to the modern risk manager.

Part of the problem, as ever, relates to definitions. Ask a dozen people for a definition of risk and there will surely be at least 15 answers. To be clear in this section we are talking here about operational risk; nasty surprises that come along and divert the organisation from its strengths and objectives (see also Chapter 5 regarding risk management culture).

The science or art (depending on your point of view) of risk management has an unfortunate foundation in people who called themselves risk managers, but were in reality buyers of insurance programmes. Other 'risk managers', including company secretaries, treasurers, auditors, lawyers, facilities managers, continuity managers, health and safety managers, security managers and business directors, all cheerfully ploughed their own risk furrows quite independently.



*Different perceptions of risk*

A business director could cheerfully accept an exposure of, say, £10 million – or £100 million – and sees doing so as a business profit opportunity; comfortably fitting within the assets and cash flows that are managed on a daily basis. The ‘insurance buyer’ in the same company, however, may be spending millions buying insurance for PCs, photocopiers and bent wings on their motor cars. The lawyer may be cheerfully transferring risks to other contracting organisations without it being part of the job description to consider the residual risks on their own organisation if that party failed to meet those contracted responsibilities.

Continuity management, on the other hand, comes into the 21st century from a 20th century foundation of IT and facilities managers owning the responsibility for and developing continuity facilities for their services. Fortunately, the science of continuity management has moved on somewhat. Increasingly, the business impact analysis is a vital tool, and there is more ownership and exercising by business managers. It is a history, however, that is still not easy to shake off fully – consider the background and the reporting lines still of some continuity managers.

## The evolution of risk management in practice

Looking at risk management first, the ground has shifted noticeably, from that under the old ‘insurance buyers’ and in different ways at the same time. First, their employer’s organisation is almost certainly undergoing such major change that the old organisation of just a few years ago, and the new, are barely recognisable as one. Following mergers, it is likely to be much, much, bigger and much more international. Computerisation and communications have created different marketing, service delivery and cost saving opportunities. These developments have reduced the need for locations and people dramatically.

The focus on creating value (see also above) at each individual stage of the supply chain has created new critical dependencies in third party organisations that are less easy to supervise in detail. These dependencies have frighteningly shorter and shorter periods where delay can be tolerated before destructive damage occurs. Entirely new risks – e-commerce, internationalism, media and others – have evolved; as have customers’ expectations been raised towards a seamless 24 hour/7day service (see also Chapter 11).

E-commerce – where basic entrepreneurial instincts are fuelled by ever more powerful computers, along with telecommunication and data mining tools – is one huge area where the rewards of the first pioneer are totally disproportionate to the rest. In that atmosphere of headlong sprint and laying bets so large that they will create – or kill – careers, the risk and continuity managers asking for time and resources to plan effectively can be ignored.

Sometimes it is an ‘old’ risk that, because of these changes, now has a new potential for total, organisation-wide, and simultaneous destruction across individual business units; miles or even countries apart. What good is it being able to produce good products if the world has lost confidence in the products’ name and will not buy them?

Conversely, these larger corporations have opportunities to absorb much more risk within the strength of their balance sheets and cash flows. They are large enough also to have some flexibility to keep them in their marketplaces while problems are being resolved without stakeholders feeling an unacceptable impact.

## New challenges

The challenges that are currently facing this new generation of risk managers therefore include:

- Make best use of the new strengths within the organisation;
- A consistency when approaching risk evaluation, risk tolerance and risk management; leading to seamless risk decision making;
- Both a bird’s eye view and a detail view across the organisation at the same time;
- Managing second-hand, destructive risks or timescales in suppliers;
- Risks that are beyond the ability of the insurance industry to support;
- Communication on matters of risk and thus managing diverse expectations; and
- Keeping up with change.

There are now more opportunities for the organisation to die, and die more quickly; and the concept of ‘killer risks’ is increasingly emerging. The brand and stakeholder confidence concerns (see Chapter 9) are such killer issues; as is solvency (see above), and business and financial control. Dependencies on central group-wide facilities such as computerisation and communications to deliver the products on time to an acceptable standard, also the intellectual assets within the organisation (see Chapter 11), are just a couple more among others. These are all not unfamiliar to the continuity manager.

As is mentioned elsewhere in this book and discussed further in Chapters 9, 21 and 22, the changing regulatory needs are also demanding a more ‘holistic’ approach to risk management. Stakeholders have no interest in internal organisational boundaries. They concern themselves only with the potential for unacceptable impact on the shareholding, or on any other relationship they may have with the organisation itself. These regulatory needs, including Turnbull in the UK, are driving organisations to consider enterprise-wide operational risks more formally. These organisations, however, are more comfortable with the clearer-cut aspects of financial risk and indeed they have experiences, sophisticated strategies and controls, developed over many years. The evaluation and cost/benefit analysis of non-financial, operational risk, decision making, however, is not as simple to quantify. Some are clearly struggling with the

commercial decision making that is being demanded. The SERM approach can be useful in this regard (see also Chapters 2 and 3).

It's worth considering at this point where the insurance programme fits into this new style corporation and its 'killer' risks. Insurance is indeed extremely useful eventually; but where is that value in those crucial, threatening, minutes and hours after a disaster where survival of the organisation and its dependencies is the only challenge? The organisation and its most crucial dependencies need to survive first to fully gain, later, the value of its insurance programme! This is discussed in more depth below.

## Stakeholders

The risk manager will consider that the organisation is no more than the brand value, its intellectual and free value asset, together with the combined influence and support of its stakeholders. These stakeholders, with their quite different interests (and ways of responding when upset!), are at the centre of the risk manager's thoughts. This is true of the continuity manager too. They include:

- Employees
- Suppliers
- Customers and distributors
- Regulators
- The media
- Private and quoted shareholders
- Bankers
- The public – via their impression of the brands
- The environment
- And others ...

## Risk evaluation

When evaluating risks, the risk manager measures them against the agreed risk tolerance levels of the organisation itself. If the risk, and/or the potential impact, is not acceptable to the organisation, then the risk manager sets out to bring these aspects within that agreed tolerance level. It is rare that the risk manager can remove all risk or impact altogether. In addressing unacceptable risks, the risk manager can consider the commercial realism of a range of options and the relative value of each option. They are:

- Reduce the likelihood or the potential frequency;
- Ensure that the impact is reduced to an acceptable level; whether that be in human, operational or financial terms;
- Transfer the impact to another organisation, e.g. a counterparty, an insurer, a captive insurer, the financial market or another; or
- Prepare for the incident by way of continuity planning of business critical issues.

The suggestion here therefore is that contingency planning is just one of the options available to the risk manager. If credible, tested plans can be in place so that the organisation can manage through an incident without serious damage, then surely that is one of the options alongside risk expenditure and resources. This is especially so where risk management constrains the organisation from doing what it is best doing and when dealing with low frequency, high impact exposures. Resultant expenditure incurred after the disaster can often be an insured expense – a benefit close to finance directors' hearts. Before we leave this though we do need an important stress on credible, tested plans ... This is all familiar to the continuity manager; who sets out to identify risks and evaluate them within the context of the impact on safety, and the urgencies, survival needs and responsibilities of the organisation. However, one should also include here not just business continuity plans but also, wherever contingency planning is needed, kidnap, extortion, bomb threat, suspicion of major fraud, succession planning, media attack, product recall and others. These have common denominators of course but the needs of each must be met.

The thesis then brings us back almost full circle. It may not be cost effective – or just unachievable – to remove risk altogether by risk management. Continuity planning may be the only answer left when all that is realistically preventive can be done. All of these measures though – ones that can include business decision making, security, health and safety, resilience in production lines, etc. – are, with continuity planning, best effective when all are part of a relatively seamless process of risk and impact understanding and management.

Even the challenges to risk managers and to continuity planners are similar. First, how to get the attention of the board to the point that the right level of priority is given. How to gain resources for risk and continuity management in competition with projects that are about what is happening today (not what may or may not happen sometime in the future). How indeed to get the directors to give more than lip service and concede fully, that not only this thing may happen, but it may happen within the ever-shorter tenancies of that particular top job!

No doubt General William Reader must have had a bad meeting when he came out with the following quotation: 'The art of management consists of issuing orders, based on inaccurate, incomplete and archaic data, to meet a challenge which is dimly understood and which frequently will be misinterpreted, to accomplish a purpose about which many of the personnel are not enthusiastic.' If we recognise that risk management and continuity management are both commercial business issues, they – with special challenges of acceptability and urgency – need to fit somewhere within this picture of management as described by the General. Not an easy task.

Each discipline is evolving within itself. There is real value in them working much more closely together and each providing valuable support for the other. Who is more important? This is difficult to say, especially until they each find their true potential in today's challenging business environment.

## Crisis management: a view from the US

Today's business environment requires that crisis management is prioritised, especially since September 11. Events that span from the threat of Y2K to terrorist attacks mean that, as demonstrated above, killer threats to the business exist in many ways. While this topic can, of course, form a book in itself, it is useful to consider the approach in the US in terms of important business risks such as the environment and health and safety from the perspective of the external advisor.

### Managing an environmental, health and safety crisis

The world collectively breathed a great sigh of relief on 1 January 2000, when the much anticipated and greatly feared Y2K bug failed to bite, and the long predicted worldwide crisis never happened. In the weeks leading up to the new millennium, even those of us who had convinced ourselves that everything was under control and that no crisis would actually occur, had quietly stashed away some extra cash and loaded up a bit more than usual at the grocery store, just in case. In hindsight, many questions are being asked about why we survived the stroke of midnight unscathed. Was it all just a hoax? Was it misinformation? Or perhaps, was it due to the unprecedented planning and testing of computers and computer-related equipment that had taken place in preparation for the new millennium?

Those who believe that the Y2K bug was exterminated by the enormous planning efforts of Corporate America think there is a lesson to be learned from this experience; namely, there is no substitution for good planning. That concept is certainly true when it comes to planning for and managing a crisis in the environmental, health and safety (EHS) arena. Unfortunately, despite an organisation's best efforts, it is almost inevitable that somewhere, sometime, a very serious EHS accident will occur. Experience has shown that companies caught without a comprehensive EHS crisis management plan suffer both severe public relations troubles and significant legal liability (see also Chapters 9, 16, 17 and 19).

### Preventing an environmental, health and safety crisis

There is an increasing threat level emerging from events like acts of terrorism and large-scale disasters (the flooding of New Orleans) that poses a very high secondary risk of environmental and human health damage.

There is a need for organisations to include environmental risks in their emergency contingency plans – businesses in the extraction sector, like oil, or the mining sector (with stored mining waste) and where organisations are particularly vulnerable to environmental risks when catastrophes occur.

The risk of hazardous materials being released into the atmosphere unintentionally in an emergency or act of terrorism is higher than thought; for example, the New Jersey Work Environment Council issued a report citing 110 facilities

that could pose chemical risks to neighbouring populations should terrorists or catastrophic disasters strike and that a disaster or accident striking six of the reported facilities would place over 1 million people at risk (Ung, E. 'Chemical risks abound in N.J.' in the *Philadelphia Inquirer*, 24 May 2006).

Risk mitigation measures include:

- Identify their potential exposures and develop contingency plans to handle any fallout from a disaster;
- After acknowledging their hazards, organisations should prepare for their disaster plans to be tested;
- In order to improve safety, organisations should ramp up worker training, improve physical security, and develop safer plant designs, i.e. after the wave of recent terrorist attacks many energy producers have improved perimeter security measures;
- Switch to lower risk processes, or use of less hazardous materials where practicable. Examples are that:
  - Since the 11 September 2001 terrorist attacks, no fewer than 225 US industrial plants have decided to use safer chemicals according to a report called *Preventing Toxic Terrorism*, quoted in the *New York Times* on 25 April 2006 (Lipton 2006); and
  - Many sewage and water treatment facilities have substituted the dangerous chlorine gas for systems like ultraviolet light systems.

## Heightened expectations

Due to the rapid pace of technological advances, a timely response to an EHS crisis is more critical than ever. Because of the widespread availability of electronic mail, cell phones and other forms of immediate communication, there is a growing belief that there is no excuse for delayed response. In the US both the public and regulatory agencies, such as the Environmental Protection Agency (EPA) and the Occupational Safety & Health Administration (OSHA), have raised their expectations considerably. Regulatory agencies have also stepped up enforcement activity in the wake of such accidents. Moreover, computer technology has assured that, not only will a company's EHS crisis make the 11 o'clock news, it will also be posted on numerous websites, complete with all the details and pictures.

These reasons make it an absolute necessity for companies to have in place well thought out, usable and responsive EHS crisis management plans. Because of the myriad complex issues involved in crisis management, it is extremely important that a multidisciplinary team develop the plan. Too many companies make the mistake of having a plan developed solely by lawyers, a public relations firm, or engineers. Such plans are inevitably missing critical elements. Once a plan is complete, it is also important to make certain that all of the players involved in EHS crisis management, from top to bottom, are familiar with it.

An example of a crisis that has not yet emerged is the pandemic of H5N1 avian influenza. However, most commentators are saying that it is still a case of

when this occurs, not if, as large-scale influenza outbreaks have been common in human history. It is estimated that if avian flu reaches the UK, then the banking system could almost be brought to the point of collapse and that average staff levels will be only 50% of normal.

So planning for pandemic influenza is critical. To assist you in your efforts, most countries have produced information and risk registers. In the US the Department of Health and Human Services (HHS) and the Centers for Disease Control and Prevention (CDC) have developed a checklist, which can be found at: <http://www.pandemicflu.gov/plan/states/statelocalchecklist.html>

It identifies important, specific activities you can do now to prepare. Many are specific to pandemic influenza, but a number also pertain to any public health emergency. For your global operations there is a global map of the incidence on H5N1 by country at: <http://www.pandemicflu.gov/>

*Bird flu – a health crisis case study by Yeshi Seli*

For nearly a decade bird flu has been raging with varying intensity across the globe.

Indians should consider themselves fortunate that despite poor quarantine procedures and low level of awareness they have managed to handle the situation fairly well.

The virus was first detected in 1996. In south-east China a virus from a dead goose was identified as previously unknown subtype H5N1. A year later it turned up in Hong Kong (infecting 18 people and killing six) but their authorities acted promptly and culled the region's entire 1.5 million poultry population and contained its spread. In 2003 zoo animals fed on chicken died in Thailand and the cause was the same virus. By December chicken farms in Korea and in 2004 in Vietnam, Japan, Indonesia and Malaysia reported similar cases. In 2005 there were reports of the virus emerging in Mongolia, Russia, Siberia, Turkey and Romania. One imported parrot in the UK died from the virus. Then it hit India.

The most likely explanation of this pattern of spread is that migratory birds carry it and local birds get infected. However, the virus can spread through the transportation of infected birds as well as by vehicles, cages, equipment and people's clothing that have become contaminated with bird droppings or secretions and the virus can mutate and spread to humans.

In India reports have confirmed that the poultry in Nandurbar district in Maharashtra tested positive for the H5N1 avian virus. As a result of which over a million birds were culled and around seven countries have banned poultry imports from India. In a developing country like India – where poultry is the livelihood of many households – this has come as a big blow. It's probably for the same reason that when it was first detected in India a decision was taken to cull only those birds within three kilometres radius and only vaccinate those in the next 10 kilometres, though it would have been prudent if birds were culled in the next 10 kilometres.

Many people didn't cooperate and tried to hide their fowl, as some felt that since their birds appear healthy they would unnecessarily be killed. In such a situation a way of preventing the spread of bird flu is providing incentives for people to report sick birds and compensating farmers for birds culled, as was announced by agriculture minister Sharad Pawar. However, compensation should ideally cover not only the cost of the slaughtered bird but also the loss of income the farmer suffers as a result of the time lag between culling and restocking.

Close to 200 people around the globe have died of the disease and there are reasons for taking this matter more seriously. Obviously there is the potential for large-scale loss of life, but also the vast economic and social impacts of potential losses of India's estimated population of 490 million domestic birds.

In response to these types of risks, drug companies in India have launched generic versions of drugs like Tamiflu and Roche that are effective against the disease and to that extent they are now probably more widely provided for other countries under threat. But as with all potentially deadly diseases, prevention is better than cure.

There have been authoritative reports on how to minimise the risks and in order to have long-term benefits the recommendation of the National Commission on Farmers on setting up a National Centre for Biosecurity should be considered seriously. In a situation where administrative responsibilities are divided between the Centre, the state and several agencies there is a need to act in unison so that this proposed Centre can act as a nodal agency for early warning. If this is done then timely action can be taken to counter biological threats to Indian agriculture, animal husbandry and fisheries.

The panic that was created because of the SARS outbreak in East Asia two years ago resulted in travel advisories against the countries that were inflicted. As a result huge economic losses were made as there was a slow-down in trade.

Thereby monitoring the situation not just now but in the future would be judicious to protect India and South East Asia's booming economy.

## The extent of environmental hazards

Globally, natural and manmade hazards are causing an increasing human and financial toll. Sudden physical or catastrophic hazardous events, which result from statistically consistent but extreme natural geological or/and meteorological events, are now having great impact on an increasingly industrialised and urbanised – and hence more vulnerable – society. While the *natural* event frequency is unchanged, the cost to society is rising. This has been witnessed more and more often both at home and abroad.



Increasing industrialisation and urbanisation has also led to many more catastrophic accidents involving contamination of the environment by man-made chemicals. Insidious chemical pollution and natural contamination or degradation of, or natural deficiencies in, the environment are also recognised as having significant long-term impacts on human health. In terms of human impact, the early 1970s saw an annual global average of two to three significant natural or manmade incidents. This increased to 10 to 12 in the late 1990s. More recently everyone has witnessed the disasters caused through the tsunami in India at the end of 2004 and the Katrina and Rita Hurricanes in the US in the summer of 2005. The following table exemplifies hazard magnitudes and costs on a more historic basis.

Type of hazard	Example of human impact	Example of financial cost
Earthquake	China, 1976; >250 000 dead Turkey, 1999; 17 000 dead	Japan (Kobe), 1995; \$150 billion total losses
Tsunami (earthquake induced 'tidal' wave)	Papua New Guinea, 1998; 2200 dead	83 events worldwide since 1990; several \$100 millions (estimate)
Volcano	Colombia, 1985; 24 000 dead	US (Mt St Helens), 1981; \$2.7 billion economic losses
Landslip/mudslide	Aberfan, South Wales, 1966; 144 dead (incl. 116 children)	US; over \$5 billion <i>annually</i>
Subsidence/mine collapse	Britain (Lofthouse Colliery), 1973; 7 dead	Britain; over £400 million in insured losses in 1998
Flood/storm	India, 1999 flood; more than 17 000 dead	US and Caribbean, 1998 cyclone; \$3.3 billion in insured losses
Manmade ground or water contamination (plus flow-on to food chain)	Japan (Minamata) 1956; seabed mercury contamination; 1250 deaths; 17 000 affected (clean-up cost £300 million)	Italy (Seveso) 1976; £35 million land remediation costs of dioxin contamination
Natural ground or water contamination	UK, radon in homes; possibly as many as 2000 lung cancer deaths annually, with healthcare costs over £3 million	Bangladesh/W. Bengal; 30 million people affected by arsenic in groundwater – remediation costs of \$50 million annually
Land degradation and mineral deficiency	Worldwide, annually; selenium or iodine deficiency; over 1.5 billion people at risk of brain or heart disease, or retardation	Worldwide, annually; estimated production loss and healthcare costs related to selenium and iodine deficiencies >\$2 billion

Research and planning can mitigate impacts. For example, a 1989 Californian earthquake of magnitude 7.1 caused 62 deaths. An Armenian earthquake of half the size (magnitude 6.8) in 1988 caused 25 000 deaths. Both struck populated areas, but the lower death toll in California was due to better engineering standards and construction practice. This problem continues (e.g. Izmit, Turkey, 1999).

### *Hazards in Britain*

The threat to life due to UK hazards is not as great as many other countries, but the economic and social costs are high. Those UK hazards with the greatest impacts are ground subsidence and mine collapse, flood, and natural and manmade ground contamination. Landslips and coastal erosion also cause some financial cost, while rising mine waters are likely to lead to future environmental costs. The location of the wide range of land stability hazards is only partially documented; there is still sparse information on important pollutants such as cadmium, mercury, organochlorines, poly-aromatic hydrocarbons, pesticides and other toxic organic substances. There is only a patchy understanding of how trace elements are important in diet and human health. In addition to costs, the public is aware of, and has legitimate concerns about, environmental risks to health. Such concerns need to be addressed by an opening of the scientific debate, and by easy availability of information regarding longer-term risk from sudden hazards, contamination or dietary trace element imbalances.

## Cost assessment of hazards and mitigation of risks

Detailed studies of earthquake hazards and their associated risks have revealed that, while prediction of individual events remains elusive, statistical estimates of their future costs can be made. In general the earthquake risk assessment process is as follows:

- Hazard identification, detection and monitoring:
  - Locate the hazard, or hazardous event (e.g. earthquake spatial distribution); and
  - Monitor its temporal pattern and behaviour (e.g. pattern of energy release).
- Behaviour simulation and modelling:
  - Determine the ‘cause’ of the hazard (e.g. geological fault associations; regional tectonic mechanisms); and
  - Model the link between cause and effect (e.g. fault movement to ground motion).
- Regional impact assessment – on people, infrastructure and the environment:
  - Determine the impacts of the hazard effect through historical and/or predictive analysis (e.g. the extent of building and other structural failures as a function of ground motion).
- Prediction of statistical losses:
  - Model future hazard, or hazardous event scenarios that reflect past, identified patterns, e.g. possible future earthquake patterns that reflect past patterns);
  - Model impact scenarios (e.g. patterns of loss of life and structural damage); and
  - Assess future cost patterns (e.g. insurance, remediation and rebuilding costs).

- The ‘risked’ selection of mitigating strategies:
  - Identify and cost a range of hazard mitigation strategies (e.g. improved construction standards and codes at risk areas); and
  - Select appropriate cost-effective responses to assessed risk (e.g. insurance rates that reflect extent of compliance with construction codes).

## Communication with the wider public

All forms of natural and manmade hazards legitimately generate significant public concern. We believe that the most appropriate approach to greater public understanding of the risks and costs associated with hazards, and the institutional decisions that might need to be taken to mitigate or ‘deal with’ hazards, is openness of information and analytical processes. BGS is moving forwards in that direction and welcomes collaboration with, and comment from, interested parties.

## How crisis leads to liability

In order to properly prepare for an EHS crisis, it is important to understand why and how companies can be subject to both public relations nightmares and legal liability in the event that such an unfortunate accident occurs. First and foremost, a company that is unprepared to deal with an EHS crisis, say a chemical spill or industrial accident, will very likely not be in a position to contain the spill or minimise the consequences of the accident. Obviously, to the extent the problem gets worse, the more expensive the clean-up bill becomes the higher the agency penalties and claims in third party law suits will be.

In addition, there are myriad requirements under environmental, health and safety laws to immediately report a spill, release or an accident. For example, both the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) and the Emergency Preparedness and Community Right to Know Act (EPCRA or SARA Title III) contain provisions for immediate reporting of chemical releases, which a company knew, or should have known, are in excess of reportable quantities set out in the regulations. EPA has taken the position that, reporting such a chemical release more than 15 minutes after the release occurs is a *per se* violation of law subject to the imposition of penalties. In fact, the reporting requirements of these statutes require that the caller provide details such as the type and quantity of the released chemical and its health effects, as well as exposure and precautionary information. In order for a company to comply with that requirement, it must have a sophisticated record keeping and reporting protocol in place before a spill occurs. A company that is unprepared to appropriately respond to such a release will undoubtedly incur significant penalties from an agency.

Moreover, history has shown that EHS crises inevitably lead to additional, and sometimes far-reaching, government regulation. Consider the track record. In the 1970s, flaming rivers led to the enactment of the Clean Water Act. Love

Canal led to the enactment of CERCLA in 1980. More recently, major air releases in Bhopal, India, and Institute, West Virginia, led to the enactment of SARA Title III, as well as a number of provisions in the Clean Air Act requiring companies to provide significant volumes of information to the public, as well as increased record keeping requirements. Finally, the *Exxon Valdez* oil spill directly led to the Oil Pollution Act, which required additional planning and which contained many new requirements for the prevention of releases of oil to waters.

## The public relations trap

Often, public relations issues feed the legal liability problems after a spill or an industrial accident. Naturally, an injured party, or someone who believes they are injured, is more likely to bring a lawsuit when they perceive that the situation was not handled properly. A good public relations strategy is key to altering that perception. Simply responding to an EHS crisis is not enough. One must manage the crisis.

A company that is not prepared to deal with the public and that does not have senior management responding in a way that assures the public the company has things under control is more likely to become the subject of intense scrutiny. That scrutiny can come in the form of government enforcement, including criminal investigations and prosecution, as well as third party suits such as toxic tort and citizen suits.

## The crisis management plan

Some companies have invested considerable sums developing EHS crisis management plans with the assistance of able public relations firms and lawyers. However, too many of them merely take the plan and put it on the shelf, satisfying them that it is there when needed. This is a mistake. A crisis is no time to test a plan for the first or even second time. Moreover, during a crisis, there is simply no time to consult a plan, particularly a voluminous one, with which you are not already thoroughly familiar. Crisis management requires almost instantaneous reaction by companies, both plant personnel on the scene and senior management, wherever on the globe they happen to be.

Everyone involved in managing an EHS crisis, from the second shift process operator to the CEO, must be familiar with both the contents of the plan and, more importantly, their role in the crisis management process. The kind of organisation required to effectively manage an EHS crisis is something that requires careful thought, planning, testing, practice and updating.

## Updating plans

For many reasons, it is very important to make sure that the EHS crisis management plan, once developed, undergoes frequent periodic review and updating. As discussed previously, there is the growing public expectation that companies

will not miss a step during a crisis. Therefore, periodic review and updating of plans will assure that they are both correct and familiar to those who are tasked with the responsibility to execute them. Outdated data, such as contact or health effects information, can cause serious delays and either over- or under-reporting of information to agencies and the public. Even sophisticated organisations with well-prepared crisis management plans end up with serious liability due to outdated data. In one such case, the material safety data sheet (a form required to be maintained by both OSHA and EPA) for a new process chemical had not made its way into the plan. This led to an incomplete report to EPA during a process release and a significant penalty. It could have been worse, however. Had the release drifted to the nearby neighbourhood, the outdated information could have led to far more devastating consequences.

In addition, in these days of frequent corporate mergers and takeovers, EHS managers are often faced with responsibility for entirely new facilities and divisions. Because of personnel changes and other reasons, EHS accidents are more likely to occur during such transition periods. Ironically, most EHS managers are simply too overwhelmed by the integration of day-to-day EHS functions to focus on integrating crisis management plans, which can unfortunately lead to serious problems in the wake of EHS accidents.

Finally, there are many new federal, state and local laws, regulations and policies that can come into play in any EHS crisis. While most companies track new EHS requirements and incorporate them into operations, many forget to make sure those new requirements are integrated into updated crisis management plans and systems.

## The lawyer's role in EHS crisis management

As stated earlier, an effective crisis management plan is the work product of a variety of professionals bringing their particular expertise to bear on the process. The experienced environmental/OSHA lawyer, particularly one that knows your business, should be an important member of the development team. In most cases, use of specialised outside environmental/OSHA counsel for this task makes sense regardless of the in-house legal structure of the organisation.

Even though many companies have specialised in-house EHS counsel, many are already overwhelmed with day-to-day regulatory issues, briefing management on significant issues, overseeing litigation and reviewing EHS issues in transactions. Despite their best intentions, consistent participation of these individuals in EHS crisis management planning is simply not feasible. Moreover, many in-house lawyers spend significant time on the road. Therefore, even assuming they are immediately reachable during a crisis, they may be unavailable to effectively participate in the necessary efforts.

Because of the many legal issues and requirements involved in a crisis, the expertise of a lawyer is necessary in both planning and during a crisis. For example, an EHS lawyer can help assess the extent of a crisis and the applicable legal reporting requirements (including reporting to insurance companies). In addition, the lawyer can assist in (although not participate directly in)

the dissemination of information during a crisis, and help prepare statements by the company to the public and regulatory agencies. Also, the lawyer can assist in the event inquiries lead to criminal investigations. A lawyer can also assist in, and potentially protect through privilege, internal investigations of root causes and can begin to develop a record for use later. Finally, to the extent the lawyer was involved in the planning and response, he or she can be invaluable in responding to the host of government inquiries in the days following the event.

#### *Ongoing considerations*

EHS crisis management is extremely important, particularly in these days of immediate and prolonged media coverage. Involvement of an experienced team of professionals, including outside environmental/OSHA lawyers, in both planning and during an actual crisis, can have payoffs far beyond the costs involved. History has shown that few managers look back on a crisis and wish they had prepared less.

## Encouraging business continuity management

In the US, business continuity management has been driven forward as an unexpected consequence of the expansion of corporate governance legislation. The 2002 Sarbanes-Oxley Act, introduced in the wake of corporate accounting scandals such as Enron, includes a requirement that organisations must understand the risks that may impact their financial reporting processes and requires them to put in place proper controls. According to the US *Disaster Recovery Journal* (2004):

Compliance requires companies to establish an infrastructure designed to protect and preserve records from destruction, loss, unauthorised alteration or other misuse.

The consequences of this legislation have been to force senior executives to examine the issue more closely (in order to avoid hefty fines), to prompt organisations to regularly test their contingency plans ahead of annual compliance reporting to the US Securities and Exchange Commission, and to increase business continuity management budgets (*Disaster Recovery Journal*, 2004). However, the legislation only applies to companies of a certain size and turnover.

There are limitations, however, to how successful or desirable such legislation would be in the UK. Increasing the regulatory and reporting burden on UK businesses beyond current levels would not be supported by the business community. Also, any legislation is likely either to have a detrimental effect on small businesses in terms of creating additional burdens because it is too severe or to provide the stimulus to action needed because it cannot be applied to small and very small enterprises.

Given that the most commonly cited reasons given by SME managers for not having a contingency plan are that they lack the time and money to do it effectively, it seems contradictory to attempt to encourage contingency planning by increasing the costs on businesses. Instead, business continuity management among smaller businesses is more likely to be encouraged by incentives, such as tax breaks, rather than compulsion and regulation.

The LCCI has previously called for a nationwide ‘buddy scheme’ in which larger companies partner up with smaller businesses to help develop their contingency plan. The DTI should offer financial incentives, such as a continuity management tax credit, to encourage contingency planning by businesses. For smaller firms these incentives could cover the initial cost of setting up a contingency plan while larger firms could be rewarded if they form continuity partnerships to offer assistance with business continuity management to smaller businesses from within their supply chain or in their local area. These partnerships could range from help and advice in developing a contingency plan to agreements to share premises, facilities or resources in the event of a disaster or terror attack.

### **The US**

Prior to 9/11 the US did not experience terrorism at home on the same scale as Britain in the 1970s, 1980s and early 1990s. However, the Federal government moved quickly to take measures to counter the ongoing threat and has undertaken wide-ranging legislative and organisational changes to safeguard national security.

#### *Machinery of government*

One of the most significant aspects of the US’s efforts to combat terrorism on American soil is that the Federal government has been restructured to provide focus at the highest levels. On 20 September 2001, just nine days after the 9/11 attacks on New York and Washington, the US government announced the creation of the Office for Homeland Security (OHS) to coordinate immediate homeland security efforts. In November 2002 the OHS was expanded into a full government department, the Department of Homeland Security (DHS), led by a cabinet-level Secretary of Homeland Security. This represented the largest restructuring of the US government in contemporary history. The DHS has responsibility for border and transport security, emergency response and preparedness, immigration and customs, and brings together 22 subordinate agencies which previously reported to 10 different government departments. These agencies include the Federal Emergency Management Agency (FEMA), the US Customs Service, the Immigration and Naturalisation Service (INS), the Coast Guard and the US Secret Service. The department’s financial year 2006–07 discretionary budget is \$35.4 billion, and accounts for approximately one in 12 federal civilian employees (Department of Homeland Security, Budget-in-Brief Fiscal Year 2007, [www.dhs.gov](http://www.dhs.gov) 2006).

The LCCI believes that the creation of the DHS in the US should serve as a model for the UK. Combating terrorism involves tackling a number of issues that are currently the responsibility of a number of different departments of the UK government, including the Cabinet Office, the Home Office, the Department for Communities and Local Government (DCLG), the Department of Health (DoH) and even the Department for Environment, Food and Rural Affairs (DEFRA). For example, the police, fire and ambulance services each report to different government departments. In order to provide strong leadership and joined-up government it is important that there is a single Whitehall department, led by a cabinet-level Minister for Homeland Security, with overall charge of domestic security and contingency plans. The US Department of Homeland Security is successful in coordinating a wide range of regulations and in ensuring that the development of policies to combat terrorism is consistent.

The US has also been successful in strengthening security at its borders and in imposing much more rigorous entry controls at airports and ports. In October 2002 the US Immigration and Naturalisation Service (INS), part of the DHS, enforced stricter immigration procedures on visitors from countries regarded as containing a threat to the US. They now have to register with the government and be photographed and fingerprinted. Passengers who visited those countries, including Saudi Arabia, and who cannot provide an adequate explanation for their visit, are also required to register.

## Staying in business – insurance issues by David Kaye

### Assessing insurance needs

It is a major disappointment, when looking at many an organisation's insurance programme, to see just how much the design of the protection package is driven by the 'off-the-shelf' insurers' products rather than by the risks of the organisation itself.

The visionary risk manager has been kicking against those traces for some years now and the successful ones have encouraged their boards to grasp the much wider values of risk management. Another driving force has been the ever-increasing interest by regulators and stock markets in the risks being carried by organisations they police or, in turn, in which they have investments. While publicly quoted companies and some others have, for decades, had sophisticated financial risk models in place, these regulators have increasingly been driving organisations to manage and give information regarding non-financial risks. These are much more amorphous challenges, where boards are much less experienced and feel much less comfortable.

Organisations are seeing more and more that both the tasks and the opportunities of risk management are much wider than auditing the flows of money



and other assets; and seeing more and more the business opportunities that lie in understanding and managing risk; and thus seeing measured risks not only as a threat, but also as an opportunity for effective business development.

An important dimension for managing potentially catastrophic risk is the issue of 'timeout'. An organisation's ability, to step out of its marketplace for a period of time while it handles crises, will vary dramatically. It will vary between each organisation, its business models, its regulatory environment, its marketplace, the ability of competitors to react quickly and the demands of its own specific range of stakeholders. The first and often the most damaging thing to be lost is the value of the brand and other credibilities. This could happen in minutes in some industries or after days or weeks in others.

*Case study: AstraZenica*

- \* Loss of or expiry of patents, marketing exclusivity or trade marks;
- \* Impact of fluctuations of exchange rates;
- \* Failure of research and development to yield commercially successful new products;
- \* Competition, price controls and price fluctuation;
- \* Taxation;
- \* Substantial product liability claims;
- \* Reliance on third parties for material and services;
- \* Delay to new product launches;
- \* Difficulties obtaining regulatory approvals on new products;
- \* Failure to observe regulatory oversight;
- \* Performance of new products;
- \* Environmental liabilities; and
- \* Forward looking statements.

## The organisation's dependencies

When considering the pressures on an organisation facing catastrophic damage, it is a valuable thought process to stand back from the day-to-day aspects of the business and think through the individual foundation stones of that organisation. Only then, I suggest, can we see the real post-damage pressures, and the needs the directors may have to face when struggling to keep the business or organisation alive.

In recent years, there have been important changes in the way businesses deliver and market their own products, changes too in their relationships with their stakeholders, and even in the risks themselves. These changes are influencing how potential damage can hit the very corner stones of the organisation, by following not only 'new' risks but also a new level of damage caused by 'old' risks. Often the real consequences of damage, moving right up and through the organisation, are unrecognisable from the consequences of a similar incident some years ago.

To explain; clear to all business watchers are the dramatic changes in the way that businesses have reorganised themselves as they take up the opportunities now available to them. These opportunities have emerged from new technology that has enabled faster and direct business-to-customer and business-to-business communications. The sheer scale of merged companies, encouraged by more open markets across the developed world and the internet, have enabled them to be increasingly multinational. Spin-offs have been the ability to squeeze new values out of supply chains and distribution chains – outsourcing. These new alternatives to large direct labour forces are now enabling a shift of power base from the workforces towards the management.

During a potentially catastrophic disaster in a modern multinational, the board's attention is on the survival of the business. The most urgent concern is not the replacing of buildings and contents (and/or defending litigation). That is the relatively easy bit. The massive organisations of today have, however, built into their procedures some new and dangerous points of exposure that, if and when the risk incident occurs, could remove crucial dependencies on which the whole organisation depends. In other words, a sudden death or removal from their marketplace is now increasingly, not less, likely.

It is valuable for the risk manager to consider the organisation through the perspective of its stakeholders' expectations, and through whether the failure to meet any one of them can be a single point of potential catastrophic failure.

Changing risks within the ingredients of the delivery process:

- **Delivery chain:** the delivery chain – sometimes called the 'value chain' – is often unrecognisable from the cosy, locally controlled, in-house delivery chain of yore. A failure, deep within a third party, just in time, supply chain, can have catastrophic and immediate consequences on the final production line.

Those jobholders who immerse themselves in continuity risk have a healthy respect for whether the in-house continuity management will or will not work in circumstances that can only be guessed at. Moving on into assuming confidence about a third party organisation's planning increases the difficulty and exposure exponentially!

- **Technology:** the dependence on technology brings its own risks and not just the obvious e-commerce exposures (see also Chapter 11). A technological failure can often be the single point of failure that could bring a multinational to a halt right across its entire organisation. That failure may not just be electronic, it may be security of information, communications, software or even the hardware infrastructure within which the electronics reside;
- **Intellectual assets:** modern organisations have dependencies on intellectual assets that cannot possibly be overemphasised. Many a 21st century organisation is no more than the sum total of owned (or rented) intellectual assets, a contracted-out delivery and marketing process, and a group of key stakeholders who can move away as fast as they moved within. The intellectual assets are much more than data on computer databases. These assets lie further in licences, paper and even in employee brains. The resilience depends

not only on the safety from harm of this information but also on the ability to regain access. Access from elsewhere needs to be possible, not only physically, but also legally or contractually. The Data Protection Act defines quite clearly who can use what personal information and for what purpose; as also may the contracts right through the various layers of the supply chain;

- The brand: this is perceived as credibility among the range of stakeholders and is a single, organisation-wide value on which the entire organisation depends for its survival; or at the very least for the current market position that it enjoys. Without this there may be no company left; as has been found out the hard way by too many organisations; and
- Human resources: as said, the relationships with workforces are very different than before. Any organisation that gives the impression that its workforce is as disposable as an old piece of office furniture or leftover food from the table is naive to believe that, in a crisis, that same workforce will continue the loyalty and deference of years ago. More and more ‘employees’ have been ‘outsourced’ to an entirely different organisation which of course has its own stakeholders and its own business models and preferences. A crisis almost always demands a sudden switch of urgencies and massively increased pressures on one part of the organisation. This may be to meet new, urgent communication needs to a new whole range of different people, or to set about the urgent task of rebuilding a critical aspect of the working environment or heal the break in the supply or delivery chain.

An employer can move internal resources around if the employees are supportive and confident of the ultimate survival of the organisation. A third party labour supplier may not wish – nor be able to – dramatically and urgently move labour or infrastructure resources around so quickly (see also Chapter 14).

#### *Modern organisations*

The modern organisation enjoys speeds and flexibilities from concept to delivery that an organisation of the 20th century could only dream about. This speed is not only in computer aided design work but right through to the delivery of the product through business-to-business, and business-to-customer, e-commerce delivery. Those same opportunities, however, enable a competitor, seeing a weakened company, to quickly ‘upsized’ and rapidly get new choices in front of the damaged organisation’s erstwhile customers.

- Regulation: the risk that can totally remove an organisation the quickest is a failure to continue to meet the requirements of a regulator or the wider law of the country. If a regulator decides that the controls needed to remain within the regulatory envelope have failed then the organisation is stone cold dead. Only too often this is in the area of information on which the organisation depends to deliver secure and effective control of the products sold.

## The evolution of impact

The risks themselves have therefore not only changed, but also the potential for damage to the organisation from these new risks is totally different. Furthermore, the potential for damage that can occur from old, perhaps insurable, risks can also be unrecognisable from the extent of damage we could envisage in the past.

In older business models the organisation was dispersed around the host country to be situated next to their customers. Now the product delivery is often from one or two key and technological ‘factories’ that, if inaccessible, could close down the whole organisation. Furthermore, these factories themselves depend on information technology and communication technology hearts that can fit onto a postage stamp. Consequently the skills of an individual or small team can be skills on which the entire delivery of a multinational depends. We have the potential and reality of much deeper impact from the same incident that would have been a blip not many years ago.

It is not the loss of the hardware that is the real concern, it is the process for which it is used, the data it stores; and what its introduction has done to the wider production process. It has replaced large numbers of trained staff who simply do not exist any more. It supplies the baseline product and client information. It enables credibility in the audit standards and the audit trail. It has the corporate formulae embedded within its software and it allows access by other authorised personnel. It communicates internally and externally. It provides usable management information and it secures sensitive information.

## Business survival

We need to meet the agenda of this particular discussion and to see how insurance can aid the management of these risks that can threaten the very survival of the organisation. A process of reducing the exposure to destruction is in two underlying steps:

- Identifying and managing any risks or impacts that have the potential to destroy; and
- An emergency response structure that limits damage, puts the heads back on the chickens, and has prepared at least minimum resources for new urgent and priority actions and deliveries.

These legs on which an organisation depends will include at least the:

- Skills of the workforce;
- Ability to communicate;
- Brand value and other credibilities;
- Legal and physical access to the information and other intellectual assets;
- Alternate means of delivering urgent goods and services into the marketplace fast enough to remain a credible player in that chosen marketplace – and to keep out the competitors;

- Legality, credibility, security and with the approval of regulators;
- Tools and information needed to remain in financial and operational control; and
- Ability to respond fast enough to keep the organisation alive.

## The role of insurance

### *The insurance industry*

If we are to assess the value of the insurance product to an organisation facing meltdown, we therefore need to measure its values against these dependencies. The roots of the insurance business therefore lie in spreading financial losses across many people so that the impact on one is bearable.

#### *Insurance products*

It is important to retain this financial perspective as we delve deeper into the relationships between insurance and the losses that are potentially business destructive ones. Whereas insurance does not have any value whatsoever to some insureds facing catastrophic loss, it would be unfair to see this necessarily as a failure of the industry. It is after all, unfair to criticise someone for not achieving what they do not set out to do. The question is more about a matching and mismatching of products and needs; and the responsibility to ensure a precise match must lie, not with the insurer, nor with the broker, but with the organisation that is carrying the risk. These clear, precise and unarguable responsibilities need to remain 'on the table' as we proceed further.

Operational risk is historically the natural world of casualty insurance providers. Indeed the very brand values of a commercial property insurer are built around the fact that the insurance provider will be there to 'see you OK' in the event of damage. The branding even includes a product named 'all risks insurance'. We should stop a second and ask whether this product in particular is seriously misnamed when taken into the very real world of an organisation in distress. Having said all this, the responsibilities for ensuring a match between risks carried and the insurance programme remain as defined in the paragraph immediately above and are clear and loud.

#### *Management of mismatches*

We appear to have two fundamental mismatches between the product and the particular potentially catastrophic needs of the insured:

- \* The first mismatch is that the insurer is contained by the need to reduce all loss into monetary terms; whereas continuity managers see their greatest exposures not to be monetary; but exposures to the operational

delivery process, to intellectual assets and other ongoing stakeholder support; and

- \* The second mismatch is that the insurer, to be able to assess and cost the risks that are to be assumed, needs to have the cause of the loss as the primary driver in the covers and negotiations. The ‘insured’, considering potentially critical or catastrophic loss, sees the impact, not causes, as the primary concern.

These mismatches need to be managed in themselves if the parties are to deliver effective insurance protections that meet the business need.

There is a further aspect that needs to be said. Organisations need to ensure that their cost of risk is evened out over a period of time and they will be considering a period of some years; maybe even a decade or more. In other words they are not able to maintain stakeholders’ support if their stability varies dramatically year by year. Insurers do have a history of withdrawing the availability of cover just at a time when it is most needed. This may entail an outright refusal of cover in some trades or a significantly reduced market capacity that has the effect of dramatically increasing premiums. Examples include the cover against terrorism (see also above) and also some liability covers when claims patterns show increased claims frequency.

We will now move on to consider the product range of the insurance industry then come back to these needs and explore where, if at all, they join in with each other.

#### *Insurance products: the headlines*

The headlines are that the primary level and conventional insurance products usually come in two forms:

- \* The ‘material damage’ policies that protect against physical damage or loss of assets, occasionally extended to include some resultant loss of revenues; and
- \* The liability policies that will reimburse monies should the policyholder be successfully sued – or indeed incur costs being unsuccessfully sued – by another person or legal body.

We do not have the space in this article to explore these in detail but there are a couple of relevant headlines worth consideration within this article.

### *Material damage policies*

These are aptly described and are concerned with the loss of physical assets. The perils insured against do vary with the type of policy. The cause of the

damage – known as the proximate cause – must be one of those perils that are mentioned in the policy. Some perils are quite specifically excluded to avoid any confusion in the wordings. These include nuclear damage, emerging damage such as pollution, war risks, (increasingly) terrorism, the consequences of the loss of electronic data and any others. The fact that these perils are not insured or insurable does not mean that they will go away; they remain a concern for the risk manager.

Conventional insurance protection may not concern itself with what the damaged things do for the insured organisation, nor the dependencies on the insured items. The policy may not concern itself either with the question whether a precise fit of a replacement item is or is not available immediately. When a replacement commodity cannot immediately be delivered it is not an issue for the insurance contract nor especially the insurer.

‘Increased cost of working’ or ‘business interruption’ covers are available from the insurance market. They set out to replace revenues, sometimes profits, and maintain those ongoing fixed costs that do not reduce directly as sales reduce. The policy can cover also any increase in operational costs of working to meet deliveries while the main delivery facility is being rebuilt.

The first item of interest to the insurer is that the interruption must be as a result of an incident that is simultaneously insured by a material damage policy. If it is not, then generally the revenue covers will fail too.

The second interest is that the replacement of lost revenues and extra costs is over a period of time that is defined in the policy. This is called the indemnity period. At the end of that period, cover ceases and the ‘insured’ organisation is on its own. The part of the cover that indemnifies the ‘increased cost of working’ is valuable to an insured, which needs to spend additional sums to ensure that it stays credible within its marketplace and to its stakeholders. Such expenditure may, for example, include marketing costs to keep the brand value alive, and the costs of outsourcing supplies that were previously built in-house.

There is an important additional constraint related to this period of indemnity. Any such increased expenditure must, to be recovered from the insurer, be ‘economic’ to the insurer. In other words that expenditure would need to bring about a reduction *in the insurance claim* at least equal to the amount spent. Needless to say therefore that the claim amount is constrained by both what is insured and also the contracted period of the indemnity, and the board may need to think much longer term and feel the need to spend much more on emergency deliveries and marketing. This must be at the insured’s own cost, just at a time when revenues, assets, cash flows and even credit ratings are already under great strain.

## Liability covers

These policies will be structured to protect against the liabilities the insured may acquire to their employees and to third parties. There are a couple of important aspects for the risk manager when considering business survival exposures.

The first aspect to stress is the importance of the adequacy of the liability covers, both in the range of cover and in the adequacy of the limit of indemnity. Liability awards can be so large that they can be many times the net asset value of the organisation. In other words a successful claim combined with a failure of the insurance protection can destroy the very financial stability and lead to closure of the entire company. That insurance failure may not only be in the inadequacy of the limit of indemnity. Policies will have exclusion clauses. One exclusion may be claims brought in the jurisdiction of American or Canadian courts; another may exclude any products or services sold to the aviation industry.

Policies may also have warranties that will demand certain activities or controls must be maintained for the cover to remain in force. The task of the risk manager, and indeed it is a business survival issue, is to stay in touch with the detailed activities around the organisation and ensure that those activities remain within the insurance policy understandings. Finally, in this flying visit to liability insurance we need to remember that insurance will never protect against a deliberate act. Fines by a regulator or the criminal justice system are not insurable.

The second case illustrates that it is not just the finite sum that catches the breath of an organisation but the relationship between that sum and the ability to pay, and also to continue as before.

## Summary

To fully appreciate the value of insurance protections in catastrophic loss situations we need first to remind ourselves of the dependencies on the back of which an organisation continues to survive. These are the issues, rather than the cost of replacing buildings and machinery, that will drive the board's concentration during these difficult times. They are the issues which, if lost, will lead to threats to the very survival of the organisation.

## Timeout of marketplaces while workplaces are reinstated

Material damage insurance covers can provide the funds that will enable the rebuilding process to begin. The physical work of rebuilding has to go through many stages, however, before the factory or office is back in business 'as normal'. The site needs to be cleared. Decisions then have to be made on exactly how the new facility is to look; and planning approvals are very likely to be needed. Only then can the tender document be prepared, estimates obtained and negotiated, and decisions made again. There follows the wait until the builders or the machinery manufacturers can begin work and a further wait until the facilities are completed and delivered. Material damage insurance does not offer any assistance in meeting delivery problems during this wait, other than the infrequent use of business interruption policies; the weaknesses of those policies are outlined above.



The ‘timeout’, however, may be because of a failure that is not related to the loss of physical property. The supply chain, whether it is external or internal, can fail for a variety of reasons. They may include financial failure of a supplier, transport blockages such as the petrol strike in the United Kingdom, non-renewal of supply contracts and a failure of raw material supply. With a conventional insurance programme, the organisation is facing these issues on its own.

Fines and penalties are not insurable; neither is the often greater resultant damage to confidence and brand values.

## Stakeholder’s loss

Policies do not go on to protect against losses, many times more costly than the original incident, when a consequence is that customers and other stakeholders lose confidence and walk away. Furthermore it is not normally possible to insure against becoming illegal; however, unwittingly. This cause can bring about the fastest way that an organisation can come to a complete closure.

Information, whether it be corporate, customer, or other information, is the very lifeblood of a modern organisation; as is the ability to ‘mine’ that information in particular ways for marketing, management information, regulatory needs or otherwise business control. Intellectual assets go much further than just data. We can extend the description to include computer software, designs, patents, research output and research verifications, audit trails for auditors and accountants, recipes, and current work on software, product and other developments. Certain contracts can be regarded also as an intellectual asset, as indeed can relationships and trust from the supply and delivery chain through to the wider list of stakeholders. The very reputation of the organisation can be described as an intellectual asset, with the brand dependencies of reputation, goodwill, credit rating, stock market analyst support and of course the avoidance of media attack. Last, but by no means least, is the culmination of experience and skills right across the workforce. These are crucial; business threatening dependencies yet insurances against the full cost of their loss are not generally available in the insurance market. Some insurance even sets out to avoid indemnifying intellectual asset exposures by specific exclusions.

The insurance market is undoubtedly useful for rebuilding balance sheets and revenues from losses caused by some damage and by some litigation. This use is for organisations looking to protect themselves against degrees of financial loss that they cannot comfortably bear internally.

The real concern, however, is that such an insurance claim is useful to rebuild balance sheets only if the insured organisation is lucky enough – or well managed enough – to keep its dependencies going and thus actually survive a major loss. Should the organisation be neither lucky nor well managed the real value of the insurance claim is insignificant in the scheme of things that then unfold.

The real driver for this debate in modern organisations are the risks that can lead directly to destruction and where the placement of a monetary value on the loss is peripheral to the real issue; or even of no real purpose at all. Such losses

are when the very foundation stones of the organisation are removed; the skills, information, other intellectual assets, the brand, the confidence of its stakeholders and a failure in the ability to supply mean the departure from the marketplace is long enough for competitors to take away the customers; probably for ever.

It is clear that the greatest damage that a major, modern, multinational can face is too often not monetary; it is operational and intellectual. It is clear also that insurers are driven by the need to identify individual causes of damage; whereas the continuity/risk managers are concerned primarily with the potential for destructive damage to one of the crucial cornerstones of the organisation's survival. They are entirely different approaches.

To reinforce the point we list below the top 10 concerns that emerged from a survey by AON among the UK's top 2000 companies. They are listed in order of importance.

- 1 = Business interruption
- 1 = Failure to change
- 3 = Employee accidents
- 4 = Employee recruitment/retention
- 5 = Loss of reputation
- 6 = Failure of key strategic alliance
- 6 = Professional indemnity
- 8 = General liability
- 9 = Product liability/tamper
- 10 = Political risk
- 10 = Physical damage

Unless the underlying conflicts can be brought effectively together, insurance may continue to have very little real value in the survival stakes of the modern organisation. Nevertheless, we have set out to encourage the reader towards a realistic assessment of the values of a conventional insurance programme to a modern company and, above all, to be quite clear where insurance is not able to extend assistance to an organisation facing potentially catastrophic damage.

The responsibilities for understanding and managing risk lie still and irrevocably within the organisation carrying those risks and sadly there are no easy options for passing those risks on to others. Too often directors have been heard to say, 'we don't need risk management as we have insurance'. Food for more thought perhaps?

## Educational programmes

An outline of a Business Continuity and Crisis Management Syllabus is provided in Appendix F, an summary of the programme is as follows:

- Understanding the risks;
- Stakeholders and their role;

- Governance, good practice, standards, regulation and the law;
- Culture, strategy, performance, risk and business continuity;
- The business continuity management cycle;
- The business impact analysis (BIA);
- The business impact analysis: a hitchhiker's guide;
- Application and uses of BIA information;
- Technology exposures and continuity;
- Dependency management: supplier management, outsourcing and business support;
- Other applications for business continuity tools and principles;
- The role of people;
- The values of insurance products in a crisis situation;
- Communications in a crisis;
- Relationships with emergency and governmental services;
- Rehearsals and exercising of plans and risk decision making;
- Maintenance, benchmarking, assurance and audit; and
- The continuity plan and its role.

## Chapter summary

It is clear that businesses need to prioritise this aspect of sustainable business risk management in this era of globalisation as there are many issues that are of practical operational concern and go to the heart of the survival of the organisation. It is also clear that insurance may not be the complete solution.

### *Useful web links*

- \* A global map of the incidence of H5N1 avian influenza, by country, at the present time can be found at: <http://pandemicflu.gov/>
- \* Awareness and Preparedness for Emergencies at Local Level (APELL) is a UNEP site on major accidents, emergency prevention and response. <http://www.uneptie.org/pc/apell/home.html>
- \* Emergency Events Database (EMDAT) of over 12,500 mass disasters <http://www.cred.be>
- \* EU Major Accidents Hazard Bureau <http://mahbsrv.jrc.it/>
- \* EU site on Chemical Accident Prevention, Preparedness and Response <http://europa.eu.int/comm/environement/seveso/>
- \* OECD provides a accident thesaurus, reports and a list of internet links to national and international sites. <http://www.oecd.org/ehs>
- \* US-OSHA Emergency Response Website Guidance <http://www.osha.gov/>
- \* US Chemical Incidents Report Center (CIRC) <http://www.csb.gov/circ/>



9

Shareholder value and  
reputational risk

# 9

## Shareholder value and reputational risk

### Introduction

Risks such as stakeholder pressure, whether it be from the financial community complaining about executive remuneration or non-governmental organisations (NGOs) bemoaning the lack of published policies, can impact upon the accumulated 'goodwill' or intangible asset value of a company.

The market value of a company is made up of three elements:

Market value = tangible assets (less debt) + goodwill + intangible value

Within a company's report and accounts the *tangible assets* are assessed and audited. The *intangible value* of a company is partially included in the balance sheet as 'goodwill' or 'intellectual capital', of which the corporate and product brand reputations are a large element. Intangible value is often regarded as too difficult to measure and break down into its constituent parts, but it constitutes an estimated 71% of market value of the UK FTSE100.

Intangible value is quite often of higher value than tangible value, according to Interbrand 2000, who estimated that 96% of the market value of Coca-Cola, 97% of Kellogg and 84% of American Express is 'intangible' (quoted in *Business Case for Corporate Responsibility*, Arthur D. Little and Business in the Community (2003)).

Reputation is the key driver to enhancing or destroying this intangible value of organisations; whether they are listed or not similar factors apply. It is not just a company's overall reputation that is important but how its reputation is aligned with and meets the expectations of its stakeholders.

There is evidence to show that the public reputation of a listed company and its share price movement in the future have a strong correlation. This research was conducted by Mori, the polling company, who found that the 'favourability' rating of the analysed companies led to corresponding moves in share performance, with a lag of between three to 12 months (*Financial Times*, 22 August 2005).

The company's reputation, therefore, becomes a key issue in enhancing or destroying its intangible value; whether it is listed or not the same rules apply. It is not just a company's overall reputation which is important but how its reputation is aligned with, and whether it meets the expectations of, its stakeholders. If this is achieved then value will be created.

The management of reputation integrity is one of the greatest corporate challenges of the new millennium. As forces of globalisation continue to gain momentum, society increasingly demands that large multinational corporations improve their performance in the areas of human rights, the environment, worker health, and other governance issues. Failure to address these demands has proved damaging to a company's most important asset – its reputation. (*Earning Your Reputation: What makes others respect your company?*, Price Waterhouse Coopers (1999))

Respected reputations are built over a long time, as they are a combination of reliability, credibility, responsibility and trustworthiness, and these reputational qualities are hard won. In the context of his organisation, Ralph Larsen, the chief executive officer (CEO) of Johnson & Johnson, has aptly stated:

Our image is that of a caring company. It is shaped not by great acts or great decisions, but rather the sum total of all behaviours and actions of the company over a period of time. (*Reputation*, Charles Fombrun, Harvard Business School Press (1996), p. 69)

A business crisis (see also Chapter 8) that results in the loss of reputational value, as a result of risk manifesting itself, has been defined as:

Any problem or disruption that triggers negative stakeholder reactions and results in potentially damaging public scrutiny. (*Annual Report 2002*, The Institute of Crisis Management (May 2003), from [www.crisisexperts.com](http://www.crisisexperts.com))

As many case studies have demonstrated reputations can be rapidly damaged or even lost. In business practice this can occur through inadequate:

- Environmental, health and safety and socio-economic risk management, such as:
  - The *Exxon Valdez* oil spill;
  - Firestone tyres recalls;
  - Concorde plane crashes;
  - Product contamination scares; or
  - Marketing promotions that backfire (see also marketing practices in Chapter 10).
- Compliance with regulations and reporting requirements (considered in previous chapters), such as the UK financial services with its well-documented sector problems over:
  - Endowment mortgages;
  - Lack of clear customer information;
  - Insider dealing allegations; and
  - Individual company difficulties, such as the Equitable Life.
- Risk management practices as a standard within an industry, such as the consultancy and accountancy industries;

- Corporate governance, as demonstrated in international cases including Enron, WorldCom and Tyco, among others; and
- Stakeholder engagement procedures, including investor relations.

This chapter provides a framework for minimising reputational risk whilst maximising stakeholder value.

## Brand protection

It should be mentioned that any business involved in building its reputation also has to consider whether it has any intellectual property or brand to protect. This is true wherever it operates and all the more so in today's global marketplace. It is also true of other organisations. For example, the UK's most highly research-focused universities, as well as a number of NHS IP hubs and Trusts around the UK, which are undertaking an increasing amount of original research work into medical devices, biopharma and other unique innovations, must consider protecting their intellectual property or ideas. Indeed, as regards sustainable risk management, taking steps to protect the future of key assets should be a natural process for any business and actually seen as an investment.

Protecting intellectual property (IP) safeguards the growth of a business as well as protecting it from theft. IP protection can help businesses of all sizes:

- Raise finance;
- Improve company performance;
- Build brand awareness; and
- Improve customer loyalty.

However, despite these clear benefits, many do not see this as an important area of risk management. Indeed, only 26% of UK businesses, and even fewer small and medium enterprises (SMEs), either recognise or know how to take full advantage of this growing area of opportunity.

Surprisingly, 98% of worldwide patents are granted for 'across-the-board' technology – for design advances and in everyday fields in the engineering and computing sectors – not for the key, breakthrough inventions profiled in the media.

## Categories of IP

Intellectual property falls into three broad categories: patents, trade marks and design protection.

*Patents* protect inventions by giving the owner of the patent the right to stop anyone from making or using the invention without the owner's permission. This is a legal right, for example, in the UK granted by the Patent Office, lasting up to 20 years. This right to stop competition is only legal in the country for which a patent has been granted. Practical steps are:

- Keep the details of your invention secret until you have filed a patent application. To get a patent, your invention must not have been disclosed publicly anywhere in the world before you apply – even by yourself;

- Ignorance that you are infringing someone else’s patent is no defence;
- Contents of patents are published; they do not remain a secret;
- A national patent only gives you rights in that country;
- The European single market does not override national patent systems;
- You have to police your own patents, or get someone to do it for you; and
- Always get professional advice – it is easy to go wrong.

*Trade marks* are signs which are used to distinguish the goods or services of one business from those of another. Most trade marks are words or logos or combinations of the two, but other forms, such as three-dimensional shapes, combinations of colours and even sounds, may also be used as trade marks. Protection lasts initially for 10 years and then, on payment of a fee, it can be renewed in 10 year blocks for an indefinite period.

Having a registered trade mark gives brand recognition and helps guarantee the origin, quality and consistency of the goods or services. Not only does this help avoid confusion with others in the same line of business, it also allows action to be taken against anyone counterfeiting or copying a trade mark for similar goods or services.

Products sold under a particular trade mark may vary but the trade mark remains unchanged. Trade marks are an important means of protecting the reputation and goodwill that a business has built up. Trade marks are, for many businesses, the single most valuable marketing tool that they possess.

*Design protection* is very important. It is often the reason that a particular product is chosen or desired. A significant amount of work may be involved in producing a design, and it is therefore important wherever possible to provide protection for this design work. Design protection can be very important in preventing competitors from using the same or a very similar design. Design protection can also be used in licensing a design to third parties and therefore potentially providing an extra income source.

The EU definition of design is the appearance of the whole or part of a product resulting from features such as the lines, contours, colours, shape, texture or materials of the product or its ornamentation. Such products can include graphic symbols, screen displays, logos, typefaces and packaging. Accordingly the scope of what is meant by ‘a design’ is very broad, and principally falls into two categories, whether the design is two or three dimensional.

Three types of protection are potentially available: *registered design* is obtained by registration, and can protect the appearance of new two- or three-dimensional designs. *Copyright* is a right associated with a particular ‘copyright work’ and is a right to stop unauthorised copying of the work. Copyright is largely applicable to two-dimensional designs, but can provide protection for some three-dimensional designs. *Design right* is an automatic type of protection that provides protection for a limited period for most three-dimensional designs.

## The pros and cons

In the context of risk management that there are many positive reasons for taking steps to protect the IP of an organisation from as early a stage as possible. IP can



be useful to raise vital finance. Intangible assets, such as registered patents and trade marks, are increasingly being used as security to borrow cash. They also provide new revenue streams from licensing and franchising activities. They may also have a residual value so that even if the company stops trading, the IP may continue in existence and can be sold on to others. Companies that protect their intellectual property often undertake a wider range of performance enhancing activities, such as research, design and development. Trade marks and patents also enable their owners to command a premium price in the market that is reflected in their financial performance.

The IP protection process, however, has never been a cheap or straightforward journey. Traditionally, the IP profession existed surrounded by an air of mystique. It involved highly skilled attorneys, sitting in distant offices, corresponded by letter to businesses large and small, using unintelligible jargon and attaching reams of complicated information. They charged significant sums of money for work that offered no clarity to their client. This led to many start-up businesses and SMEs making little use of formal methods of protection requiring registration, such as patents. They preferred informal methods because they were cheaper and within the control of the company. The principal method of maintaining confidentiality was through working with customers, suppliers and employees who could be trusted. They saw the greatest threat to their IP as loss of key people, far more than the threat of copying by the competition.

However, there have been key developments and advances in the IP sector of late. In the UK, for example, the volume of IP has grown enormously, and gets greater and greater still each year. A much larger proportion of technology patents are being applied on a global scale.

Inventors, and indeed most SMEs, now seek more and more *practically* angled advice, especially advice that is tailored around the commercial hopes of the business, its customers or end-users. In the past, patent agents operated much like solicitors: the provision of patent law advice, but little more. All that has now changed dramatically and IP protection is a much more accessible method of managing risk to the brand. Moreover, what may become the biggest long-term change is that a much broader range of commercial and corporate clients are harnessing the IP system, with much of it funded by third parties such as investors of venture capital firms.

## Corporate governance

This issue is covered in Chapters 21–23 but is also embedded in each chapter. Good corporate governance is one of the foundations of good risk management practice and is critical to reputational matters. Its importance is embedded in each chapter. The issue is dealt with in *Due Diligence and Corporate Governance* (Dr Linda Spedding, Lexis Nexis (2004)), and within *Tolley's Corporate Governance Handbook*, 2nd Edition (Andrew Chambers (2003)), and *A Practical Approach to Corporate Governance* (Dr Saleem Sheikh, Reed Elsevier (2003)) (see also Bibliography).

### *Corporate governance*

A company will have certain issues, such as corporate governance, that are specific to the company as they are under the company's control. These are the issues that, if managed well, will help enhance a company's reputation, or, if mismanaged, could ultimately destroy its reputation.

As regards risk management and good corporate governance procedures, including non-financial risk in particular, of key importance as a reference tool is the *Combined Code* (revised) on corporate governance, which resulted from the merging of recommendations offered by the Derek Higgs review (released in January 2003) as well as those offered by the Turnbull, Cadbury, Greenbury and Hampel committee reports. The Code has been incorporated into the listing rules for all UK listed companies and applies for reporting years beginning after 1 November 2003.

Sites that offer guidance on the most appropriate corporate governance best practice for UK companies are the Institute of Chartered Accountants in England and Wales ([www.icaew.co.uk](http://www.icaew.co.uk)) and the Association of British Insurers Institutional Voting Information Service (IVIS) website at [www.ivis.co.uk](http://www.ivis.co.uk) (see Bibliography).

## SERM criteria

A SERM system is interested in the following indicators which are considered to be elements of corporate governance best practice:

The following criteria can help determine the robustness of a board:

- That there are an equal or greater number of non-executive directors than executive directors;
- The non-executive directors are independent of the directors (e.g. not related or previously employed by the company or executive directors);
- The chairman and CEO are separate roles;
- The CFO is operationally independent from the CEO; and
- The CFO is a strong and respected member of the board.

The functions of the board in promoting risk management are improved by:

- A clear governance structure for the organisation, including the major committees in operation;
- Mission statements, internally developed codes of conduct or principles, and policies relevant to environmental, health and safety and social performance;
- An outlining of the process for determining the expertise of board members, including issues related to environmental, health and safety, and social risks and opportunities; and
- Board-level processes are present for the overseeing of the organisation's identification and management of economic, environmental, and social risks and opportunities.

The following criteria can help determine the effectiveness of the non-executive directors:

- Roles are clearly defined;
- They are required to be re-elected at the end of their term; and
- They are perceived to be independent.

Remuneration and share options: some of the criteria for determining the effectiveness of a share options scheme:

- Linkage between executive compensation and the achievement of the organisation's financial and non-financial goals;
- The strike price is within similar range to current share price, to discourage artificial engineering of volatility;
- Options should be staggered over a range of periods, not merely one large amount; and
- CEO and CFO awards should be based on company performance rather than market performance, to reduce merely sector gains.

The following criteria can help determine the effectiveness of auditors:

- The separation of audit from consultancy;
- The auditing firm should not be undertaking any, or at least minimal, levels of consultancy for the organisation;
- Well-respected audit firm;
- The auditors have not been given professional indemnity insurance; and
- The auditors' fees are stable (no increase of more than 10% year on year).

Stakeholder engagement: ensuring there is a provision of mechanisms for shareholders to provide recommendations to the board. This is covered in the following section in more detail.

## Stakeholders

SERM's starting point for a company to assess reputational risk and how it interacts with the intangible value is to list its key stakeholder groups. These can be broken down under several main categories.

The SERM stakeholder template:

- Academic and research organisations;
- Business partners, suppliers and trade bodies;
- Customers and their representatives;
- Direct actions groups and NGOs;
- Employees and their representatives;
- Financial institutions (banking, investor and insurance criteria);

- Governmental organisations;
- Local and regional governmental organisations;
- International governmental organisations;
- Journalists and media organisations;
- Key competitors; and
- Local communities.

As is mentioned further below, the list should then be expanded to show the key individual stakeholders under each category. Agreeing exactly who their key stakeholders are can be a challenge to most boards. The key stakeholders' trust and high regard for the company is paramount to the company's sustainable growth. As is illustrated below stakeholders can have a direct impact upon the value of a company:

- Actual and potential shareholders of a listed company will decide what they think the value of a company is with the prices they are willing to buy and sell at; and
- Regulated industries can have their prices set by government departments or regulators, or are taxed by the government, thus affecting the demand for their offerings (e.g. alcohol, tobacco, oil, etc.).

There are numerous indirect risks and stakeholder pressures which can damage an organisation's reputation. These can include changes to the company's operating environment through regulation; for example, imposed restrictions, loss of licence, likelihood of government intervention, etc. These may also be closely related to environmental, health and ethical concerns. The government as a key stakeholder has raised the pressure on pension funds to help protect the reputational value of UK plc; for example, amendments to the Pensions Act 1995, which became law in July 2000, implemented a requirement for pension funds to declare their 'social, environmental and ethical policies, where they exist' in their Annual Statement of Investment Principles (SIPs statements).

#### *Stakeholder management*

The link between the companies and their key stakeholders are the issues that the company has the ability to manage/influence and thereby improve the position for the stakeholder. For each of the stakeholders the company should consider the pertinent issues that could enhance or destroy their relationship. The issues' impact varies from stakeholder to stakeholder as their expectations are not necessarily the same.

It has already become evident that, to be complete, an institution's operational risk profile should reflect intangibles such as reputation which are acknowledged to be central to the success of an institution. Listed companies in

particular are under increasing pressure from external ratings agencies, indexers, investment advisors and others over their safety, environmental and social performance. Poor communications or communicators can attract media interest or outrage. As part of a reputational risk analysis it is necessary to capture stakeholder sentiments about the organisation. This is part of the reputational risk assessment reviewed in the following sections.

## Reputational risk

It is now generally recognised by most organisations that without risk there is no reward and, as a general rule, the higher the potential reward the higher the potential risk. Those organisations which have struck the optimum balance between risks and rewards are the modern-day heroes. Indeed many organisations are assessed upon the basis of their risk appetite and how far they are risk averse.

Achieving a balance between risk and reward is becoming more and more difficult, as there is now an increasing and often unrealistic expectation from stakeholders that reward can be delivered without risk. In order to build and retain a good reputation, these unrealistic expectations need to be expertly managed through transparency, education and inclusion.

Therefore from the SERM perspective the starting point for any company is to have a clear understanding of the key issues surrounding its 'risk versus reward' strategy:

- How could its reputation be damaged?; or
- How, if managed well, could it enhance its reputation over that of its competitors?

The organisation needs to work closely with all of its stakeholders by:

- Discussing with them the wider implications of their expectations, the management and deliverability of their expectations; and
- Ultimately, agreeing with them how their interests can be aligned with those of the other stakeholders.

In essence, the company and its stakeholders should be working together harmoniously. The issues are dynamic and need to be continuously reviewed. Expectations these days mean that even good surprises can be unacceptable.

## Reputational damage

Media interest and non-governmental organisations (NGOs) activities work together to create public awareness. If an issue is newsworthy and a stakeholder launches a campaign about the issue, it will keep gaining momentum and lead to ever-increasing public awareness. This is a key area of risk management.

Companies need to assess the current and potential damage or value the issue could have. How sustained could the coverage be? 'Does the story have

legs?’ A negative, one-off headline can be fairly damaging but a long drawn out campaign can severely undermine a company’s reputation, even if it is only in the local press. The issue could potentially centre on a major accident, leading to a public enquiry and class action for compensation. The whole process will ensure maximum media coverage.

This can increase public awareness of the issues; the company should consider the public’s reaction on the basis that they are aware and have an understanding of both sides of the argument surrounding the issue. Will the issue lead to anger, outrage or fear? The media and NGOs will only be able to create and sustain public awareness if the issues, which they are promoting, are likely to lead to a high level of anger and outrage among the general public. ‘Bad news sells newspapers.’ Industry lives with these issues and often comes to accept them as being part and parcel thereof. The public perspective can be very different, however, and a company should try to understand how angry the public could be if it fails to manage the issue.

It is generally the case that once a company is in the spotlight over a certain issue; a strategic option to try to limit the damage is to convince the press and public that it is a sector issue rather than a company specific issue. For instance, Shell’s reporting of their known retrievable oil and gas reserves under the US Securities and Exchange Commission’s (SEC) guidelines was a well-documented example. Shell appeared to be successfully turning it into a sector issue, but the subsequent disclosure of the board’s damning internal emails turned the focus of the blame clearly back onto the company. This resulted in fines of \$151 million (£83 million) to draw to a close the dispute with the SEC and UK’s Financial Services Authority (FSA) over its wrongly booked reserves (*Financial Times*, 30 July 2004).

Some issues can be quickly addressed and, if carefully managed, can even enhance a company’s reputation, such as in the case of product recalls if the company initiates the recall prior to media exposure of the risks. Others just simply will not go away; these are issues which the company has to live with and are, therefore, an inherent part of a company’s operations. General and specific examples include:

- Oil companies that are active in parts of the world where their staff and operations are at risk from saboteurs and media exposure of environmental damage; and
- J.P. Morgan Chase setting aside an extra US\$3.7 billion to cover investor lawsuits in relation to its ‘alleged role in corporate scandals such as WorldCom and Enron’ (*Financial Times*, 22 July 2004).

The media and NGOs have long memories and will continue to make examples of a company’s poor management of an issue. Once a company has entered this territory it is very difficult to reduce the onslaught of adverse publicity. For instance, in the UK Jarvis plc provided a case in point as their loss of reputation over safety incidents was then compounded by the loss of contracts and the resultant cash flow problems and redundancies.

## Intangible risk

The extent to which a range of intangible risk factors influence share price is vital information. These risk factors include:

- Corporate reputation and individual brand values;
- Regulatory regime and government reaction to public pressure;
- Media and NGO interest; employee morale; and
- Investor, lender and insurer confidence.

Some of these are considered below.

- **Corporate reputation:** the organisation's reputation. This reflects key stakeholders' perception of the company's strength and corporate governance; this is a function of size and visibility. It includes the credibility, reliability, trustworthiness and responsibility of the organisation;
- **Individual brand values:** the product's reputation. This reflects the relevant customer's perception of brand name and resultant loss of sales/increases in returned goods/inventory costs; related to visibility; and
- **Stakeholder value:**
  - Academic and research organisations: vital to some sectors that need scientific approval for their products;
  - Business partners and suppliers: reflects the effect on voluntary or imposed partnering due to operational structure;
  - Customers and their representatives: not only the demand for products and services, but also brand loyalty, quality and product safety perceptions;
  - Direct action and NGO interest: reflects the likelihood of NGO campaigns against some aspect of the company's operations (e.g. internet-based campaigns). This also includes the actions of militant action groups and reflects the adverse pressure (often unlawful direct action) against the company over perceived malpractice (i.e. anti-vivisection protestors);
  - Employees and their representatives: employee morale and industrial relations are included. This reflects the damage which could occur, resulting in resignations/recruitment costs, loss of productivity and concerted trade union pressure;
  - Financial viewpoints: investor's, lender's and insurer's confidence;
  - Government and the regulatory regime: reflects changes to a company's operating environment beyond its control (e.g. leading to imposed restrictions, loss of licence, likelihood of government intervention, etc.);
  - Government reaction to public pressure: reflects the extent to which perceived unethical business practices are becoming untenable, i.e. over-charging and monopolistic tendencies;
  - Government: local government pressures and permits, including planning regimes and processes which can aid or inhibit operations;
  - International governments and regulatory regimes: for example, the European Union, United Nations and international labour organisations;
  - Journalist and media interest: reflects the extent to which intrusive and maintained media coverage could adversely influence stakeholders' perception;

- Key competitors: the extent to which major competitors affect the ‘competitive environment’ like resource and product prices, their reporting and stakeholder engagement activities; and
- Local communities: local communities can prove of critical importance and can pose risks of their own from activism and objections to planning applications and business operations. They are also the source of employees and local reputation is of importance.

### *Anger/outrage*

The media and NGOs will only be able to create public awareness if the issues that they are promoting are likely to lead to a high level of anger and outrage among the general public. ‘Bad news sells newspapers’ and the press want to highlight the culprits. Industry lives with these issues and often comes to accept them as par for the course. The public perspective can be very different and the owner should stand back and try to see the issue through the public’s eyes. How angry could they get if the company was to fail to manage the issue?

## A SERM stakeholder reputation audit

An overview of the framework for a SERM reputation risk assessment is set out below.

The company’s executive board should have a set of high-level or prime objectives which need to be achieved over time. Failure or success in achieving these aims/objectives will have a major negative or positive impact on the reputation and, ultimately, the value of the company. These objectives will be regularly considered and challenged by the non-executive directors (NEDs) as there can be a tendency for companies to become blinkered and to overmanage their ‘pet’ issues and not recognise the true reputational opportunities and challenges that lie ahead.

A reputational risk assessment should:

- Identify, quantify and evaluate the risk of the company of failing to achieve its stated aims/objectives; and
- Then actively reduce that risk.

Assessing the risks which are inherent within the business has six stages:

- The public profile of the stated objectives and aims;
- The level of public awareness and concern in the event of a failure to achieve any of the stated aims;
- The longevity of public awareness and concern of the failure;
- The focus of blame on the company in isolation from the rest of the sector;
- Stakeholder reactions in the event of a failure; and
- The inherent risk of failure of these aims.



There should then be an assessment of the residual risk, which is considered after:

- Operational controls and methods of mitigating risk are considered; and
- Stakeholders' expectations are assessed, engaged with and measured.

The residual (net) reputational risk can then be calculated by dividing the inherent reputational risk by the risk reduction scores for each issue:

$$\text{Residual (net) reputational risk} = \text{inherent (gross) reputational risk} / \text{the risk reduction score}$$

The owners of a company should then be in a position to map their risks and consider where additional resources can increase their risk reduction effort and will, therefore, have the most impact on reducing the level of reputational risk.

Such an assessment is essential in successfully managing the reputation and, ultimately, the value of a company. It enables the formulation of a risk mitigation strategy that will:

- Identify, focus and prioritise on the critical issues and stakeholders;
- Obtain the 'best possible risk mitigation results for the resources employed' to manage the risk;
- Monitor and review progress;
- Assist in the decision-making process by providing valuable insight into 'reward versus risk' strategy determination;
- Complete the risk registers;
- Measure internal perception of concerns against external stakeholder sentiment;
- Integrate, rationalise and lever conflicting stakeholder expectations;
- 'Granulise' and weight the aims, stakeholders and mitigation categories;
- Work effectively throughout the sourcing value chain;
- Encourage industry solutions to industry problems;
- Work as a pre-emptive planning tool; and
- Communicate the results to the wider stakeholder audience, for example through wider and more effective reporting.

The list should then be expanded to show the key individual stakeholders under each category outlined above. Agreeing exactly who their key stakeholders are can be a challenge to most boards. The key stakeholders' trust and high regard for an organisation is paramount for sustainable growth and ability to manage risks instead of 'fire fighting'.

### *Fear*

It is not just fear from the perspective of the individual but also fear for their family members. If you did not trust someone's driving you certainly would not want them taking your children to school. A breakdown of trust creates fear as in potentially managing one issue badly the public will start to ask the question 'who is going to suffer next?'

The link between a company and its key stakeholders is an issue which the company has the ability to manage or influence, and thereby improve the position for the stakeholder. For each of its stakeholders the company should consider the pertinent issues, which could enhance or destroy their relationship. The issues may vary from stakeholder to stakeholder as their expectations are not necessarily the same.

## Stakeholder reporting

For extra-financial reporting there is an increasing number of guidelines and reporting frameworks for organisations to become immersed in; the main ones in the UK are the Turnbull Code, the Corporate Governance Combined Code (the Code) and the forthcoming EU Accounts Modernisation Directive that the Operating and Financial Review (OFR) sought to implement. There is a trend towards the internationalisation of Accountancy Standards with the introduction of the IFSB *et al.* Within the SRI field there have been great strides forward in parts of the EU with new legislation in France, for example, and reporting requirements are being strengthened in Asia, with a combination of voluntary approach and countries like Australia imposing legislation. Moreover bodies like the Association of Chartered and Certified Accountants (ACCA) have supported the value of narrative reporting for organisations worldwide.

Under the Turnbull Code and the proposed OFR a company should have these issues clearly identified and entered onto its risk register. They are dynamic and in further analysing the issues new issues will often emerge which, if managed well in advance, could significantly enhance the company's reputation. With regards to specific risk issues there are social, environmental and ethical (SEE) risk reporting recommendations from the Association of British Insurers' (ABI) guidelines (available at <http://www.ivis.co.uk/pages/framegu.html>), although they are intended for listed companies. The Global Reporting Initiatives (GRIs) template for reporting non-financial performance (see [www.globalreporting.com](http://www.globalreporting.com)) can be used in parts in order to provide a structure to communicate with stakeholders.

Management of these issues sets the company apart from its competitors and helps answer the question 'What makes you different?' If the service the company provides is similar to the competitions, the only differential is price. The ultimate goal is to be ahead of the field and align the company's policies and operations with its stakeholders' growing expectations.

### *The EU Accounts Modernisation Directive (AMD)*

The legislative background is that it derives from the Accounts Modernisation Directives, the 4th and 7th directives on the annual and consolidated accounts of companies (Directives 78/660/EEC and 83/349/EEC respectively) and the directive on the annual and consolidated accounts of banks and other financial institutions and insurance undertakings.

The Accounts Modernisation Directive became effective for financial years beginning on or after 1 April 2005. It requires a mandatory enhanced directors' report (EDR); large quoted and unquoted companies must produce an EDR with a 'fair review' of the business of the company. This review should report relevant environment and employee matters using key performance indicators (KPIs) 'to the extent necessary for an understanding of the development, performance or position of the business of the company'.

The enforcement structure for the AMD is similar to that for the now abandoned OFR, namely it is the ultimate responsibility of company directors to sign off the EDR, which will be enforced by the FRRP (Financial Reporting Review Panel). Company auditors are required to state whether the information given in the EDR is consistent with a company's accounts.

The objectives of the extended business review in the directors' report are that:

- (1) The directors' report for a financial year must contain:
  - A fair review of the business of the company; and
  - A description of the principal risks and uncertainties facing the company.
- (2) The review required is a balanced and comprehensive analysis of:
  - The development and performance of the business of the company during the financial year; and
  - The position of the company at the end of the year, consistent with the size and complexity of the business.
- (3) The review must, to the extent necessary for an understanding of the development, performance or position of the business of the company, include:
  - Analysis using financial key performance indicators; and
  - Where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters.

## Stakeholder reporting channels

The following reporting channels are seen of primary importance in reporting sustainability performance to stakeholders:

- Academic and research organisations:
  - Collaborative research papers; and
  - Grants and sponsorship.
- Business partners and supply chain:
  - Tender document; and
  - Supplier meeting.

- Customers and industry partners:
  - Corporate responsibility or sustainability report;
  - Purchasing; and
  - Guidelines.
- Direct action groups and NGOs:
  - Corporate responsibility or sustainability report; and
  - Face-to-face meetings.
- Employees:
  - Corporate responsibility or sustainability report;
  - Internal magazine; and
  - Intranet.
- Financial investors:
  - Annual report;
  - Briefing;
  - Press release;
  - Questionnaire; and
  - Road shows.
- Governmental organisations (local, national and international):
  - Briefings;
  - Corporate responsibility or sustainability report; and
  - Regulated disclosure.
- Journalists and media organisations:
  - Briefings;
  - Corporate responsibility or sustainability report; and
  - Press releases.
- Key competitors:
  - Sector journals and sector quality standards; and
  - Industry trade bodies.
- Local communities:
  - Site newsletter;
  - Local press article; and
  - Cause-related marketing channels.

## Stakeholder risk analysis

An organisation needs to consider the currency of an issue by asking the following questions:

- How current is the issue and is it of growing relevance or concern to the stakeholders?
- Is it an old issue which is lying dormant and could suddenly take off?
- Is it a new emerging issue?
- What are the dynamics of the issue and the stakeholders involved?

Stakeholder assessments and engagement will enable a company to see in a new light the relationship between itself, its stakeholders and the issues. It will give a company its overall view as to which stakeholders to target for engagement

and to enter into dialogue with, in order to see how their common interests can best be aligned.

#### *Benchmarking the issues*

Having analysed each of the issues under the SERM criteria the owners of the business can then build up a matrix and form a consensus view of the scores to help rank the issues in order of high and low reputational risk profile. This can build into a positive strategy to deal with this sensitive matter of the reputation of the business.

It has been found when dealing with the reputation of an organisation and when considering sustainable risk management that any surprises, even pleasant ones, can unsettle stakeholders. Stakeholders like to know the company's position regarding the issues; the last thing an investor wants is to see a sudden upswing in a company's position when he has recently reduced his holding. Therefore an overview of the relevant SERM stakeholder categories is set out below.

#### *Stakeholder engagement*

Further analysis will enable the owners to see the relationship between the stakeholders and the issues in a new light. It will give them their overall view as to which stakeholders to target for engagement and to enter into a dialogue with to see how their common interests can best be aligned.

The stakeholders' view will often vary with how the owner sees the issues. For example, in one case the owners may effectively be looking at themselves perhaps for the first time in the mirror. On the other hand, the view may be from the external perception of the stakeholders. Neither side is right or wrong but where there is a difference of perception the owner needs to know why? This forms the basis for constructive dialogue between the stakeholders and owners. Well-managed stakeholder engagement leads to transparency, which will ultimately prevent any 'nasty surprises'.

Any surprises, even pleasant ones, can unsettle stakeholders, they like to know the company's position regarding the issues – the last thing an investor wants is to see a sudden upswing in a company's position having recently reduced their holding.

## Stakeholder review

The following section reviews the main stakeholder groups that should be considered for your assessment. The trends and drivers that emanate from these stakeholder groups have been covered in Chapter 3 as well.

*The SERM stakeholder template*

- \* Academic and research organisations;
- \* Business partners, suppliers and trade bodies;
- \* Customers and their representatives;
- \* Direct action groups and NGOs;
- \* Employees and their representatives;
- \* Financial institutions (banking, investor and insurance criteria);
- \* Governmental organisations;
- \* Local and regional governmental organisations;
- \* International governmental organisations;
- \* Journalists and media organisations;
- \* Key competitors; and
- \* Local communities.

## A Academic and research organisations

Academia research and government scientific research councils often conduct research into risk. They contribute through the assessment of risk, the development of responses, and prediction of future risk and monitoring of the effect of preventive actions. Research organisations have raised the level of awareness of the dangers posed by manmade chemicals (pesticides, fungicides, endocrine fertility disrupters) and other influencers of human health. They can also prevent a company's products reaching the marketplace on health and safety grounds, for example, or they are likely to be the source of research which has a damaging effect on an existing product. This is especially true of regulated industries like the pharmaceutical sector.

## B Business partners, suppliers and trade bodies

Businesses are being encouraged to become more responsible, moral and ethical as the public and government become infuriated at the end results of business self-regulation. There are concepts of corporate social responsibility (CSR), corporate accountability, sustainability, business durability and moves to account for non-financial performance. Some prominent business organisations are also vociferous in promoting these concepts. The Confederation of British Industry (CBI) proclaimed:

It is a prime responsibility of managements to ensure that companies are good corporate citizens, caring not just for those with a direct stake in business – shareholders, employees, customers, suppliers – but for the general public and the environment, in the broadest sense of the term. Social responsibility encompasses many different aspects of business life. It means putting customers first, and providing them with good, safe and reliable products and services. It means being a first class employer, providing fair pay, good conditions and decent pensions for employees. It involves genuine concern for

health and safety, and a commitment to good employee involvement and communications. (Quoted in *A Practical Approach to Corporate Governance*, Dr Saleem Sheikh, Lexis Nexis Tolley (2003), p. 297.)

These concepts can help organisations and can also be used as a framework for supplier selection.

*Management of the issues*

Having completed this stage of the exercise the owners should then consider the company's performance in managing these issues. They should ask themselves the question, 'Is the company meeting the key stakeholders' expectations?'

As part of the strategy, management systems, their implementation, internal and external communications need to be assessed. A matrix should be drawn up by the owners to consider the company's overall performance in managing the issues and agree 'risk reduction scores'.

As a guideline, under SERM's system the maximum risk reduction factor is 5 and the minimum 1.

## *Suppliers: auditing and management systems*

There is a wide variance in purchasing companies' approaches to their suppliers' environmental performance. Some companies make their supply chain 'green'; this can involve excluding suppliers or extensive performance criteria and evaluation processes for suppliers to achieve.

Increasingly common are the requirements for supplier declarations on their finances and approach to risks, which could impact upon the purchaser or business partners. It is all too common that suppliers or subcontractors who do not have the same standards compromise a good internal risk and reputation management system. A prime example of this is the damage suffered by clothing and footwear manufacturers when it was found that poor labour rights were endemic in the business (e.g. forced, child and low-paid labour). Purchasers are now engaging with their suppliers to ensure that minimum expectations of behaviour on environmental, health and safety and labour issues are adhered to by key suppliers. One of the more common environmental requirements is for the supplier to be having an environmental management system like the ISO 14001 standard (see also Chapter 18).

*Supply chain pressure: case studies*

- \* Japanese companies are seeking a reduction in the complexity of their supply/value chains. They are setting targets for reducing the number of components by 20% per annum, which means fewer suppliers and a greater opportunity for quality and environmental control;

- \* GAP Inc. has learnt from their reputational disaster and have removed or refused to work with hundreds of overseas suppliers;
- \* Compaq Computers put potential suppliers on notice if their environmental performance is substandard in any of five selection criteria;
- \* Hewlett-Packard, Lloyds TSB and Volvo send suppliers information about their environmental commitments along with a self-assessment questionnaire;
- \* IBM and Hewlett-Packard have environmental expectations included in formal contracts and product or process specifications; and
- \* Crest Nicolson, the UK house builder, are seeking a reduction in their number of suppliers but are increasing the percentage of suppliers with environmental policies and/or management systems. They also hold supplier of the year awards.

## C Customers and their representatives

These risks are explored in more depth in marketing theory or analysis, as customers are mostly silent and usually vote with their purchasing patterns. If customers are dissatisfied with an organisation the business will tend to be unaware until sales start to plummet. Brand reputation is also important here, as customers are prepared to pay a premium for quality, reliability and durability.

Some companies confuse reputation management with public relations, corporate 'green washing' (where the environmental management systems and claims are part of the public relations (PR), or investor relations (IR) departments, and are not embedded into the corporate culture of an organisation), or putting a false picture of an organisation into the world. In truth, the general public and NGOs place trust in a brand (which translates into sales) if they believe that an organisation is honest. The financial sector also places a premium on transparency, as they prefer planned disclosure of risks and bad news instead of sudden surprises. For example, a senior McDonald's executive said recently that changes to the fast food chain's menu were prompted not by a desire to appear socially responsible but by customer demand. Many may perceive it as a defence mechanism against the obesity issue, which has hit the courtrooms and the media.

## D Direct action groups, including NGOs

The NGOs want to fight campaigns that they can win, attract new members and gain sponsorship. The high profile NGOs, such as Greenpeace, like to win people and they focus their attention on the major multinationals and their suppliers. Smaller but focused NGOs can run effective campaigns on a single issue; their members are passionate about the issue and will tirelessly fight their corner. Good examples are local groups fighting planning permission against the sighting of telephone masts and parents who are convinced their children have suffered from the side effects of taking the MMR vaccine.



There has also been a rapid growth in the number of NGOs and their membership numbers. In the UK alone the number of people who belong to environmental and social NGOs is large: the Royal Society for the Protection of Birds (RSPB) membership is three times greater than the total members of all the political parties combined; the National Trust (UK) has over 3 million members; and the WWF-UK has over 330 000 members. Globally groups like Greenpeace are hitting the 2.8 million members worldwide mark. One rationale for this is:

The most important reason for the growth in NGO power is the loss of credibility of governments with respect to issues the public cares about. (*When Good Companies Do Bad Things*, Schwartz, P., John Wiley & Sons, Inc. (1999), p. 137)

The UK is an interesting case study for analysis in this area as it has always been at the forefront of environmental activism, and is home to some of the first ever environmental legislation (e.g. the Clean Air Act 1956), and birth place to some of the most active NGOs (e.g. Greenpeace, Friends of the Earth, Oxfam, Christian Aid) and award winning businesses (five of Europe's six best reporters were UK based in 2003 and the Co-operative Bank was voted the world's best reporter and most sustainable organisation).

This trend is continuing and is helping to set the responsible business agenda, as NGOs seek to engage with businesses on a range of issues.

There is an increase in direct, and potentially hostile, action which is also helping to force the pace of change. For instance, fund managers Phillips and Drew were threatened by animal rights activists over their investment in Huntingdon Life Sciences (which undertakes experiments on animals), resulting in a high profile and speedy sale of their interest in Huntingdon. In 1999, the Bank of Scotland had its reputation badly damaged by its attempted partnership with the controversial US evangelist Pat Robertson, which resulted in the temporary loss of important account holders and 5% of its market value.

## E Employees and their representatives

It is self-evident that employees are easier to attract and retain if the organisation portrays a professional image. Employees can also be an effective source of environmentally beneficial suggestions. Good industrial relations with employees and their representatives (trade unions and committees) reduce the incidence of lost production time and some case studies even indicate an increase in overall productivity levels. It has also been noted that organisations with the Investors in People (IiP) recognition are, on average, 1% more profitable than those without the recognition.

## F Financial institutions – investors, insurers and lenders

### *Investors*

Investors are beginning to pursue a socially responsible method of investment (SRI). In the US this accounts for over \$2 trillion in investment assets, or

approximately 17% of their investment universe. The proportion of UK funds invested in this manner is far smaller but there was a large leap in SRI assets from £23 billion in 1997 to £225 billion in 2001 mainly linked to the SRI Pensions Disclosure Regulation and a number of insurance companies applying SRI criteria across all their equity funds. But ‘ethical investment’ is becoming increasingly important in pension fund management due to a huge rise in public awareness and demand. Companies selected for adequate performance against SEE criteria gain inclusion in a range of traded indices like FTSE4Good series or Dow Jones Sustainability Index.

There is increasing demand for investment in the ‘acceptable’ stocks. The Ethical Investment Research Services (EIRIS) figures on the UK retail SRI market show an increase from £3570 million in June 2003 to £4555 million a year later in June 2004. Additionally, more than 75% of UK adults believe that their pension scheme should operate an ethical policy (*Pensions and Ethical Policies*, EIRIS and NOP Solutions Survey (2 November 2001), [www.eiris.org/Files/PressReleases](http://www.eiris.org/Files/PressReleases)).

*What is socially responsible investment (SRI)?*

SRI is best defined as taking into account the social, environmental and moral impacts of investments, as well as the financial consequences. The UK Social Investment Forum phrases this as: ‘Socially Responsible Investment (SRI) combines investors’ financial objectives with their concerns about social, environmental and ethical (SEE) issues.’

SRI is also viewed as an extension of good corporate governance responsibilities. From 3 July 2000, the Pensions Act (1995) Amendment, Section 35, requires trustees to state:

- \* The extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments; and
- \* Their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to investments.

The government believe trustees should feel they are able to consider the ethical considerations in relation to their work and improve the voting records of pension funds. However, funds are not forced to comply but must state so in their SIP (Statement of Investment Principles).

The history of SRI can be found at: <http://www.uksif.org/Z/Z/Z/sri/hist/index.shtml>

In brief this means that more shareholders will become proactive in engaging with companies. The box below highlights strategies which responsible investors are increasingly following.

### *Socially responsible investment strategies*

- \* *Best in class*: ranking companies according to how well they encompass environmental, health and safety, and social policies and trying to invest in the best performing companies;
- \* *Engagement*: encouraging companies to implement ethical practices and improve their policies through persuasion, support and voting. Approaches may be to communicate ethical policy to companies, subscribe to a corporate governance service, or to invest only with managers who engage with companies. This approach is less exclusive as managers are able to invest in entire portfolios as long as engagement occurs, therefore minimising risk. This is viewed by some as the best way of implementing an SRI policy;
- \* *Integration*: the explicit inclusion by asset managers of corporate governance and environmental, social and governance (ESG) risks into the traditional financial analysis methodology;
- \* *Pioneer screening and thematic investment*: these are based on specific ESG issues, or criteria, such as an organisation's transition to sustainable development, or its moves towards a low carbon economy by investment in renewable technology; and
- \* *Screening*: *positive screening* is the creation of a list of acceptable practices to apply to companies and, from this, to choose the best performers. *Negative screening* can be the creation of a list of unacceptable practices and to avoid investment in companies or sectors using such techniques. *Norms-based screening* is a form of negative screening of companies according to their non-compliance with international standards and norms such as issued by OECD, ILO, UN, and UNICEF.

In the UK the majority of the largest UK pension funds are now applying some of these forms of SRI strategies to at least part of their portfolios. Some of the largest pension funds (e.g. BT's £29 billion and the Universities Superannuation Scheme's £20 billion) are managed entirely on SRI principles.

## *Insurers*

Major adjustments are occurring in the insurance world as the insurers respond to the new and often unprecedented level and scale of some claims from risks which materialise. There are increased risks of losses from the following:

- Increased environmental catastrophes and hazards: manmade catastrophes now account for 96% of traditional risks such as fires, explosions and earthquakes. Around 4% of US claims are now made as a result of natural catastrophes (*Annual Report 2002*, Institute for Crisis Management (May 2003), [www.crisisexperts.com/](http://www.crisisexperts.com/)). The case study of the Katrina Hurricane and its disastrous impact on New Orleans demonstrated in a hitherto unprecedented

manner that environmental disasters do not only affect the developing world. Moreover the earthquakes in India and Pakistan – and elsewhere – have to take account of building standards and the responsibility of the industry. Many insurance experts are forecasting a huge rise in the impact of manmade catastrophes over the next decade (*Best Review*, the monthly insurance magazine, from NewsStand (September 2001), [www.newsStand.com](http://www.newsStand.com));

- Flooding: this and other environmental liability covers are seeing premiums increase in most parts of the world. There are many well-documented case studies that have recently taken place and demonstrate this point from Europe to Asia; and
- Corporate governance risks: these are increasing as directors and officers of insurers in the UK are raising premiums to cope with the tougher regulatory climate. In addition to stiffer financial reporting obligations for companies listed on the London Stock Exchange, insurers say the ‘cyclical nature of the market’ and inherent risks in some areas of business forced their hand (*BestWire*, O’Connor, R. (May 2004)).

## Lenders

Lending criteria are becoming more aware of these risk issues as the banks and other lending agencies can also receive indirect reputational damage for supporting a contentious project (e.g. banks that fund road or dam building in ecologically fragile areas). The main global banks have also developed a code of conduct, the ‘Equator Principles’, which will seek to set a global standard of what is acceptable to their sector (see also Chapter 3).

The ‘Equator Principles’ are used to analyse over 36 signature banks’ risk to investments arising from damage to the environment among other factors. They are:

A financial industry benchmark for determining, assessing and managing social and environmental risk in project financing.

These voluntary lending criteria have been strengthened recently and will be applied to a greater variety of projects as a result of this new agreement. They state:

We will not provide loans to projects where the borrower will not or is unable to comply with our respective social and environmental policies and procedures. (<http://www.equator-principles.com/principles.shtml>)

## G Governmental organisations

In most jurisdictions a variety of government departments and agencies are responsible for the establishment of standards seeking to reduce the level of harmful substances entering the environment and harming the public by:

- Imposing penalties;
- Prosecuting offenders;
- Issuing enforcement notices; and
- Raising and enforcing taxes and subsidies.

In the UK the present government's approach to many environmental issues is to use market mechanisms as corrective forces. This has led to a range of environmental taxation, which includes:

- Aggregates tax;
- Climate change levies;
- Tax for company cars and business vehicles used for private use;
- Landfill taxation; and
- Utility bill increases (sanctioned by government regulators) to pay for environmental remediation. For example, the water companies will be allowed to raise customer charges to invest environmental improvements.

The main development for the UK was to be the proposed Operating and Financial Review (OFR) and will now be the EU Accounts Modernisation Directive. The OFR was to: 'Simply demand that directors explain their stewardship to their shareholders,' as stated by Patricia Hewitt, Secretary of State for Health. Therefore obliging all listed companies to provide details of factors affecting future performance, including the social and environmental risks they face.

The objective of the OFR was to 'improve transparency and accountability by providing shareholders with better and more relevant information on the business, its performance in the past and its prospects for the future' ([www.dti.gov.uk/cld/financialreview.htm](http://www.dti.gov.uk/cld/financialreview.htm)).

It was to be intended that if directors were to agree an OFR and later they were found to have included false information, or omitted important information, and then try to plead that they don't know of a company's situation or activities, then they may be guilty of a new criminal offence of 'recklessly approving an OFR', for which the penalty is an unlimited fine. This threat may have encouraged pressure upon the UK Chancellor to abandon this legislation, although many companies follow the spirit of the disclosure requirements (having prepared for years anyway) but now without the threat of prosecution.

## H Local and regional governmental organisations

Again in most countries local authorities can directly regulate some elements of business activity, such as:

- Planning consent for expansion of business operations, activities or works access; and
- Planning consent for developments, which is especially important for some sectors like house building, construction and sectors that use a lot of land capital (i.e. out of town retailers).

## I International governmental organisations

There are a wide range of international bodies that can affect an organisation's risk management systems. There are bodies like the United Nations (UN), World Health Organisation (WHO), International Labour Organisation (ILO) and a

myriad of others that make recommendations on industrial sectors. They can recommend advertising bans, launch crackdowns on industries and even pronounce dangerous products (i.e. WHO stating that passive smoking is deadly).

Within the European Union (EU) the European Commission and Parliament hold increasingly large legislative power over a wide range of issues. The impact of the European Union on the environmental agenda has been dramatic, and it has been responsible for a range of environmental measures including the preferred instrument, the directive. Noteworthy directives are the chemical restricting REACH, or the Integrated Pollution Prevention and Control (IPPC) Directive 96/61/EC, which facilitates Europe-wide comparisons of environmental performance of operations.

## J Journalists and media organisations

Media interest activity works to create public awareness. If the issue is newsworthy and a major stakeholder in a company raises an issue (e.g. an NGO's campaign launch or a shareholder revolt), that issue will keep gaining momentum and lead to ever-increasing public awareness.

For example, the Co-operative Bank's estimated losses at Esso, due to the boycott of their parent company Exxon Mobil Corporation, run into the hundreds of millions of pounds each year. Exxon Mobil Corporation is one of two companies that are losing the most ground as highlighted in a study on reputations by Harris Interactive and the Reputation Institute, reported in the *Wall Street Journal*, 19 February 2004:

Exxon Mobil is financially robust, but its continuing fight over punitive damages in the 1989 *Exxon Valdez* oil spill keeps the Alaskan disaster fresh in people's minds and lowers its rating for environmental responsibility.

Journalists focus on these companies and their continual negative commentary acts as a magnet for them to be sent additional information by whistleblowers and other aggrieved stakeholders. Once a journalist is in this envious position it is very difficult to shake them off.

It is possible to reverse these factors, as can be seen from a case study on Microsoft.

### *Case study: Microsoft*

It is a company, which always scores well for leadership, vision and financial performance, but it has suffered from an identity problem which revolved around its monopolistic power base and how it purchased as many potential competitors as possible. In short, Microsoft was viewed as abusing its power (as the recent large EU fines might suggest). However, largely as a result of Chairman Bill Gates' philanthropy, there are fewer critics now accusing Microsoft of monopolising the software market, and indeed there are more people praising the company; reputations can therefore be turned around (reported in the *Wall Street Journal*, 19 February 2004).

## K Key competitors

The review should determine the extent to which major competitors affect the ‘competitive environment’ like resource and product prices, their reporting and stakeholder engagement activities.

## L Local communities

Local communities can prove of critical importance and can pose risks of their own from activism and objections to planning applications and business operations. They are also the source of employees and local reputation is of importance.

## Chapter summary

As this book seeks to demonstrate risk is part of the entrepreneurial culture needed by any organisation that wishes to develop, expand and improve. An effective risk management structure allows an organisation to understand the risks in any initiative and take informed decisions on whether and how the risks should be managed. Risk management is now a practical feature of doing business in today’s world, just as due diligence should be recognised as another proactive tool that is of vital assistance in the management of risk.

### *Reputational risk management*

Nowadays no matter where an organisation operates – and whatever its size – risk management is becoming an increasingly essential part of today’s business environment and is of interest to:

- \* CEOs, financial directors, other executive and non-executive directors;
- \* Company secretaries;
- \* Heads of internal audit, risk management or other assurance functions; and
- \* All managers with an interest in risk management.

### *Residual reputational risk*

Residual reputational risk can then be calculated by dividing the inherent reputational risk by the risk reduction scores for each of the issues:

$$\text{Residual reputational risk} = \frac{\text{Inherent reputational risk}}{\text{Risk reduction score}}$$

The owners are now in a position to map their risks and consider where additional effort can increase the risk reduction score and will therefore have most impact in reducing the level of residual reputational risk. This will help the owners identify ‘the greatest bangs available for their bucks’.

Reputational risk management should be regarded as an opportunity to improve not only the management of the particular risk or uncertainty in a specific project but also the business as a whole. The methodology and approach provided by SERM has been recognised as valid among the investment community as well as among stakeholders generally.

### **Hints and tips: key questions**

#### *Ownership*

The board, having gained common consensus of the key issues, should allocate the issues to individual executives to take ownership of their management and assessment.

#### *Issue*

The first step for the owner should be to consider the currency of the issue by asking:

- \* How current is the issue and is it of growing relevance/concern to the stakeholders?
- \* Is it an old issue that is lying dormant and could suddenly take off?
- \* Is it a new emerging issue?

#### *Public awareness*

Media interest and non-government organisation (NGO) activity work together to create public awareness. If the issue is very newsworthy and a major NGO launches a campaign around the issue, it will keep gaining momentum leading to ever-increasing public awareness.

#### *Media interest*

The owner should assess the current and potential news value the issue could have. For example, they should consider: How sustained could the coverage be? ‘Does the story have legs?’

Clearly, whereas a negative one-off headline can be fairly damaging, a long drawn out campaign can severely undermine a company’s reputation, even if it is only in the local press. The issue could potentially centre on a major accident, leading to a public enquiry and class action for compensation. The whole drawn out process will ensure maximum media coverage.

Some journalists centre on certain companies and their continual negative commentary acts as a magnet for them to be sent additional information by whistleblowers and other aggrieved stakeholders. Once a journalist is in this envious position it is very difficult to shake them off.

#### *Useful web links*

- \* Association of British Insurers’ (ABI) Disclosure Guidelines on Socially Responsible Investment: <http://www.ivis.co.uk/pages/framegu.html>
- \* UN Business Guide to Partnering with NGOs: <http://www.resourcesaver.org/file/toolmanager/custom016c45f85703.pdf>



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10

Corporate power, business and  
marketing risks

# 10

## Corporate power, business and marketing risks

### CHAPTER OVERVIEW

In this chapter we summarise key corporate power risks that in SERM's experience impact on the company's risk profile and sustainability. Case studies are drawn upon to highlight some of the current international research. There is a review of the following issues:

- \* Unrestrained use of corporate power risks;
- \* Adverse business practices risk; and
- \* Adverse marketing practices risk.

These business issues can cause an average loss of 1.4% of market value.

The main principles of good corporate governance assist in the management of these corporate power issues, both internally and externally. This includes the balance of power between chairman and chief executive, the executive and non-executive directors, the culture and tone from the top, the effectiveness and diversity of the board; the effectiveness of the chief executive and internal controls are also significant in the corporate success, as mentioned in Chapters 6, 9, 21 and 23.

#### *Risk management*

Examples of positive risk management of these issues include the following:

- \* Policies and management systems, and compliance mechanisms related to product information and labelling;
- \* Management and compliance systems for measuring customer satisfaction;
- \* Respect for the privacy of customers; and
- \* A policy of adherence to standards and voluntary codes relating to business practices, marketing and advertising.

### Unrestrained use of corporate power risks

As a result of research, the following results were obtained:

- Unrestrained corporate power risk is 0.5% of market value to be put at risk (the average net risk for the top 500 US and EU listed companies); and

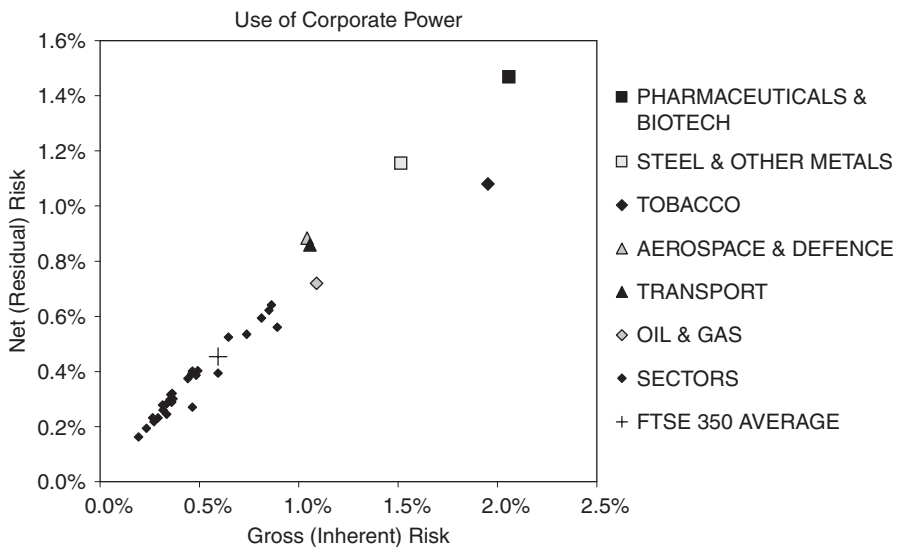
- This risk exposure has been reduced from 0.6% of market value but the management of these issues is substandard compared to other risk categories. There are improvements in the management of corporate governance risks within the UK, however.

The following factors are looked at when considering unrestrained use of corporate power risks:

- A statement of company and directors' duties;
- Improved transparency and accountability, with improvements to the quality, timeliness and accessibility of information available for shareholders and others; and
- More effective machinery for enabling and encouraging shareholders to exercise effective and responsible control.

The legal aspects of social and ethical risk are discussed in Chapters 12–17 and this includes director and officer personal liabilities (Chapter 16) and issues with manslaughter and corporate killing legislation (Chapters 6 and 16).

The following graph shows the social and ethical risk (net) from unrestrained use of corporate power risks by sector.



## Case studies

### Allegations of market manipulation or monopolistic power:

- Microsoft: the European Union (EU) has imposed the highest ever penalty on Microsoft of €497 million (£334 million, or US\$613 million) for alleged abuse of its Windows monopoly. This is significantly less than the \$3 billion fine the EU could have levied, although it could be followed by further billion euro settlements with the company. This is the highest ever EU fine, eclipsing the €462 million imposed against Hoffman-La Roche in 2001 ('EU hits Microsoft with record fines', 24 March 2004, [www.eweek.com](http://www.eweek.com));

- British Airways shares weakened 0.5% to £323.5 on news that it had been asked for information from the EU and the US Department of Justice ‘relating to alleged cartel activity’ involving a number of airlines and cargo operators (*Financial Times*, 15 February 2006); and
- Vodafone’s (the mobile network operator) share value dropped 4% to 119½p on the news that the European Commission plans to cut ‘excessive’ charges that are levied on roving calls that customers make with their phones when abroad. The estimates are that the new laws could cost between £750 million and £1 billion in turnover (*Financial Times*, 29 March 2006).

**Government and regulators have impacts upon shares prices through their structuring of market forces:**

- Tate & Lyle, the UK sugar and sweetener producer, fell 1.1% on 21 June ahead of the EC’s proposals for sugar price reforms (*Financial Times*, 22 June 2005);
- Shares in Moody’s Corporation, the rating agency, fell 3% after it emerged that Eliot Spitzer, New York attorney-general for information on how it conducts its reviews of reinsurers (*Financial Times*, 30 July 2005);
- UK retailer WM Morrison fell 0.8% to 163½p on fears that the Office of Fair Trading may be considering a probe into the UK groceries market (*Financial Times*, 1 November 2005); and
- The UK directory services company Yell Group fell 9.8% to 422¾p on 5 April 2005 after the Office of Fair Trading announced their interest in the lack of competition in the classified directories sector and that they were referring it to the Competition Commission (*Financial Times*, 6 April 2005).

**Membership of pressure groups and lobbying firms:** British Telecom was noted as a member of the European Social Forum which is a lobby group, lobbying for further liberalisation of services through the renegotiation of the GATTs Treaty within the WTO. This agreement has been criticised for increasing the power of corporations to challenge the efforts of national governments to regulate environmentally damaging industries and to protect welfare provision.

**Political donations of any type are seen as divisive:** GlaxoSmithKline plc was listed on the boycott Bush website as one of the top 30 donors to the US Republican Party. This is mainly due to the freedoms afforded to staff to contribute to political companies through work collections.

Corporate governance risk issues have risen in importance again during the 2004 voting season in light of failures such as Ahold, Enron, WorldCom and Vivendi. There is an increased activism among financial investors to ensure companies are adhering to the Higgs guidelines and the Combined Code of Practice. There is a growing belief that trustees are not doing their fiduciary duty unless they engage in issues like accountancy compliance, remuneration, golden parachutes, etc. The shareholder revolts over pay issues, like GlaxoSmithKline’s annual general meeting (AGM) in 2003, or the ABI’s (Association of British Insurers) ‘red top’ warnings on companies like WPP plc’s pay plans are all examples of this. Reckitt Benckiser is an example as there are concerns over excessive director remuneration and golden parachutes, as their CEO received

a £5.1 million pay deal and would attract a payment of 1.5 times his annual salary if he were fired.

The regulatory regime is set to strengthen even in the otherwise red tape-free US there are moves to further extend the Sarbanes-Oxley Act. The requirements were initially expected only to affect public companies, but nearly two years after being passed, non-profits and private companies now have to familiarise themselves with the regulations.

The following corporate governance information has been reviewed in research:

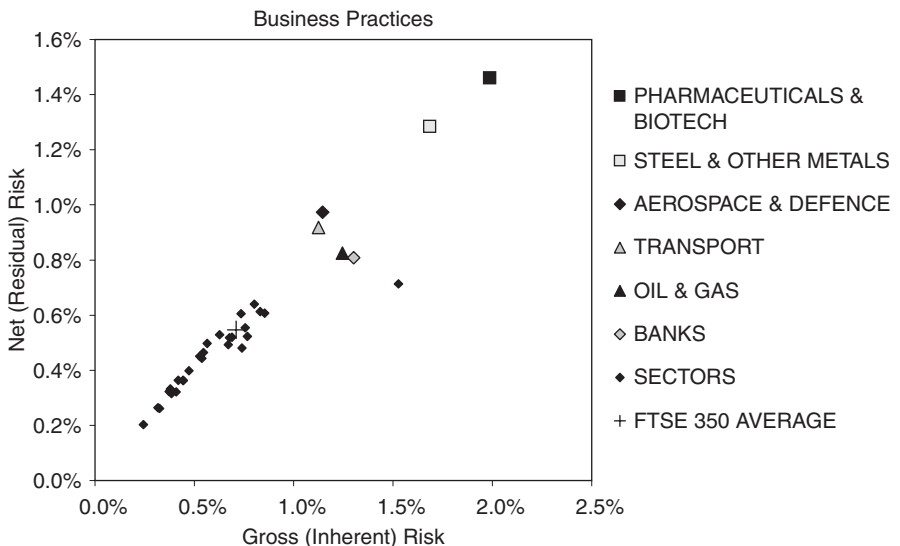
- Whether the role of the chairman and chief executive is split;
- How long the chairman, chief executive and financial director had been in place and where they had been recruited;
- The executive remuneration package;
- The composition and background of the board;
- Information about mergers and acquisitions;
- Strategy development and implementation; and
- The use of complex financial engineering techniques.

## Adverse business practices risk

Research results show that:

- Adverse business practices risk an average of 0.5% of the market value to be of the top 500 US and EU listed companies; and
- This risk exposure has been reduced from 0.7% of market value by good risk management techniques (the risk reduction/management factor).

The following graph shows the adverse business practices risk by sector.



National governments are starting to act in the wake of these scandals which reflect poorly on their management of the business environment. International groups like the European Commission have been strengthened in their pursuit of cartel members and escape prosecution in exchange for information on their agreements with other parties.

General business practices also include elements of all the other chapters by direct and indirect impact as the actions of as business organisation and their management practices, therefore by default as consequences of their business practices.

In this section the definition is a bit more defined and refers to the types of risks that the Basel banking risk framework reviews as business practice risks:

Clients, Products & Business Practice – Losses arising from unintentional or negligent failure to meet a professional obligation to specific clients (including fiduciary and suitability requirements), or from the nature of design of a product.

## Case studies

The flood of accountancy scandals has led to a large increase in litigation in the US according to a report by Stanford Law School and Cornerstone Research, the *Securities Class Action Clearinghouse Report*. It cited a 17% increase in the number of actions filed for 2004 and that the companies being sued lost \$169 billion in market value. This figure was almost treble the figure for 2003 and Professor Joseph Grundfest said that many of the allegations and cases arose about the companies' financial performance:

- UK Defence Company BAE Systems fell 3.1% to 238p in November 2004 after the Serious Fraud Office announced the company was under investigation for alleged false accounting in Saudi Arabia (*Financial Times*, 4 November 2004).

Following September 11, the UK Anti-Terrorism, Crime and Security Act 2001 was introduced. A number of the provisions attempt to address the problem of bribery and corruption abroad and enable criminal prosecutions to be brought within the UK against a company and its officers.

In addition the Enterprise Act 2004 has come into force after 18 months in the legislative pipeline. The Act is designed to crack down on company directors who conspire to inflate prices, and sets out penalties of up to five years' imprisonment and unlimited fines for directors found guilty of serious market abuses. In addition, directors who blow the whistle on cartels and who cooperate with subsequent investigations will be offered immunity from prosecution (for further information visit [www.oft.gov.uk/enterpriseact.htm](http://www.oft.gov.uk/enterpriseact.htm)).

- UK airline operator British Airways fell 5.9% to 346p on news that the Office of Fair Trading had raided its offices as part of joint UK/US investigations into price fixing (*Financial Times*, 23 June 2006).

As in many jurisdictions, UK regulators are becoming more empowered and the Financial Services Authority (FSA) and other authorities are beginning to

extend their investigations. One example is Ofcom, which is planning an investigation into BT's axing of its standard tariff (the most common choice for competitors' customers to use the BT infrastructure).

There are a large number of recent case studies in doubtful business practices worldwide. Corporate scandals include WorldCom, Enron, Andersen, Xerox, CNN, Warner AOL, Elan, ABB, Tyco, Merck (Merck 'exaggerated' revenue in accounts), Kmart, Global Crossing, Qwest, Johnson & Johnson (pending probe), GE and compensation, GSK and financial institutions. Even Coca-Cola Co. was being investigated by the US government into whether it engaged in accounting fraud (*Wall Street Journal*, 3 May 2004).

A range of examples that have been seen to affect the value of companies are as follows:

- When UK regulator Ofcom launched an investigation into Patientline (a hospital patient communications company) the shares had fallen from above 100p in 2005 when the investigation was launched to 50½p when it announced it had closed its investigation (*Financial Times*, 19 January 2006);
- With regards to the rebooking of reserves, Shell had been hit by lots of embarrassment due to the reworking of its estimates of its oil and gas reserves – with repeated rebooking of reserves particularly affecting share prices; and
- Tax avoidance: JTI-MacDonald, Japan Tobacco's subsidiary in Canada, had to seek protection from creditors in August 2004 after the Quebec provincial government demanded immediate payments of C\$1.4 billion (US\$1.1 billion) in tax charges relating to alleged cigarette smuggling.

Governments can have an effect upon work practices of organisations which it deems to have adverse business practices:

- The US Internet Gaming Prohibition Act when endorsed saw internet gambling sites take a fall with Partygaming of the UK down 4.5% to 148p, 888 Holdings down 5.8% and Sportingbet down 4.6% (*Financial Times*, 4 May 2006);
- UK electrical retailers Dixons and Kesa shares rose 3% and 9.4% respectively when it became known that the UK government ruled against the banning of the extended warranty sales at point of purchase (*Financial Times*, 20 December 2003);
- Mobile phone operators lost market value after they were charged by European Regulators for excessive charges for international travellers which could involve up to 10% of annual sales being fined. The shares of UK operators Vodafone and MMO2 lost 1.9% and 1.5% on the news in July 2004 (*Financial Times*, 27 July 2004); and
- US stun gun maker *Taser International* fell 13.1% after it said the US SEC was stepping up an investigation to the point where it could subpoena documents (*Financial Times*, 28 September 2005).

**Tax benefits and subsidies:** the removal of, or threat of removal of, subsidies can affect organisations' values dramatically. The Irish budget airline Ryanair fell 30.6% to €4.70 and suffered its first ever profit warning in January 2004. This coincided with the news that the EC would soon rule on the legality of subsidies



to airlines to fly from airports. UK operator easyjet also fell 7.9% on news it may be affected (*Financial Times*, 29 January 2004). When the decision arrived the next month of a decision to pay back subsidies of at least €4m, this figure was much lower than expected and the companies rebounded with Ryanair gaining 6.4% and easyjet 4.2% (*Financial Times*, 4 February 2004).

## Financial services sector

The levels of payments are vast at the present moment, illustrated by the following examples from the financial services sector:

- Citigroup, the largest financial services group in the world, has acknowledged that it has lost business due to the controversy over its involvement in the euro-zone government bond market. Corporate banking earnings fell in Europe, the Middle East and Africa by 29% (*Financial Times*, 12 February 2005);
- The Anglo-US fund manager Amvescap was involved with US authorities over an alleged market abuse scandal. The fine level being discussed was \$255 million for allowing improper trading. This fine posed a threat to the dividend levels of the company and the share price had slid from 568½p (*Financial Times*, 4 August 2004);
- \$6 billion was wiped off of the value of shares of publicly traded asset managers in November 2003, as well as 40 people losing their jobs and 30 lawsuits being launched over a scandal which centred on the improper trading of fund shares. Firms alleged to be involved or implicated in the scandal included Amvescap, Bank One, Bear Sterns, Citigroup Brokers, Janus Capital, Chares Schwab and Strong Capital among others (*Financial Times*, 21 November 2003);
- Securities regulators announced the final terms of a \$1.4 billion Wall Street research settlement, ending almost two years of investigations into charges that analysts issued biased research to gain investment banking business;
- Citigroup Inc.'s Salomon Smith Barney unit, Credit Suisse Group's CSFB and Merrill Lynch & Co. settled charges of securities fraud, according to the US SEC (Securities and Exchange Commission); Citigroup's \$2.6 billion WorldCom payout;
- J.P. Morgan Chase has set aside an extra \$3.7 billion to cover investor lawsuits in relation to its alleged role in corporate scandals such as WorldCom and Enron (*Financial Times*, 22 July 2004);
- General retailers and the financial sector are coming under renewed criticism about the record profits of store cards. Marks & Spencer have 28% market share;
- All 10 of the participating investment banks, including Goldman Sachs Group and Morgan Stanley, settled lesser charges of violating market regulations;
- The US Federal Reserve fined Switzerland's UBS \$100 million for transferring dollar notes to countries under US economic sanctions, such as Cuba and Iran; and
- Deutsche Bank, Morgan Stanley and Bear Stearns have been fined a combined \$15 million by the US brokerage regulator for improper handling of shares in hot stock market flotations.

## Tobacco sector

- The Justice Department is suing the industry for allegedly conspiring to deceive the public about the dangers of tobacco products and smoking, and the addictive properties of nicotine and how these can be boosted. It is estimated that the tobacco companies gained \$280 billion through fraud;
- Tobacco growers and three of the four major US cigarette companies agreed to settle a three year old price-fixing lawsuit. The deal, if approved by a North Carolina judge, will pay tobacco growers and quota holders \$200 million in cash. It also sets a formula for minimum purchases of domestic burley and flue-cured tobacco;
- When a smoker dies, the Czech government on average saves US\$1227, noted Philip Morris in a report that became public, later forcing a public apology, saying the study showed an ‘unacceptable disregard of basic human values’ (*New York Times Upfront*, 17 September 2001, p. 9); and
- The EU plans to drop legal action against Philip Morris International, part of Altria, the US tobacco and food group, in return for payments from the company totalling US\$1 billion over 12 years (*Financial Times*, 6 April 2004, p. 18). The EU eventually dropped its money-laundering and smuggling claims against Philip Morris International in a \$1.25 billion settlement (*Financial Times*, 10 July 2004).

## Company specific examples

- Airlines in the European Union must pay higher compensation for lost baggage, up to €1200 under the new liability limit set out in the 1999 Montreal Convention (*Financial Times*, 29 June 2004);
- The EU is also vowing to force mobile firms to cut roaming call charges by 70% as there was profiteering at the expense of customers according to Viviane Reding, the media commissioner;
- Insurance and banking call centres: the issues surrounding call centres are likely to intensify as jobs move overseas from the UK and US. Capital One of the US has already pulled out of an Indian call centre deal as it became apparent that Indian workers had misled US customers with offers of unauthorised credit. UK companies may soon follow this new trend as the business risks become apparent;
- BAA are reviewing their awarding of free car passes to MPs and MEPs valued at £5245.20 each after the issue was raised by shareholders who were concerned at concessions to politicians (*Financial Times*, 28 July 2004);
- *The Guardian* claims that BAE have moved evidence of ‘covert payments to foreign politicians’ to the legally safe haven of Switzerland;
- It is said that Barclays have moved their highly profitable Barclaycard operations to Ireland to avoid disclosing how profitable it is;
- GlaxoSmithKline have been ordered to hand over internal documents to the state prosecutor in Minnesota, which is investigating whether the

pharmaceuticals giant colluded with other companies to prevent cheap drugs being imported into the US (*The Independent*, 12 May 2004);

- HBOS: the Bank of Scotland was fined £1.25 million by the industry regulator for ‘particularly serious breaches’ of anti-money laundering regulations;
- Jarvis shares fell 16% in value in one day after the announcement by Network Rail as to how Jarvis had supplied them with documents that falsely certified work as having been completed. (*Financial Times*, 24 October 2003);
- Philip Morris agreed to pay \$1.25 billion over 12 years to settle smuggling charges brought against it by the European Union;
- Powergen, one of Britain’s biggest energy producers, has been fined £700 000 by Ofgem for ‘unfairly stopping 20 000 customers’ switching provider;
- Reckitt Benckiser: there are concerns over their tax havens in Ireland, Switzerland and Costa Rica;
- Ryanair: there have been numerous concerns over local government payments. The recent EU ruling will mean the return of some of these funds. Other low cost airlines have boycotted Ryanair’s European lobby group the European Low Fares Airlines Association;
- Thames Water (UK water supplier) was warned that it could face fines of up to £140 million if it did not meet the leak reduction targets set by the UK water regulator (*Financial Times*, 22 June 2006);
- Exxon Mobil has been denied a request to have an award for \$1.2 billion to 10 000 Exxon service station dealers in the US reversed. They have been noted to overcharge dealers for fuel over 12 years. The average recovery by the dealers is expected to be about \$130 000 plus interest;
- Shell Transport & Trading: US federal criminal prosecutors are to probe Shell over their reserves (*Financial Times*, 18 March 2004). This has already claimed the chairman and head of operations. The FSA are also probing the issue;
- Vodafone and O2 have been accused of ‘unfair and excessive’ roaming rates by the European Commission. Vodafone shares fell 1.9% and MMO2 lost 1.5% on the day of the news (*Financial Times*, 27 July 2004); and
- WestJet, Canada’s biggest low cost airline, apologised to their rival Air Canada after admitting that its executives were engaged in ‘unethical and unacceptable’ industrial espionage. WestJet settled for paying all Air Canada’s costs totalling C\$5.5 million (US\$5 million), a C\$10 million donation to a children’s charity and C\$220 million in compensation and damages (*Financial Times*, 30 May 2006).

### *Risk management*

Examples of positive programmes and projects by companies in dealing with adverse business practices include the following:

- \* Johnson & Johnson have donated new barrier gel to non-profit organisation, the International Partnership for Microbicides. The sector is increasing the general level of contributions to worthy causes;

- \* GlaxoSmithKline plc was accused of attempting to block an Indian company from making cheaper generics of an anti-AIDS drug. This issue has since been resolved with a partnership deal. GSK have also cut AIDS drug prices five times this from 2003 to 2004; and
- \* Vodafone plc has barred users from accessing child pornography websites from their mobile phones. This avoids risks associated with their products being used to break the Protection of Children Act (1999), under which it is an offence to download or possess child pornography. This follows a similar move by BT Group who has already stated that they have blocked over 20 000 attempts to break this law (*Financial Times*, 23 July 2004).

## Adverse marketing practices risk

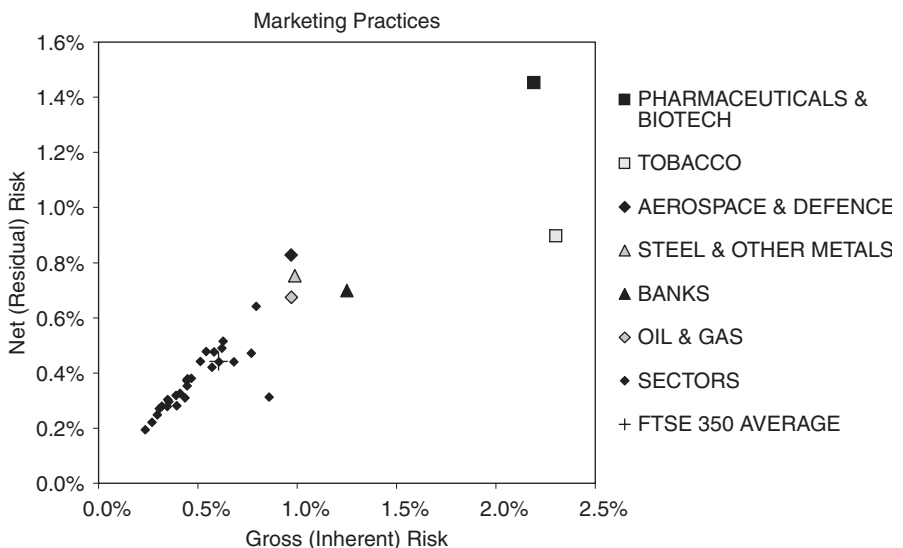
Results indicate that:

- Adverse marketing practices puts an average 0.4% of market value at risk for the top 500 US and EU listed companies; and
- This risk exposure has been reduced from 0.6% of market value by good risk management techniques (the risk reduction/management factor).

This section covers all advertising and promotional activities undertaken by a company. Examples of bad practice include:

- Concealing harmful side effects of the product (e.g. cigarette advertising in the developing world);
- Advertising harmful products to children; and
- Invading consumer privacy (e.g. abusing data confidentiality).

The following graph shows the adverse marketing practices risk by sector.



There is the potential for a shift in marketing practices to become more sustainable in line with other business practices. This can occur by putting emphasis upon socially, environmentally or ethically beneficial aspects of a product or service. As marketing is about conveying information about offers, the producing organisation should also convey the spirit that the organisation is here for the duration and that there is a belief in ‘sustainability’. An example of this would be advice on the reuse, repair or safe disposal of products or the facility to return them to the producer for recycling or reconditioning.

Developing a stakeholder concept of sustainable marketing involves seeking to satisfy a whole range of disparate customer demands, where appropriate. Organisations that develop a stakeholder view of sustainable marketing are serious about improving their sustainable performance (economic as well as social and environmental) and improving these aspects of their marketing mix.

Increasingly important are the key issues of reputation and brand protection (explored in more depth in Chapter 9). Brands and the brand of the organisation, its reputation, are seen as guarantees of quality and service and part of a widening total and sustainable customer experience. The development, protection and communication of the essence of an organisations reputation and brand are key functions for all employees and essential for continued survival as Sally Shire, Head of Brand Management at Barclays plc, notes:

A brand is like any other asset; if it is not well managed it will decrease in value. A well managed brand on the other hand is a great competitive advantage. (Quoted in Adkins, S., *Cause Related Marketing* (1999) from a speech at the Business in the Community Cause Related Marketing Seminar 1996)

## Case studies

- The regulation of advertisers is becoming more enforced with the EU and UK taking stronger positions on the advertising of products deemed to have harmful effects, like Tobacco, alcohol or high fat content foods;
- There is an extension of marketing regulators roles, an example is that the UK’s Advertising Standards Authority (ASA) has become the overall regulator for all print and broadcast advertising complaints on the 17 July 2004, previously it had only dealt with print and poster adverts;
- Ofcom, the UK media and telecoms regulator, imposes fines on companies that break its programme codes. An example is that it fined Digital Television Production £50 000 for advertising its promotional material for its pornography channel before the 9pm watershed. The regulator noted the company was ‘excessively complacent, unfocused and insufficiently protective of the interests of children’ (*Financial Times*, 28 July 2004);
- The UK Department for Environment, Food and Rural Affairs can also bring prosecutions, as in the case against the Asda supermarket chain. Asda has been fined £1000 and £6000 costs for having breached the European Union’s marketing standards on 13 counts, at its store in Fareham in Hampshire (*Financial Times*, 29 July 2004);

- A unit of Pfizer Inc. has agreed to plead guilty to criminal wrongdoing, and will pay about \$430 million in fines in a settlement that will end federal and state investigations into the marketing of the blockbuster drug Neurontin (*Wall Street Journal*, 13 May 2004);
- The brewery sector is coming under renewed attacks as the Georgetown University's Centre on Alcohol Marketing and Youth recently discovered that in 2002 the alcoholic beverage industry spent over \$990 million on television advertisements that were watched by young viewers between the ages of 12 and 20. Those who have lawsuits pending against brewers and other alcohol companies claim that the study gives credence to the notion that these companies are promoting under-age drinking (*Washington Times*, 22 April 2004). In the UK Luminar, the leisure group, is set to end its 'all you can drink' offers, as a response to government calls to restrict binge drinking (*Financial Times*, 26 July 2004):
  - UK public house alcohol retailer JD Wetherspoon fell 0.7% when they were successfully challenged by a rival for serving alcohol without complying with licence regulations and selling products outside their allocated time period. The challenger, a nightclub owner, Luminar, put on 2.4% in share value.
- In the UK, a construction company has even been castigated for inappropriately using a street banner to advertise a housing development when they were supposedly sponsoring a community event;
- The food industry has started to come under assault for their product and marketing activities. McDonald's of Norway has apologised for a new product which charitable groups have branded 'tasteless'. The McAfrika has been seen as an insensitive product launch considering the starvation and famine that is currently blighting much of Africa. McDonald's said that it is considering the idea of sharing proceeds with charity;
- The World Health Organisation (WHO) are now considering a resolution treating obesity as a disease, and Culture Secretary Tessa Jowell admitted recently that an advertising ban could be introduced as a final resort. The sector relies heavily on new products to keep consumers, particularly children, excited and interested;
- A Florida judge approved a class-action lawsuit against America Online noting that internet pop-up advertisements are unsolicited messages programmed by websites which interrupt material a viewer may be accessing ('Florida judge approves class-action lawsuit against America Online', *CNN.com*, 25 June 2000);
- The tobacco sector is facing increased restrictions to its marketing abilities in the developing world, as the Indian Parliament has made new regulations designed to limit the opportunities for tobacco sponsorships and marketing (*Marketing Week*, 11 March 2004, p. 22);
- The tobacco industry is also waking up to the fact that the ban on tobacco advertising has stubbed out the prospects of new brand launches. Gallaher has recently withdrawn its Mayfair brand of rolling tobacco after less than a year and British American Tobacco's 555 brand has also failed to reach its

anticipated sales. Industry pundits say that the brand failed because consumers simply did not know they were there. Shares in Imperial Tobacco and Gallaher dropped sharply when the Office of Fair Trading (OFT) confirmed that they had launched a formal investigation into the companies' trading practices. The OFT asked for copies of contracts with major retailers and petrol station operators, including Tesco, WH Smith and Safeway, BP, Texaco and Esso (*The Independent*, 16 December 2003); and

- The Racketeer Influenced and Corrupt Organisations Act, passed in 1970 and known as RICO, had the original goal of eliminating the effects of organised crime on the US economy. It has now been used in a lawsuit accusing the tobacco industry of concealing information that nicotine is addictive and smoking cause's disease. The US government also contend that the companies targeted children through advertising to lure new smokers. A government estimate puts those profits, and therefore potential fines, at more than \$280 billion (*Health & Medicine Week*, 5 April 2004, p. 786).

### *Risk management*

Considering that perception is so important to maintaining reputation and brand value then marketing claims can have a large effect on stakeholders' perception of the organisation. It is also true that many companies have positive activities that are not being reported and are not therefore contributing to intangible value of the organisation. There is also the opportunity for marketing to become sustainable and become part of the solution as Ed Mayo, chief executive of the UK National Consumer Council notes:

While marketing got us into this mess, it may be that marketing can get us out.

One example of best practice is the mobile phone companies who have proactively agreed to work together to reduce access to pornography by youths' mobile phones.

Positive risk management programmes and projects by an organisation for improving management of the marketing function may include the following:

- \* Marketing policy and management systems, the marketing Ps:
  - Strategic marketing policy: the potential for developing a stakeholder concept of marketing which seeks to satisfy a whole range of disparate customers' demands, and sustainable marketing. Includes the selection of causes and partnerships;
  - Profit/pricing/cost policy: there can be additional costs to being sustainable with ethical and environmental stances costing additional money, these can be passed onto the consumer if communicated in an effective manner;
  - Product/customer policy: this could involve the minimisation of resources, or designing for the ability to recycle the items;

- Promotion/channel policy: this can involve the highlighting of positive aspects of the products or service offerings, credible claims and honest approaches that help build reputation. It can also involve a policy of adherence to standards and voluntary codes related to advertising;
- Packaging: improving the compliance mechanisms related to product information and labelling, which might include the reduction of waste packaging by way of example; and
- People and personnel policy: employee awareness, commitment and training contribute and make possible sustainable business strategies.
- \* Management, information and compliance systems are designed for understanding customer desires and satisfaction. Market research is critical and an overview of the market environment and the trends of customers changing tastes are covered in Chapter 3;
- \* Maintenance of quality: reputations can take a long time to build and product and services quality and effectiveness contribute a lot to this customer perspective, thus ensuring that a long-term business view requires a long-term relationship to be built with consumers;
- \* Sustainable distribution channels are important and include the cost effectiveness, in the long run of transport systems (i.e. that involve less energy usage and environmental impact), while maintaining an unbroken value chain, ensuring products and services are received by customers;
- \* Respect for privacy of customers; and
- \* The development of cause related marketing (CRM) systems which can be a very effective marketing tool and can align charitable and philanthropic giving to business strategies. This process involves the selection of partners, negotiation and formalisation of the arrangements, and managing, monitoring and evaluation of the programmes. CRM models include:
  - Advertising, which quite often focuses on a particular sales promotion with proportions of the sales revenue going to a ‘good’ cause, like retailers using sales vouchers to help schools purchase computers, sports equipment and books;
  - Direct marketing: the ability to utilise another channel to reach charitable organisations’ customer lists and databases is an asset;
  - Giving: direct charitable and community giving can be directed towards specific projects like charitable premises where the giving organisations’ profile can be raised. Another version of this is facilitated giving such as the use of premises or staff to assist with the collection of donations, like airplane companies collecting unwanted foreign currency for charities;
  - Public relations: the benefits are much the same as any other PR activity but the level of balance and honesty in the communication has to be stronger to be effective;



- Sales promotion: typically a small percentage of sales goes towards an affiliated cause, which usually results in mutual benefit as the sales revenue growth can outweigh cost of sales commission to the cause; an example is the Barnum's animal crackers which sold out all its World Wildlife Fund affiliated products in just six weeks;
- Sponsorship of events, activities or charitable and philanthropic organisations: all organisations involved are actively marketing the relationship, thus contributing to improved brand awareness, value and reputation, an example might be the Coca-Cola community hero scheme or sponsorship of the Olympics; and
- Licensing: organisations can pay for the right to use charities' logos and identity in their promotional materials, on products or with relation to services offered; there are benefits of implied endorsement and effects on own brand and reputation.

### *Cause related marketing*

Marketing is developing at a fast rate and so are the subsets, including cause related marketing, but it does pretty much what is says on the label; it's about marketing activities related to a cause, quite often charitable or community based in nature.

The Marketplace Responsibility Principles have been drawn up by senior business leaders to help identify the management behaviours that make it more likely that businesses will achieve their aims. The Marketing Responsibility Principles cover the relationships that are crucial to achieving this: customers, suppliers, governments and the impacts of products or services on third parties and the environment.

The key principles are:

- \* Actively discourage product misuse;
- \* Have consistent standards;
- \* Manage the impact of product or service;
- \* Respect your customers;
- \* Support vulnerable customers;
- \* Seek potential customers within excluded groups;
- \* Actively manage responsibility in your supply chain;
- \* Treat suppliers as partners; and
- \* Work with the rule makers.

Their key recommendations for management actions are:

- \* Put the principles at the heart of business strategy and make it part of the culture;
- \* Aim to provide quality results;

- \* Anticipate trends;
- \* Encourage and motivate responsible behaviour;
- \* Have consistency of message; and
- \* Share best practice within the business.

You can find an extended explanation from the download at: [www.bitc.org.uk/marketplaceprinciples](http://www.bitc.org.uk/marketplaceprinciples)

## Trends

Independent research commissioned by GreenPortfolio, entitled, 'Green relations: the communication viewpoint' (available from: <http://www.greenportfolio.co.uk/index.html>), reveals that being green is rapidly becoming a marketing 'must', with 58% of marketing and PR professionals believing this provides competitive advantage. UK organisations interviewed believe customers are prepared to pay more for environmentally friendly products and services.

Despite these findings, nearly three out of four (72%) companies have no green marketing plans in place and only one in three (33%) has senior management buy-in when it comes to going green.

There is an increase in award schemes that are highlighting these best practices, such as the Green Awards for sustainability communications ([www.greenawards.co.uk](http://www.greenawards.co.uk)) aimed at rewarding marketing campaigns that best communicate the importance of sustainable development and responsible business practices to consumers (see Chapter 11 for examples and case studies).

Companies, including those referred to below, have already started to improve the links between marketing and sustainability and CSR, with impressive results:

- According to Marks & Spencer's corporate responsibility chief Mike Barry, the company's 'Look behind the label' marketing campaign has been their most successful ever;
- Barclays won a best corporate communications using video for its training film which aims to challenge entrenched attitudes towards disability in the workplace;
- BT won an award for best sustainability communications using interactive media. Players of its web-based game, the 'BT Better Business Game', are invited to run a fictional company, trying to keep stakeholders happy throughout a string of management dilemmas;
- Honda has won awards for its advertising campaign and slogan 'Hate something, change something, make something better' for the promotion of the cleaner, quieter diesel engine used in the Accord I-CTDI;
- Kraft scooped a prize for best strategic communications for its Kenco sustainable development coffee brand. Developed with the Rainforest Alliance, the product was praised for challenging consumers to compare it with other mainstream coffees;

- Toyota was recognised for a series of advertisements for its hybrid vehicle, the Prius. The commercials aimed to explain that hybrids are not only about fuel efficiency but also about cleaner air;
- Procter & Gamble's 'Turn to 30' campaign, which encourages consumers to wash clothes at lower temperatures;
- Levi Strauss Europe has become the first major denim label to launch a sustainable brand of jeans. Levi's Eco jeans are made from 100% organic cotton. But it is not only the denim that is certified as sustainable. Buttons come from coconut shell, and dye-finishes are made from natural substances such as potato starch, mimosa flowers and Marseille soap. Even the tag is made from recycled paper and printed in soya ink; and
- The iPod Nano (Product) Red from Apple Computers (US) has joined the Product Red campaign – a cause related marketing effort to help fight AIDS, which means that approximately 5% of every sale goes to the Global Fund for AIDS, Tuberculosis and Malaria ([www.joinred.com](http://www.joinred.com)).

*Useful web links*

An IFC report entitled: Stakeholder Engagement: A Good Practice Handbook for Companies Doing Business in Emerging Markets was released May 2007: [http://www.ifc.org/ifcext/enviro.nsf/Content/Publications\\_GoodPractice](http://www.ifc.org/ifcext/enviro.nsf/Content/Publications_GoodPractice)



11

Information technology (IT) and  
e-commerce: issues of risk  
management and corporate  
governance

# 11

## Information technology (IT) and e-commerce: issues of risk management and corporate governance

### CHAPTER OVERVIEW

Issues of risk management and corporate governance have various dimensions and impacts depending upon whether the organisation uses technology as a tool or deals with the risks through its supply chain. Whichever is the case there is no doubt that the choice of and reliance upon technology and IT in particular has become increasingly critical. Moreover it can represent a core ingredient of the organisation's risk management and exposure. For example, as the global economy continues to reel from the corporate scandals, organisations also have to cope with a stringent new regulatory framework. This era is often described as the 'New Economy'.

There are some brief overviews of new technologies and the risk implications are explored at the start of the chapter; then a framework for evaluating liability issues is presented. The main case study is the impact of information communications technology (ICT) upon organisations, although other chapters cover aspects of technological changes as the discussions in Chapter 3 on trends and drivers demonstrate.

### Use of new technology risk

Research and analysis results indicate that:

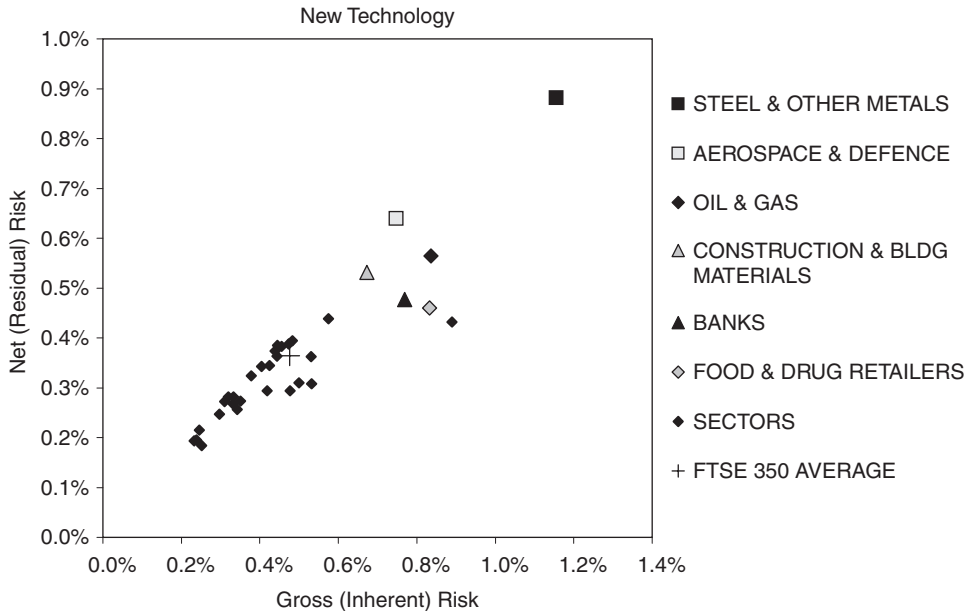
- Use of new technology risk is 0.4% of market value of the top 500 EU and US companies; and
- This risk exposure has been reduced from 0.5% of market value by good risk management techniques (the risk reduction/management factor).

The potential opportunities are of course large, but in terms of general risk management companies should aim to provide the following as examples of good practice:

- Effective communications;
- Robust product trials;

- Good security; and
- Safety guarantees.

The graph below shows the use of new technology risk by sector.



Technology is more than the creation of new products and processes, it now has the power to transform our society and can take our development dramatically forward or backwards. An example of this is the internet and information technology which we will review as one of the main case studies of risk in this section. The benefits of new technologies are often slow to become apparent, as are the risks in comparison to the speed of their implementation.

Technology is a broad term dealing with the use and knowledge of humanity's tools and crafts. It refers to those tools that are used to produce the goods and services of organisations, but is not exclusively concerned with information or communication technologies, although that is our primary focus in this chapter. The following distinctions can be made:

- \* *Science* is the process of investigating natural phenomena. It produces information and knowledge about the world; whilst
- \* *Engineering* is a goal-orientated process of designing and building tools and systems to exploit natural phenomena for a practical human means; and
- \* *Technology* is the consequence of these two processes and societal requests. The term technology is often used as the name for all engineering products.

## The pace of change

The rapidity of change and therefore of new risks materialising is phenomenal. What we as a society achieve in a day today used to take a year for many activities: in a day we send what was a year's worth of email traffic only 10 years ago; a whole year's foreign exchange dealing in the 1970s and 1980s is now a daily trade volume; we can achieve what used to be a whole year's scientific research in a day now with the aid of new supercomputers. The risks and opportunities of the new technologies like information communications technologies (ICT) are staggering. It is estimated that the information we receive is doubling every five years (from *New Working Habits for a Radically Changing World*, Pritchett, P., London Pritchett and Associates Inc. (1996)).

Another analogy is that of the potato chip vs the computer chip, as since 1948 potato-based products have:

- Remained the same size and have the same functionality, but the price has increased 19-fold.

In the same time scale silicon chip-based products have:

- Decreased in size by a factor of 2 million, price vs power also decreased by a factor of 2 million and functionality has increased by over 300 million.

## Risk management

There are positive examples of the business opportunities afforded by new technologies and how these can simultaneously benefit society. As well as the commonly touted examples of medical technologies, renewable energy, hybrid cars and fuel cells, there are opportunities for innovations in older products and scientific research into products to reduce product liabilities in the future.

The most common examples of how technology can assist us reduce risk are unlikely to be the ones that do so in the future. The true nature of inventions and innovations, and their applicability to human societies, is rarely apparent at the time of creation. With regards to measurable risk management potential some clear trends are apparent though. An example, in which the aims of businesses and society are the same, is the use of technology to improve resource efficiency. The ability to produce more items with fewer resources, to become more efficient, economically and environmentally, is beneficial to all, or as Peter Schwartz of the Global Business Network noted in 2003:

In effect, every industrial society enters a race between the rising use of materials and energy and the growing efficiency and effectiveness of its technology. Over time, efficiency and effectiveness tend to win ... at that moment, society as a whole takes a definite tilt toward greenness (in *Inevitable Surprises: Thinking Ahead in Time of Turbulence*. Schwartz, Peter. Gotham Books, 2003).

Examples of the use of science, engineering and technology (referred to here as technology) to reduce risk include the:

- Development of new products and services, as well as associated processes:
  - An example is that Xerox Research Centre of Canada and PARC (Palo Alto Research Center Inc.) scientists have invented an ‘erasable paper’ whose images last only a day, so that the paper can be used again and again. The technology could ultimately lead to a significant reduction in paper use as two out of every five pages printed in the office are for a single viewing;
- Improvement and evaluation of existing products and services.
- Enabling of communication technologies that allow for the improvement of other processes and systems, i.e. teleconferences can reduce the need for travel and speed up organisational communications;
- Selection of technologies and processes that support sustainable personnel and organisational learning and development;
- Improvement of communications externally as well as internally, allowing the views of stakeholders to be obtained and processed a lot quicker, i.e. customer feedback and complaints can be dealt with more promptly leading to improved quality of offering in the long term;
- Human resources functions can be improved with computer-assisted recruitment, employee reward and recognition, skill and career development analysis and improved internal marketing and communications systems; and
- Technology can have benefits for reducing environmental impacts and improving assessment processes. An example is that emails and electronic facsimiles can assist organisations to become paperless, but only if staff are encouraged not to print off everything that is received.

## New technology risk case studies

### Product redesign for sustainability

Innovation and eco-design also include the issues discussed in Chapter 3: dematerialisation; decarbonisation; eco-efficiency; miniaturisation; simplification; substitution; and waste reduction. An assessment toolkit that takes organisations through this process is available from <http://www.iisd.org/pdf/eetoolkit.pdf>

- An example is that the UK construction industry is stated to be almost 20 years out of date on some production methods (off-site construction, prefabrication and levels of energy efficiency), but there are signs of changes as John Laing Homes in the US is using central vacuum suction to clean the air in their new homes. This has the benefits of reducing product liability (as the house has a reduced impact upon human health); maintaining energy efficiency (in line with building codes); and is proving to be a great selling point with asthma and allergy sufferers as well as health organisations (*The Denver Post*, 15 February 2004, p. K-01).



## Agriculture and genetically modified organisms (GMOs)

The speculation based on the technological prospects of new technology such as genetically modified organisms is coming under greater scrutiny as some research shows increased external impacts of technologies (i.e. crop varieties) upon the environment and unclear economic benefits (i.e. for some GM crops there are estimates of reduced crop yield sizes).

The risk increases as liability for contamination of ‘normal’ or organic crops will rest with the GM grower and patent holder. This has contributed to GM maize being withdrawn from the UK. Angola has also banned GM food (*Financial Times*, 30 March 2004). There is likely to be a political backlash in much of the world as the technology is seen as coming from the US. The British Medical Association said:

Britain is not ready for widespread commercialisation of GM crops and more research is needed into their health risks. (*Financial Times*, 10 March 2004)

Case studies here are already plentiful:

- Technology: Sainsbury’s plc had their head office invaded by GM protestors who complained that they sold milk from animals fed with GM ingredients. The company stated that their milk does not contain GM materials (*World Environmental News*, 19 May 2004);
- Cadbury Schweppes plc: according to Greenpeace, Cadbury’s Dairy Milk sold in the US contained GM ingredients. Roast Almond and Fruit & Nut were also said to contain GM ingredients;
- Aviva: according to the *Ecologist*, Norwich Union was the first insurance company to use genetic testing to assess customer premiums on 30 occasions; and
- Marks & Spencer plc: much of M&S clothing was made of GM cotton, also its skin care and cosmetic products contained GM ingredients. According to scientists, GM cosmetics are riskier due to being directly absorbed into the bloodstream.

Examples of risk management by companies as a response to GMO uncertainties (the Precautionary Principle as explained in Chapter 18) include the following:

- A survey by Friends of the Earth (FoE) has revealed that the UK’s biggest foods companies will continue to reject GM ingredients in their products when tougher GM labelling laws are introduced on Sunday 18 April 2004. The following quotes are company responses to a FoE survey entitled, ‘Food Firms Reject GM Ingredients’, 15 April 2004;
- ‘As a 100% own brand retailer we are able to offer our customers a very clear proposition that all Marks & Spencer food is produced using non-GM ingredients and derivatives’ (Letter, 12 March 2004);
- ‘Tesco does not ... have any own-label GM foods on its shelves, and this will not change as a result of the new EU legislation in April’;
- Morrisons/Safeway: ‘We have removed GM ingredients and GM derivatives from all our own label products’; and

- ‘Iceland own brand products have been made without GM ingredients since 1998 and we can confirm our commitment to this policy remains ... the new regulations will not lead to any change in this position’ (Letter, 14 March 2004, Friends of the Earth ‘Food Firms Reject GM Ingredients’, 15 April 2004).

## Nanotechnology

Another area of concern is the development of nanotechnology, which will provide many challenges for the insurance industry, according to a report published by Swiss Reinsurance Co. While nanotechnology has huge benefits in many areas, potential risks associated with the technology are as yet unknown and are hard to assess (*Business Insurance*, 10 May 2004). There are also concerns about the level of testing and potential human health issues which are discussed in Chapter 17.

There are already more than 350 nanotech consumer products now available, including:

- Cosmetics, sunscreens, food containers and stain-resistant clothing;
- Samsung now sells a new kind of washing machine that releases nanosilver ions during the wash and rinse cycles to kill bacteria; and
- L’Oreal has a nano particle-based formulation in its High Intensity Pigment color cosmetics line.

In a review of these new products and associated risks Andrew Maynard, chief science advisor for the Project on Emerging Nanotechnologies of the Woodrow Wilson Center, wrote:

Without strategic and targeted risk research, people producing and using nano-materials could develop unanticipated illness arising from their exposure; public confidence in nanotechnologies could be reduced through real or perceived dangers; and fears of litigation may make nanotechnologies less attractive to investors and the insurance industry. (The Woodrow Wilson International Center for Scholars quoted in *Nature*, 15 November 2006)

Some of the possible human hazards of nanotech that have been identified or suspected include:

- From a safety perspective:
  - They are more combustible than common, micron-size particles, raising the possibility of explosions;
  - Their ability, identified in animal studies, to clog airways, trigger intense immune-system reactions and ‘toast’ living cells; and
  - Some particles that behave like little ball bearings can cause slips and falls.
- From a health perspective:
  - Some carbon nanospheres and nanotubes behave differently than conventional ultrafine particles, causing fatal inflammation in the lungs of rodents, organ damage in fish and death in ecologically important aquatic organisms and soil-dwelling bacteria; and

- And a California team working with laboratory-grown cells showed that carbon nanotubes specifically activate ‘cell suicide genes’ (extracts from ‘Toxic warnings for nano industry’, *Risks*, issue number 256, 13 May 2006).

## Pharmaceuticals

The pharmaceutical industry is an excellent case study of how apparently miraculous medicines have unforeseen side effects, ranging from thalidomide to antidepressants. The US Food and Drug Administration (FDA) have warned that taking antidepressant drugs could increase the chances of suicide. This was prompted by trials of Cymbalta, which caused concern. Also of concern: GSK (Paxil, Wellbutrin/Zyban); Lilly (Prozac); Pfizer (Zoloft); and Wyeth (Effezor).

## E-waste health and safety risks

There will be increased clean-up and disposal costs of products as the nature of their toxicity is understood more clearly:

- E-waste comprises electronic devices (TVs, PCs, etc. – due to their obsolescence rather than their being broken) with lead, mercury, and other hazardous materials being discarded in vast quantities;
- The majority of the e-waste collected for recycling is also exported to countries where there are concerns for the labourers and unsafe conditions; and
- The Silicon Valley Toxics Coalition and others discovered that dust on computer processors and monitors contains chemicals linked to reproductive and neurological disorders, including brominated retardants (Konrad 2004).

## Sustainability, technology and reporting issues

Whereas the increasingly extensive regulatory and related frameworks may seem overwhelming for organisations, the overall intention should be recalled to enable stakeholders to see financial statements clearly and accurately. A SERM methodology explaining the concept of stakeholders is set out in Chapter 9. The regulations require businesses to be able to produce, when requested, both financial information and records of how decisions were made. In practice data must be accurate and accessible rapidly so that:

- Auditors must be able to see a company’s financial statements; and
- They must be able to look in detail at the data that fed into those statements.

## Managing liability issues

In view of the fact that technology issues are increasingly critical to business, whether purely e-commerce or not, liability concerns can represent an unparalleled business risk. This is a vast topic and only selected matters can be covered. The task of a business and its legal advisors is to ensure that once the

types of technology risks have been identified, the legal ramifications are clearly understood and analysed. Any potential economic loss should be quantified wherever possible. With this information, the enterprise would then be able to prioritise the legal risks and make legal risk mitigation decisions. Enterprises can minimise, if not eradicate, such legal risk exposures by designing terms and conditions in their service agreement that exclude or limit their liability in the event of system failure that causes non-delivery of essential services.

#### *Company business terms*

As seen above, by the very nature of enterprise being in 'big businesses', it is not uncommon to see 'pro-company' terms being imposed on the customers. While customers might simply accept such terms that exclude or limit the liability of the enterprise particularly when they are not in a strong negotiating position, it makes a lot of sense for enterprises to focus on managing their relations with their customers in other more productive ways such as in the form of client education.

## Consumer interests

For most consumers transacting over the internet, the primary concern when a transaction fails is usually whether he suffers a pecuniary loss, for example payment made but the goods or services are not received, or when the wrong or unsatisfactory goods or services are delivered.

From the perspective of the customers, confidence is about knowing what the customers can expect from the enterprise when there is a disaster or an attack that affects their commercial transactions. Individuals and consumers also need to understand the available remedies of a failed transaction over the internet, regardless of whether it is attributed to a merchant that was a target of a hacking or the action of fraudulent third parties. In general, customers think in legal terms only when there is a major economic loss on their part (although the trend in society is towards more litigation). In any event, the way to manage possible legal risk exposures that might result from contractual obligations is an assurance programme that is sound, well publicised and that engages the clients of the enterprise in times when there is no disaster.

#### *Communication with consumers*

While taking the legalistic approach of protecting one's interests by defining and controlling legal risk through the 'fine prints' might serve its purpose, a better strategy is to focus on assurance and effective communication to parties that may potentially sue the enterprise in the event of major service disruptions.

## Evidential issues

In any cases involving breaches of security (see also Chapter 8), companies must have in place work policies and procedures to ensure that evidence can be properly presented to the prosecuting agencies and the courts. If proper steps are not taken in relation to digital evidence, the chances of proving one's case or to disprove the other side's case will be much less. Given the fragility of digital evidence and the need to collect, preserve and present evidence to the prosecuting agencies in a criminal legal proceedings, enterprises should ensure that digital evidence can be properly detected, preserved and presented in a manner that legally complies with the local laws of the country. Also, given the transient nature of digital evidence, time is of the essence in all cases involving information security breaches. In general, companies should have in place policies and procedures to include the following:

- Steps to isolate or quarantine the evidence;
- Recovery of evidence;
- Reproduction of evidence;
- Processing and analysis of evidence; and
- Preparation of report by an expert for use in the courts.

In the event digital evidence and data are not properly secured or preserved, such evidence may subsequently be found inadmissible in court for the purposes of criminal or civil proceedings. Therefore, as part of the enterprises' post-incident operation procedure in areas of disaster recovery and business continuity planning, there is a need to ensure that legally compliant procedures are pre-established so that they can be activated expeditiously when the incident happens.

Businesses should also seek legal advice on how to determine whether a crime has been committed and the possible courses of action that can be taken based on the evidence available. Digital forensics work will invariably have to be undertaken together with legal personnel to identify the crime, the offender and to collect and reconstruct the necessary evidence which are typically found in disks, logs and other media. Legal advice should be sought on issues such as preservation of evidence, issues of admissibility and the overall presentation of such evidence to the prosecuting agencies in a manner that not only complies with the law but also is managed in a manner that would make a strong case for the prosecution. Aside from criminal proceedings that the public prosecutor may take against the perpetrator for the offences committed, the victim enterprise may also consider filing civil claims for damages and other losses that may have been suffered as a result of the attack.

## Design of a risk management framework

Two aspects may be considered:

- Exposure to risks through IT; and
- The use of IT to manage risks.

In designing the overall legal risk management framework, businesses should, as a general rule, have a proactive and structured programme of action involving the following elements:

- An overall system to identify, classify, measure, prioritise and assess legal risks that are relevant to the enterprise's operations;
- A plan that is documented in the form of an operation manual (both hard copy and embedded into the system in the form of web-based documents containing policies, practices and procedures that address and control these risks). Such a plan must specify the responsibilities of all parties involved in the whole risk management process from the operational level right up to the CEO;
- A regular test plan that when implemented approximates all possible worst-case scenarios for the purpose of testing the system to its fullest potential;
- A monitoring programme to assess all types of technology and other operational risks and the evaluation of the effectiveness of such programmes;
- The regular updating of such plans in the light of developments in the technology, law and business practices;
- Post-incident recovery procedures which must incorporate digital evidence collection, preservation and presentment techniques which are legally compliant;
- The fulfilment of legal compliance requirements as specified by the regulatory bodies; and
- A security awareness programme that will help nurture a more security conscious environment.

## Business intelligence

The value of a good business intelligence solution system is becoming increasingly important. It should have a data warehouse that ensures that all reports are based on the same information. It should provide a solution that allows users to follow an audit trail by drilling down from the high level into more detail. For instance, commentators have remarked that had Shell been compliant with SOX they would not have been able to state that they thought that they has one-third more oil reserves than they actually had. One of the requirements of SOX is for real-time reporting so that if a major event takes place that has an impact on a company's financial statements then the company must respond quickly by making updated financial reports available (see Chapter 22). This requires:

- Having a very agile infrastructure;
- Being able to capture information in relative real time;
- Having the tools to assess it very quickly; and
- Assessing the implication for the profit-and-loss account or balance sheet.

Some experts warn that many firms implementing solutions are losing sight of the need for a holistic view by considering, for example, the regulations separately. For instance, initially the Basel II and IFRS requirements on reporting

losses were not compatible: although the issue has been resolved such conflict demonstrates the need to take a high level view. In addition, by taking a short-term view that solves current problems businesses fail to protect themselves against possible M&A issues. To deal with the constant increase in new demands solutions should provide a coherent view across the organisation and the functions that are in place within it.

Therefore, it is clear that in today's complex business world those organisations that use the right business intelligence should be more successful in handling all of the issues, relevant to sustainable risk management, in a more holistic way. However, it also means that many of the complex concerns around IT and e-commerce should also be considered as a priority. As a result of the growing reliance upon technology more risks must be managed both as regards the internal use of technology in monitoring business concerns and as regards the handling of external relationships and matters. Many smaller businesses, for example, cannot afford to protect themselves in the ideal way. Therefore in this chapter an overview is provided of some of the developments that have occurred – and current issues – in the context of the e-debate. This is such a broad subject, which spans both macro and micro issues (from handling the above requirements to dealing with everyday email nuisance such as spam), that it requires a manual in itself. This chapter can only touch upon issues that relate to due diligence, risk management and corporate governance.

## Technology due diligence: managing legal risk exposure

Another issue concerning the use of IT relates to technology due diligence in so far as it is often one key aspect of the overall due diligence process performed by those wanting to acquire or invest in companies. In this context it is primarily an exercise about managing both commercial and legal risks. It is about managing risks in a way that will enable the parties involved in the business transactions ultimately to maximise their respective commercial returns or to minimise bottom-line losses. Here technology due diligence is about assessing the quality of technology assets and any attendant risks that an acquirer would assume in acquiring such assets. In this spectrum of risks, legal risk exposures probably rank among the top concerns of senior management.

## Intellectual assets

In the New Economy, one of the key assets of organisations is often its intellectual assets. Acquiring intellectual assets is often one of the key objectives in mergers and acquisitions and they are also increasingly exploited for strategic advantage. In this discussion 'intellectual assets' covers those generic cluster of intangible assets which, when narrowly defined within a precise legal context, emerge as rights which are protected or can be protected by law. Such intellectual property rights typically include patents, copyrights, trademarks, design and trade secrets. They are often intangible and come in the form of technology

or know-how which can be software or hardware driven or simply business processes driven by technology.

Companies typically want to acquire technology from others for any one of the following reasons:

- The technology is useful in itself;
- The technology may enhance the acquirer's own product range, service offerings or technology development cycle;
- The acquisition of the technology will enhance the acquirer's corporate branding;
- The acquirer sees long-term investment value by acquiring the technology at what the acquirer regards as fair market value; and
- The acquirer sees benefits in terms of positive public perception of the acquisition that would result in a better market price for its shares.

Investors typically insist on having a very clear view of the strengths and weaknesses of the technology in the overall corporate and industry context. R&D houses may also use technology due diligence to assess or validate their performances while technology start-ups may use the result of technology due diligence for their own self-assessment or evaluation for the purpose of fundraising. The ultimate aim of any technology due diligence exercise is to use it as a management tool that helps increase the probability of a successful investment, a partnership or a merger and acquisition. As with all due diligence exercise, a risk assessment has to be made.

In a technology due diligence process, the purchaser or investor typically would want to achieve one or more of the following objectives:

- To identify technology asset strengths and weaknesses that would help in closing the deal successfully;
- To remedy any identifiable flaws in a way that will be conducive to further negotiations but often in the hope that it will reduce the acquisition cost for the acquirer or purchaser and secure better terms in general; and
- To ensure the eradication or minimisation of all if not most legal risk exposures from the acquisition of that technology.

The main assessment that the advisor has to make typically revolves around the key questions that are set out below, they are acting for:

- An acquirer intending to purchase a technology company; or
- An investor taking up an equity stake in a technology company; or
- Parties to any transaction with a technology component.

The questions cover:

- Whether the technology that is the primary asset of the company being acquired does what it is supposed to do: its capabilities must be evaluated and verified;
- Whether the acquirer can verify that it would be able to extract business value from acquiring the technology in particular and whether the management team responsible for the creation of the technology can deliver what the



technology purports to be able to do for businesses; in short, the commercial prospect of the technology;

- Whether the owner of the technology does legally own all the rights to the technology;
- The nature and magnitude of legal risks that the acquirer would be assuming if the acquisition is made; and
- What the true measure of the value of the technology being acquired is, that is, its strengths, weaknesses and therefore its real worth.

Given the primacy of intellectual assets in the New Economy and the essence of such assets being the technology itself, the issue of protection of such assets is of paramount importance. In a technology due diligence, managing legal risk exposures in relation to the intellectual property rights of the company is always one of the primary concerns of parties. Therefore this central aspect of technology due diligence, that is, the evaluation of and the risk assessment of intellectual property rights issues, both internal and external to the company or individual owning the technology, is considered below.

## Ongoing risks

In internet-based commercial transactions where technology risks such as systems failure or attacks are particularly accentuated and the ‘risk turnaround time’ is much faster, the need to design and develop a proactive and structured legal protection regime has become a corporate imperative. A legal risk management system to assist internet commerce at both the strategic as well as the operational level that would protect enterprises from legal problems that might flow from information security risks is essential.

### *Information security*

As has been seen above, in a world of increased security risks and threats, information security in internet commerce has assumed a centre stage role. With advances in information technology and with an increasing number of consumers relying on internet-based services, intrusions and other forms of attacks on IT systems will not only continue but are likely to increase in frequency.

The internet has become an essential and integral aspect of most information technology systems today. The internet, which can be described as the global network of networks, has shaped and is continuing to shape the industrial landscape where internet-based transactions are becoming increasingly common. The IT systems, which include the networks and databases, have now become an integral part of most nations’ critical infrastructure and this infrastructure is increasingly linked to the internet. Within this huge internet-based system, internet commerce has emerged as one key sector.

The scope and reach of information technology systems in the business sector, particularly those with internet connectivity, have expanded greatly in recent years. We are also likely to witness an increasing degree of sophistication in attacks of systems. At risk is the potential criminal violation of data and assets of consumers particularly in sensitive sectors involving banks and financial institutions. As a consequence, technology risk management particularly in relation to information security breaches has become even more important. At the same time, the deployment of such technologies has become more complex thereby making technology risk management even more difficult.

Dealing with information security breaches can be complex as the attacks are difficult to detect. The fact that it is not always clear whether certain types of activities are necessarily illegal creates further problems in prosecution. Also when computer crimes are committed across borders and digital evidence is by nature transient and fragile, the problem becomes compounded.

## Technology services in internet commerce

Enterprises need to take pre-emptive measures to prepare them against cyber attacks as well reactive measures after an incident has taken place to limit their losses and to pursue the perpetrators of the attack. Most types of risks inherent in internet commerce are not fundamentally different from traditional commerce. However, given the very nature of internet commerce – which is much more technology dependent than traditional commerce – technology risks have become increasingly prevalent and accentuated in complexity and magnitude.

Commercial enterprises typically provide internet-based systems through two basic sources:

- Primary sources, from the enterprise's own internal system and applications which may be developed internally; and
- Secondary sources, such as systems and applications provided through service providers typically outsourced from external partners or providers.

In the development of such systems in the past, enterprises tend to deploy proprietary or closed-loop networks which pose less of a risk from attacks via the internet. However, the increasing use of internet technologies in an open environment in the commercial sector has created new risks and created greater vulnerabilities and threats.

On the part of the customers of enterprises, they in turn expect the deployment of internet technologies to mean greater access and quicker service turn-around. In internet commerce, customers tend to expect that such enterprises deliver their online services on a continuous, consistent and timely basis. As indicated above, particularly during peak times, customers of online commercial enterprises expect:

- Continuous service on a  $24 \times 7 \times 365$  basis; and
- Short transaction processing cycle.

The higher risk in providing internet-based commercial services coupled with customer expectation of quicker, more accessible but nevertheless more secure systems continue to pose a major challenge to the senior management of corporations in providing quality effective service.

## Nature of technology risks in internet commerce

Technology risks in internet commerce like in other internet-based systems include any potentially adverse outcome in the form of damage or loss that results from failure or disruption arising from the use of or reliance on information technology systems including hardware, software, equipment, devices, systems, applications and networks. Such risks typically could result from any of the following three forms of risk events, namely:

- Attacks such as intrusions, malicious hacking and fraudulent actions;
- Systems flaws such as processing errors, software defects, operating mistakes, hardware breakdowns, systems failures, capacity inadequacies, network vulnerabilities, control weaknesses and information security shortcomings; and
- Management failure to provide adequate recovery capabilities such as the absence of a disaster recovery plan.

Such risks can arise from within and outside the organisation with the risks being higher if the threat is internal. While most spending on IT security tends to focus a lot more in developing a perimeter defence to ward off external attackers from penetrating IT systems, there is a realisation that resources also need to be provided to prevent an attack from within, which could be far more disastrous.

While protecting IT systems – which includes the network, hardware and software – is very important, it is the data that resides within the system that is far more important than the system or infrastructure itself. In the internet commerce arena, such critical data includes customer and accounts particulars. Such data can be remotely accessed, altered, deleted, manipulated or inserted by someone with hacking skills. Unless the system is able to trace and track such intrusions, it is likely that the damage or loss may not be noticed early enough. Given the unique characteristics of internet commerce as one primary internet-based distribution channel for commercial activities, the risk exposure when there are attacks and service disruptions is therefore much higher compared with traditional bricks and mortar commerce.

Disaster can range from a total loss of service due to deliberate attacks, natural disasters, or a catastrophic system failure owing to software faults or hardware malfunctions (see also Chapter 8). While an aeroplane being crashed deliberately into a skyscraper such as the World Trade Center terror attack may not be anticipated on a day-to-day basis, system downtime for whatever reasons must still be planned for. In the aftermath of any disaster or attack, disaster recovery planning then becomes a critical element in any commercial enterprise's risk management framework. The substantial task of the enterprise is to put together robust and effective contingency operating procedures that cover all possible types of operational disruption or system breakdown.

## Legal risk issues in internet commerce

There are several characteristics of internet commerce that require us to review the management of legal risk issues in a different light and these include:

### Digital and other information assets

Internet commerce deals with hitherto new types of digital and information assets. Such assets in a way define what internet commerce is all about for the traditional bricks and mortar enterprises. In cases where the enterprise itself is a 'pure' internet company, that is, one without a physical presence, the internet-based business model is actually the very business itself. These digital and information assets are particularly vulnerable to attacks which can threaten the commercial viability of the business.

### Borderless and global

Internet commerce is by definition a borderless, global activity. The internet is a global network of networks. Internet connectivity itself crosses political boundaries with no hindrances so long as the networks in two different jurisdictions are connected. Business methods that are effective and in compliance with the laws and regulations in one enterprise's home market may not work in markets that operate in a totally different legal environment, and might even expose the enterprises to unexpected legal liability. An example would be a US online bank trying to offer its services to citizens of other countries located in different legal jurisdictions. This kind of business model would probably be affected by the laws affecting such citizens in their respective home markets.

### Timing for product and service roll-outs

In internet commerce, the 'go to market' time for a new project is much shorter compared to bricks and mortar commerce. This reduced time frame means that legal issues must be addressed much earlier than is traditionally expected.

## Managing legal risk issues in internet commerce

As a result of the more internet-intensive commercial environment, technology-related legal risk management is now becoming an increasingly familiar concept to the board and senior management of all enterprises. If it is not, it should be.

If the legal risks that flow from technology risks are serious enough to threaten the legal and commercial interests of the enterprise, the senior management needs to ensure the establishment of a legal risk management framework to identify these risks and take adequate measures to address them. The

company's board of directors, for instance, have a fiduciary duty to protect the organisation from security attacks and other forms of cyber crime and security risks which may have a critically negative impact on the organisation's reputation, assets and commercial viability.

Enterprises should ensure that adequate steps are taken to protect themselves legally. Apart from liabilities for breaches of contractual obligations, the failure to take reasonable and adequate steps to provide security measures may possibly lead to an enterprise being liable for negligence, either in not taking sufficient steps to protect data and information where it has a duty of care to protect, or in being used as a platform or a channel to mount an attack against another party. Preparatory steps should therefore be taken in advance in planning the procedures to handle security breaches.

The board and senior management should therefore review and approve the organisation's legal risk management policies taking into account technology risks and the capacity of the organisation to deal with such problems. Legal risk management in this new technology-intensive environment cannot be a task that is merely carried out periodically, say yearly or half yearly. In today's accentuated security risk environment, legal risk management has to be regarded as an oversight process undertaken by senior management on a continuous basis. This process involves legal risk identification, assessment, control and mitigation. Also the scope of legal risk management should embrace a broader horizon which incorporates proactive legal risk management. A key component in this legal risk management framework is the protection of digital assets.

## Compliance relating to business continuity

Another legal issue that enterprises have to address in the provision of internet commerce services relates to compliance requirements in relation to business continuity planning. Enterprises such as banks and financial institutions typically operate in a legal environment that is very tightly regulated. The regulatory authorities may require legal compliance in terms of having a sound business continuity plan or disaster recovery that is subject to regulatory review and penalties for non-compliance. Such regulatory non-compliance is one form of legal risk exposure that the enterprise's legal advisors must address.

A business recovery and continuity plan is essential for every business that owns any mission critical application or system. To ensure adequate availability, enterprises typically provide for contingency back-up systems to mitigate denial of service attacks or other events that may potentially cause business disruptions. As has been mentioned in Chapter 8 a business continuity plan or disaster recovery plan is an essential part of the overall risk management framework of the business. Such a risk management framework typically also includes issues pertaining to data confidentiality, system and data integrity and security practices in general. The board of directors has a fiduciary duty to ensure that in the event of system failure for whatever reason, there is continuity of service for the enterprise's clients and partners.

## Relationship with technology providers

Most commercial enterprises are not in the business of providing technology solutions and they rely greatly on external parties such as internet commerce technology service providers to provide the technology infrastructure to enable them to provide internet commercial services. This is another dimension in the legal portfolio that senior management must handle.

As has been discussed above, a vitally important aspect of the legal protection framework in internet commerce is the use of effectively drafted contracts with third party vendors and solution providers to ensure the enterprise's potential legal liabilities are adequately managed. These are contracts that typically manage the relationships that enable the enterprise to provide secure and continuous services, covering such matters as:

- Web hosting;
- Development of applications (for example, internet commerce software);
- Access services provided typically by infrastructure providers such as telecommunication and internet service provider companies; and
- Security services including the supply of security products such as firewalls and encryption software.

Since the provision of technology services are typically not part of a commercial enterprise's core competencies, such services are typically outsourced to external providers. However, the enterprise's primary responsibility to its customers is to provide an accessible, direct, secure service. In the event of the failure of the enterprise's service provider, the enterprise itself would still be accountable to its customers. There is therefore a need for enterprises to ensure sufficient counter-indemnity arrangements are entered into between themselves and the third party technology providers.

### *Legal indemnity*

Therefore when there is a major service disruption caused by technology or system failure, the issue that often arises is the extent to which the enterprise is able to pass on or share any legal risks to the technology service providers. This typically takes the form of indemnity provisions which require the technology service providers to indemnify the enterprise for losses that result from the service provider for failure to ensure business continuity.

### **Commercial risk case study**

#### *Legal aspects of metadata and electronic documents*

It has been mentioned elsewhere that two of the key risks that a business faces in modern day commercial activities stem from the threat of litigation and problems found in the IT area. Many examples have been cited

about the commercial risks in connection with hacking, identity theft and related phenomena: one aspect that should also be discussed as a separate area of concern relates to metadata. This discussion therefore considers the meaning of metadata and its use – and significance – in litigation. Moreover whether or not there is any litigation pending it is vital that small businesses should handle their data extremely diligently: as technology improves and rapid developments occur in this sector it is increasingly important to behave ethically regarding documents and corporate records.

*Metadata: its meaning and significance*

Metadata is defined as data about data and as regards electronic documents it is the information relating to a document that is not evident on the face of the document but is stored as a matter of course in the computer and recorded by the document that created the software. Its main significance is that often in litigation it is crucial for the parties, investigators and litigators to know more about the provenance of a document: the proper interpretation of document metadata can help to provide missing information. Such information can be vital in many aspects of commercial litigation, ranging from contract issues to employment disputes.

By way of example, in an unfair dismissal and sexual discrimination matter claims can be contested by examining the history of key documents such as dates of letters, the details of notice procedures, the authors of documents and when they were printed, as well as the path of earlier versions. This can reveal, in turn, the authenticity of documents which can counter allegations regarding creation dates and their original features. Moreover metadata about the original author and the origin of the document can be cross-referenced with records from mobile telephones and emails found on the hard drive. Clearly such information can be vital to clarify the real background to a document that can support or destroy what emanates from the face of the document.

*Typical metadata*

It is helpful to understand the basic components of metadata and what can usually be accessed by viewing the properties of the document in the application that created it – such as Microsoft Word™ – or by using specific software. Typical metadata includes:

- \* Document title;
- \* Document author, in accordance with the system's determination. It should be noted of course that this may not be reliable as regards who actually wrote the document or who last worked on it since often commercial documents are revised by many persons and may be copied many times. Nevertheless a complete analysis may be possible that explains how and when the system recorded the details of the document author;

- \* The company from where the document originates (subject to the same concerns mentioned above);
- \* The location of the file on the computer;
- \* The date and time when the file was created, as well as the location from which it was opened;
- \* A record of when the file was last accessed;
- \* A record of when the file was last modified, such as the time and date when the size changed, which can be a useful indicator; and
- \* A record of who last saved the file.

Additionally specialist software can extract the following details:

- \* The identity of the last 10 authors and document locations. This is most significant as evidence since the information can demonstrate how the document arrived at the current location and who had been involved in it. It should be noted, however, that any discrepancies as regards the computer's internal clock and real time must be noted carefully, along with any time conversions in relation to different time zones when, for example, documents are being transmitted across varying time zones as in the case of transatlantic communications;
- \* When the document was last saved; and
- \* When the document was last printed.

#### *Role of a forensic copy*

Whereas metadata can be extracted from both live documents and recovered or deleted documents there must be a proper forensic copy of the original file available before the analysis of metadata. This is in order to:

- \* Preserve the original time and date stamps; and
- \* Maintain any other potentially useful information regarding the file.

The metadata information can be combined with other information obtained through other investigations, such as through an analysis of email and telephone records, in order to add real value to an investigation in these circumstances. For example, there may be many cases – not only those in which fraud is alleged – where information that is contained in metadata should be hugely useful to provide evidence regarding an important issue.

A non-forensic copy is likely to contain inaccurate information because time and date stamp information – as well as any other useful information – will be altered if the file has been opened and copied from the original computer system.

#### *Disclosure rules and metadata*

The disclosure rules state the following:

- \* A document is 'anything on which information of any description is recorded' and therefore includes electronic documents;



- \* Standard disclosure involves a ‘reasonable’ search for all documents that either support or adversely affect either side’s case; and
- \* Specific disclosure can be ordered at the request of the parties, which relates to specific documents or classes of documents.

In order to decide whether or not a search is reasonable relevant factors have to be considered such as:

- \* The number of documents involved;
- \* The nature and complexity of the matter;
- \* The significance of any document that is likely to be located; and
- \* The ease and expense of retrieval.

Accordingly experts appear to have accepted that standard disclosure ought to include a search of active data on a computer system. In such instances it would seem advisable that where there are documents in proceedings whose provenance is disputed these should be identified at an early stage and agreement reached as soon as possible or orders sought for their preservation in their original format. Moreover there may need to be searches for residual copies, if any, in the case of a disputed document, bearing in mind any time and cost implications. Once the document has been identified and located it should be copied in a forensically sound manner in order to preserve its metadata. In commercial cases, for instance, a procedure may be agreed upon as regards the extraction and production of the document. Moreover in fraud cases, for example, the courts may well be sympathetic to applications for the specific disclosure of document metadata.

### *Conclusion*

The above considerations highlight in a vivid way the importance of ethical business practice and appropriate due diligence in connection with the handling of documents in the business as part of usual business policy. Regardless of the value of the hidden information encoded into most electronic documents – metadata – for the purposes of litigation, clearly today’s business climate demands an increasing level of sophistication in working with IT having regard to risk management. As has been noted elsewhere, the information set out here is of a general nature: any particular concerns should be referred to an expert in order to obtain appropriate specific advice.

### *Useful web links*

The International Institute for Sustainable Development have produced an assessment tool kit that takes organisations through the sustainability product design process. It is available from <http://www.iisd.org/pdf/eetoolkit.pdf>

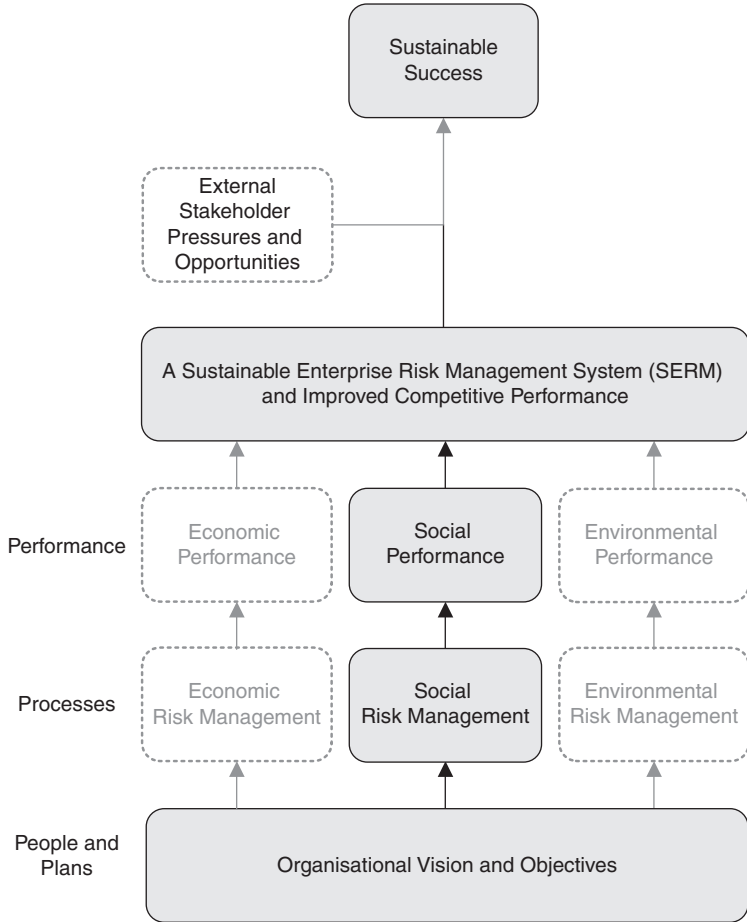


# PART C

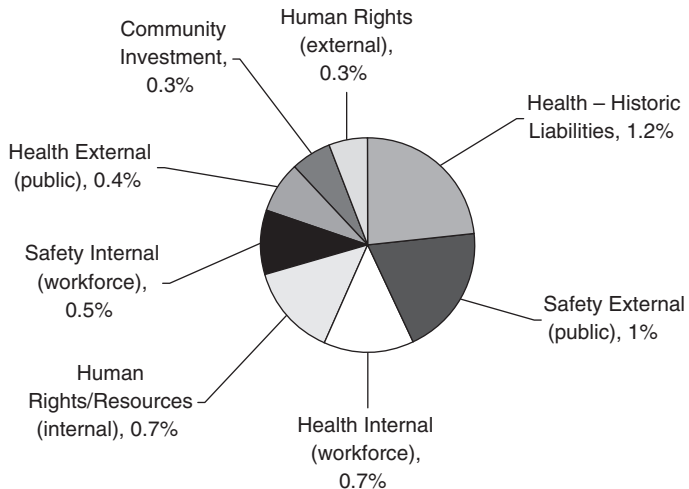
## Overview of the Social Aspects of Business Risks

Social risks are as varied as the communities and cultural groupings from which they emanate. We use a SERM system to estimate that 5.1% of market value is at risk from these types of internal and external issues including:

- Social and ethical risk overview (Chapter 12);
- Cultural risk management (Chapter 13);
- Human rights and resource issues inside the workplace (Chapter 14);
- Human rights outside the workplace (Chapter 15);
- Health and safety in the workplace (Chapter 16); and
- Health and safety of customers and product liabilities (Chapter 17).



The net risk to market value from these issues is outlined in the pie chart below:





12

Social and business ethic risk  
overview

# 12

## Social and business ethic risk overview

### CHAPTER OVERVIEW

This chapter provides an overview of the socio-economic and business ethic risks an organisation faces, assessing their impact upon profitability. All business activities could be viewed from an ethical viewpoint, in effect what stakeholders perceive to be 'right' or 'wrong', but we are reviewing just a few elements of this wide area of risk.

In this chapter whereas there is a brief overview of some of the social and ethical risk issues, most are covered in more depth in other chapters indicated in brackets:

- \* Risks from a lack of community involvement (in this chapter);
- \* Human resources and workforce human rights, including the avoidance of forced or child labour (Chapter 14);
- \* Wider human rights issues outside of the organisation, including the avoidance of suppliers (Chapter 15); and
- \* Health and safety for staff, and historic liabilities (Chapter 16) and customers (Chapter 17).

Other issues that have large ethical dimensions but which are not covered in this section are:

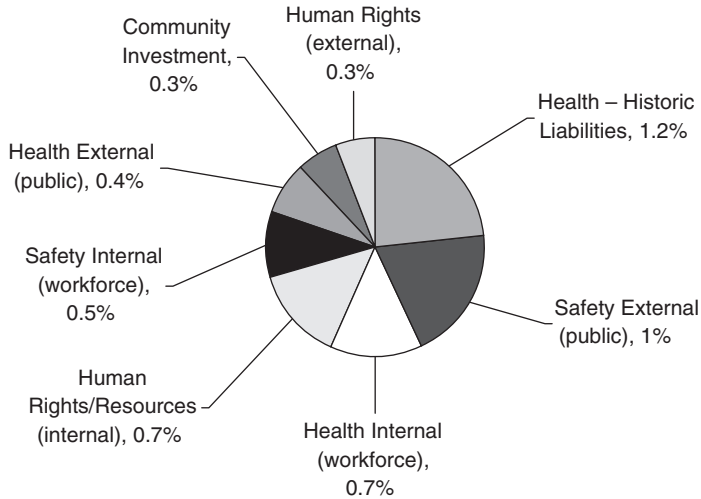
- \* Involvement in bribery and corruption (Chapter 7);
- \* The use of corporate power (Chapter 10);
- \* Business and marketing practices (Chapter 10);
- \* New technologies impacts (Chapter 11);
- \* Natural resource degradation risks (Chapter 18 and 19); and
- \* Corporate governance and ethical codes of corporate behaviour (Chapters 21, 22 and 23).

### The social aspects of business risk

Social risks are as varied as the communities and cultural groupings from which they emanate. The average risk to market value is estimated at 5.1% of

market share for the risks highlighted below, mostly from health and safety of staff and customer issues. Many mistakes are made by organisations that are far removed from their marketplaces, physically or culturally or both. SERM reviews these types of risks as well as external issues such as product safety, human rights and employment law.

The chart below shows the total social and ethical risks broken down by category by (net) risk to market value for the top 500 companies in the EU and US.



We also look closely at the risks associated with the impact on the smooth running of operations, from social, cultural and ethical issues. We have included an overview of human rights and health and safety issues which are covered in the other chapters in this part of the book. Experience demonstrates that the list is growing exponentially, as well as the costs and claims for reimbursement. A brief overview of relevant risks and the chapter number where they are covered in more depth follows:

Social and ethical risk	Net (residual) risk to value	Covered in
Community investment	0.3%	Chapter 12
Cultural risk	Not available	Chapter 13
Human rights/resources (internal)	0.7%	Chapter 14
Human rights (external)	0.3%	Chapter 15
Health internal (workforce)	0.7%	Chapter 16
Safety internal (workforce)	0.5%	Chapter 16
Health external (public)	0.4%	Chapter 17
Safety external (public)	1.0%	Chapter 17
Health and safety – historic liabilities	1.2%	Chapter 17
<b>Total</b>	<b>5.1%</b>	

## The business context

The business community is increasingly acknowledging the risks from operating within a society and managing these in such a way that both businesses and society benefit. Some of the most enduring businesses and brands have this principle of mutual progression at the heart of their business models.

There are a number of financial and non-financial ethical issues which require attention from organisations' risk management and due diligence systems, including issues covered in the other sections, for example: anti-money laundering provisions, tackling bribery and corruption, the integrity of the organisation and its trustfulness as well as honestly abiding by codes, principles and standards if publicly committing to them.

In trying to perceive the business environment through the eyes of the wider society and stakeholders, management should gain a perspective on the risks and how to deal with them in a broader social context. The business case includes managing and avoiding the following risks:

- Social and ethical incidents, or a reduction in the number of incidents and/or their impact;
- Non-compliance convictions, criminal prosecutions and enforcement notices;
- Enforcement actions for remedial work;
- Civil claims;
- Damage to reputation and brand; and
- Stakeholder pressure.

Media coverage of the research on these issues highlights that there are benefits to be gained from incorporating the following types of risk into an organisation's management system.

The IBE (Institute of Business Ethics) findings strengthen the argument that companies must take a thorough approach to corporate ethics. (Alastair Ross Goobey, 2003 Quote from a Institute of Business Ethics Press Release about Does Business Ethics Pay? by Simon Webley & Elise More. <http://www.ibe.org.uk/DBEPpr.htm>)

There is strong evidence that those FTSE350 companies which are clearly committed to ethical behaviour perform better financially over the longer term than those lacking such a commitment. (Institute of Business Ethics (IBE), 'Does business ethics pay?' 2003)

19 out of 24 companies which have figured consistently in 'Management Today's' annual 'most admired company' league table over the past five years have codes of ethics, and are rated more highly by SERM than those without codes. (Simon Caulkin, Business & Media, *The Observer*, 20 April 2003)

## Social and ethical risks and trends

### General comment

All organisations are at risk from a range of social, cultural and ethical impacts and different sources, even if they are only from, for example, the local newspaper or planning authority. These impacts can be significant and the direct

and indirect costs to businesses have been assessed as being 5.1% of the value of the top 500 US and EU listed companies. This has been reduced from a potential 9.0% by the risk management activities of companies.

This risk to an organisation's value increases as the amount of legislation, volume of litigation and level of awards increases. The level of activism by the public or stringency from the government or stakeholder groups, like the trade union movement on labour rights, are all on the increase. There is also the view that the power of businesses is outstripping all other checks and balances, and that political power is now becoming subservient to corporate interests. Indicatively it is now said that 52 of the 100 largest global economic entities are companies and that correspondingly there is an increase in the degree of responsibility, accountability and ethical conduct expected of organisations with so much power and influence.

## Types of social and ethical risk

As society is always changing, the risks it poses to an organisation are continually changing too. However, the main types of risk companies need to review are: liabilities; operational risks; financial penalties and enforcement costs; damage to the public perception of the company (see also Chapter 9); emerging social issues (human rights, employee welfare and community issues); traditional 'ethical' issues concerning products or areas of activity; countries of operation and company activity (tobacco, armaments, gambling, pornography, alcohol); and newer emerging issues (e.g. animal welfare, directors' pay).

It should be emphasised again that in this chapter there is a brief overview of social and ethical risk issues, although most are covered in more depth in other chapters indicated in brackets:

- Risks from a lack of community involvement (in this chapter);
- Human resources and workforce human rights, including the avoidance of forced or child labour (Chapter 14);
- Wider human rights issues outside of the organisation, including the avoidance of suppliers (Chapter 15); and
- Health and safety for staff, and historic liabilities (Chapter 16) and customers (Chapter 17).

Other issues that have large ethical dimensions but which are not covered in this section are:

- Involvement in bribery and corruption (covered in more detail in Chapter 7) and anti-money laundering measures ([www.jmlsg.org.uk/](http://www.jmlsg.org.uk/));
- Use of corporate power (Chapter 10);
- Business and marketing practices and fines for non-compliance (Chapter 10);
- The impacts of new technologies on customers and the wider public (Chapter 11);
- Natural resource degradation risks (Chapter 18 and 19); and
- Corporate governance risk and codes of corporate behaviour (Chapters 21, 22 and 23).



Case studies and surveys analysed by SERM have shown that there is little consensus around either the scope or the validity of social and ethical measures of business performance. As an area of concern or risk, it is often perceived by the business world merely as the product of highly politicised and altogether unrealistic non-governmental organisations (NGOs) – not as a serious set of business risks. However, companies can face serious financial penalties from operating in an unethical manner:

- Unethical practices escalate the risk of consumer boycotts;
- NGO activism can deplete the morale of employees;
- Failure to engage with the concerns of the communities in which they operate can lead to regularised vandalism and theft of the company's assets;
- Prolonged mistreatment and abuse of employees can lead to the politicisation of the workforce and the proliferation of restrictive practices;
- Failure to self-regulate can lead to harsh government-imposed restrictive laws; and
- Failure to set ethical standards of business with corrupt governments can lead to ever-escalating bribery costs.

Looking at just one of the risk categories – unethical business practices – demonstrates how active these risks can suddenly become. Within only a year, a wide range of business scandals and misbehaviour almost destroyed public confidence in businesses *per se*. The business world seemed a very different place before Enron, Elan, Railtrack, Tyco, WorldCom and certain sections of society became more engaged in activism and terrorism. These social and ethical issues have become part of the mainstream, but few analysts or researchers have incorporated these issues into their risk assessment methodologies, and even fewer predicted the highest impact events.

Understanding socio-economic activities through a risk prism may help to appreciate the risk posed by misunderstanding cultures. Recently the costs have greatly increased. The September 11 attacks demonstrated this when the New York Stock Exchange was shut down for four trading days and cut nearly 1400 points from the Dow Jones Index by 21 September 2001.

The consequences of business interruption are estimated at 90% of medium to large companies. If they cannot resume near-normal operations within five days of an emergency, they are out of business within a year (Neal Rawls, security columnist and author writing about *Avoiding Disaster* by John Laye, 2002). This is covered in more detail in Chapter 8.

## Interconnecting risks

Just as different elements of society are interconnected so are the risks they pose, and several of the risk categories overlap. This is demonstrated by human rights risks, as they permeate throughout the other chapters of this book, as most risks ultimately involve human beings, as reviewed in Chapter 15:

- *Environmentally related human rights*: pollution and environmental degradation caused by operations. Peripheral pollution in the UK such as recent odour-related infringements of the Human Rights Act 1998;

- *Health and safety-related human rights*: consumer protection and the improper use or distribution of products that may be a danger to consumers; and
- *Social and ethical related human rights*:
  - Business issues such as the misuse of products by private organisations and/or public bodies in a manner which violates human rights, e.g. products for warfare and taking advantage of absence of, or poorly enforced, laws/regulations. Sourcing from suppliers with lower standards of operation, lower than the norm. Use of local security forces to protect company interests that operate contrary to human rights standards;
  - Community issues like the displacement of local communities and indigenous peoples. These can extend to intellectual property issues and the appropriate use of indigenous knowledge; and
  - Transparency issues, including involvement in bribery and corruption, facilitation payments. Also the lack of effective controls on advertising or engaging in improper advertising.

## Stakeholder and reputational risks

The human rights implications of corporate conduct are attracting focused attention from a variety of interested parties, such as national and NGOs, governments, community groups, consumers, shareholders, the media and the investment industry. With the increased expectations, ignoring human rights risks can have adverse effects upon companies in a number of key, inter-related areas. For an in-depth exploration of these issues reference to Chapter 9, which discusses reputational issues in more detail, can also be made.

### *The SERM stakeholder template*

- \* Academic and research organisations.
- \* Business partners, suppliers and trade bodies;
- \* Customers and their representatives;
- \* Direct action groups and NGOs;
- \* Employees and their representatives;
- \* Financial institutions (banking, investor and insurance criteria);
- \* Governmental organisations;
- \* Local and regional governmental organisations;
- \* International governmental organisations;
- \* Journalists and media organisations;
- \* Key competitors; and
- \* Local communities.

Although all stakeholder groups have a part to play in the dynamics of social and ethical risks, the following stakeholder groups are of particular note:

**Business partners and suppliers:** the purchasing company's approach to its suppliers' social and ethical performance varies. There are also trade and

industry associations such as the Association of British Insurers, Apparel Industry Partnership, Forge II and the banking sector's Equator Principles which seek to develop standards of social and ethical behaviour.

**Customers and their representatives:** these are one of the ultimate drivers of change within society. Change can come from the election booth, the consumer boycott or the groundswell of public opinion on an issue. It took years of activism by members of the general public and consumer boycotts of companies like Barclays (during the anti-apartheid campaign) to bring this issue to the forefront of the political agenda. In the UK and Ireland it has been announced that McDonald's will start serving some 143 000 cups daily of Kraft Kenco fair trade coffee sourced from Rainforest Alliance Certified farms in Colombia, Brazil and Central America. The company perceives this will raise its ethical footprint in areas where its market share has been under pressure from competitors deemed by customers to be more 'ethical'.

**Direct action groups, including NGOs:** NGOs and their recommendations for good practice include: the Voluntary Principles on Security and Human Rights, the Amnesty International Human Rights Principles for Companies, Global Sullivan Principles, Ethical Trading Initiative, etc.

**Employees and their representatives:** trade unions and workers' councils campaign for the raising of labour standards and the ethical conduct of businesses.

**Governmental organisations:** a variety of government departments and agencies are responsible for the establishment of standards seeking to reduce the level of damage to society from activities or business behaviour. These are agencies that can have an impact upon an organisation. In the UK, for example, there are:

- Enforcement agencies such as the police, Serious Fraud Office, Office of Fair Trading (OFT), Trading Standards and Competition Commissions which try to keep criminal and unethical practices out of market places and societies;
- Industry regulators like the UK's Ofgem, Ofwat, Oftel and the newly invigorated Financial Services Authority (FSA), organisations that will become active when consumers are at risk from a company's activities; and
- Tax officials, like the UK's HM Revenue and Customs, can launch investigations by officials who may believe that a company is failing to make true disclosures of its tax liabilities.

**International governmental organisations:** the UN Norms are of increasing importance and the advice is to improve human resources risk management and the uncertainties of the world by companies:

- Adopting a proactive approach;
- Applying the UN Norms to their operations, and
- Learning from them.

**Journalists and other media:** reporting on the social implications and what is going on in society is a key method and the wider community can become knowledgeable about the changes occurring in society and the causes of these

impacts. There is also a role of researching and reporting on the ethical stances of the public.

**Local communities:** the elements of society that are close to organisations' operations can have a direct impact, i.e. rejecting planning applications for expansion, etc., but also indirectly as they will have a view of the organisation that will affect things like staff attraction and retention.

## Risk management best practice

Social and business ethical risk concerns an organisation's impacts on the social systems within which it operates. Social performance can be gauged through an analysis of the organisation's impacts on stakeholders at the local, national and global levels. In some cases these risks can influence the organisation's intangible assets, such as its human capital and reputation.

## Management structure

The organisation's approach to managing internal corporate governance (see Chapters 6 and 21–23) and indirect economic, environmental and social impacts from social and ethical risks resulting from its activities should include the following:

- Company/CEO statement;
- Adherence to codes of conduct;
- Organisation-wide policies;
- Major programmes to improve performance;
- Internal communication and training;
- Performance monitoring; and
- Internal and external auditing and senior management review.

Ethical policies include:

- Codes of conduct;
- Communication of standards through training;
- Methods to encourage employees to report possible violations to management;
- Enforcement mechanisms through investigation and discipline; and
- Oversight and review to achieve ongoing improvement.

## Social and ethical management systems

The financial benefits of social and ethical management systems have not been clearly proven yet. Most are still in their development stage. This chapter reviews the systems deemed relevant to managing the associated risks. They are mostly voluntary guidelines on managing and reporting on social and ethical issues, as well as the environmental and health and safety management systems discussed in other chapters. Organisational cultural risk management systems are discussed in the next chapter.

## Reporting the benefits to stakeholders

There are numerous, although presently unquantified, benefits from communicating effectively with stakeholders. Business partners, suppliers, customers, employees, financiers and governmental organisations want to hear that the organisation's risks are understood and effectively managed. This should occur at a number of levels of engagement, including internal marketing. However, at present large companies use their annual report to convey their progress. A stakeholder analysis model is reviewed in Chapter 9.

## Social and business ethical risks

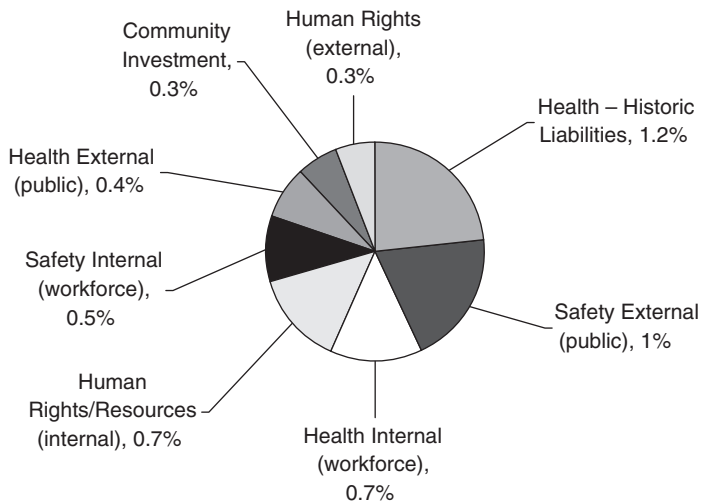
### An overview of the risk issues

Analysis indicates that indirect social, cultural and ethical risks are more of a financial threat to organisations than direct risks, at 5.1% (of net risk to value):

- The average exposure to social and ethical risk for the top 500 EU and US companies is 5.1% of market capitalisation (the net risk); and
- This risk exposure has been reduced from 9.0% of market value by good risk management techniques (the risk reduction/management factor).

### Categories of social, cultural and ethical risks

The chart below shows the total social and ethical risks broken down by category.



The following table shows the social, cultural and ethical risk categories by net risk to value.

<b>Social and ethical risk</b>	<b>Gross (inherent) risk</b>	<b>Net (residual) risk to value</b>	<b>Covered in</b>
Community investment/involvement	0.70%	0.3%	Chapter 12
Cultural risk	Not available	Not available	Chapter 13
Human rights/resources (internal)	1.20%	0.7%	Chapter 14
Human rights (external)	0.40%	0.3%	Chapter 15
Health internal (workforce)	1.50%	0.7%	Chapter 16
Safety internal (workforce)	1.10%	0.5%	Chapter 16
Health external (public)	0.60%	0.4%	Chapter 17
Safety external (public)	1.60%	1.0%	Chapter 17
Health and safety – historic liabilities	1.90%	1.2%	Chapter 17
<b>Total</b>	<b>9%</b>	<b>5.1%</b>	

A breakdown of the social and ethical risks by issue raises some interesting observations, with the highest risk seen to be those that are historic health and safety issues incorporating a large element of product liability issues at 1.2% of market value. The second highest risk issue, the safety of the public and customers, has increased in potential impact upon organisations and also involves product liability and safety issues, as well as protection from acts of vandalism and terrorism. Other risks that are external to the organisation in nature are community investment and involvement issues at 0.3% of value as are external human rights.

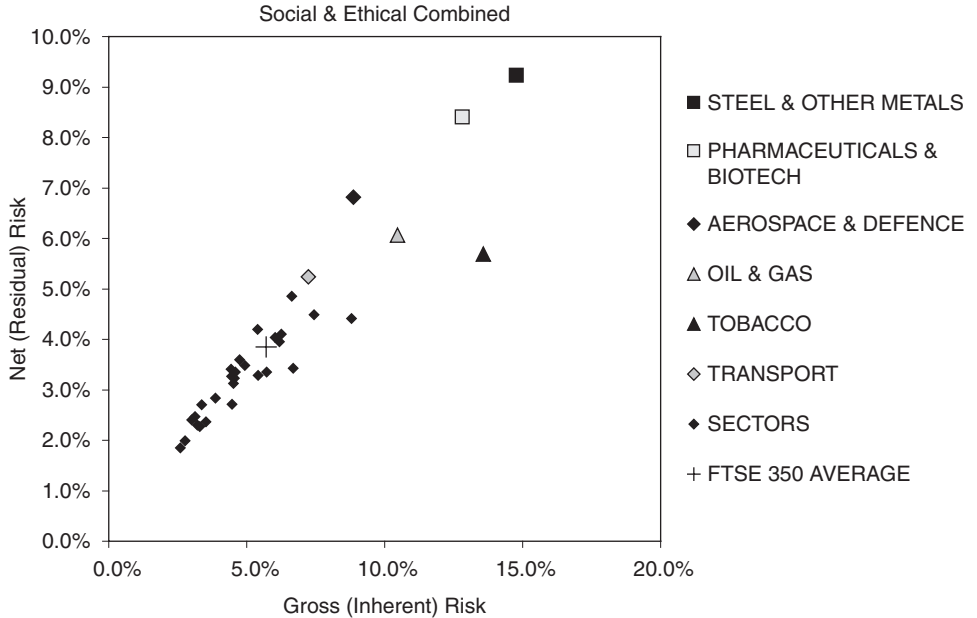
Risks internal to organisations are of a high impact with internal human rights issues and internal workforce health issues both being a 0.7% average risk to value, with staff safety issues accounting for a 0.5% of organisational value.

Risk categories that have an ethical perspective but are covered in the economic risk section of the book are: the unrestrained use of corporate power; illegal activities like economic crime, bribery and corruption; as well as the often contentious use of technology, like animal testing (which certain elements of society deem unethical while others approve as a necessity).

## Social and ethical risk overview by sector

The graph below indicates the sectors with the highest net risk from social and ethical issues.

An initial consideration is that there are few companies that comprise the steel sector in this study, so the results are skewed. The pharmaceutical risk largely lies in the countries in which the main companies are operating, and also the nature of their products – profiting from treating illnesses that many observers believe should be done on a not-for-profit basis, animal testing, product trials and recalls. The counterbalance to this is that their products could also be said to have a large ethical impact as well, preventing deaths and relieving pain and suffering. The aerospace and defence sector is a sector which a lot of people object to on ethical grounds as it profits from making products that



are designed to kill; there is little recognition of the separation of products used for defence and those used for offensive purposes. The oil and gas sector is often located in areas of turmoil and conflict and this can leave these companies with great ethical dilemmas that are well covered by the media.

## Analysis of social, cultural and ethical risks

### Community involvement/investment risks

As a result of SERM research, the following results were obtained:

- Lack of community involvement risk is 0.3% of market value for the top 500 EU and US companies; and
- This risk exposure has been reduced from 0.7% of market value by good risk management techniques (the risk reduction/management factor).

Companies benefit from the society in which they operate and as such are expected to make contributions to its development. This is often also referred to as the licence to operate. Companies that repatriate all their profits back to an external country are more likely to be viewed negatively, and be subject to labour unrest and consumer boycotts. The benefits of programmes related to community investment (CI) or cause related marketing (CRM) can be substantial, and not just from the perspective of reducing risks and negative news

potential. An example of how stakeholders can view organisations' positive community investment activities can be seen by the following quote from UK Prime Minister, the Rt Hon. Tony Blair MP:

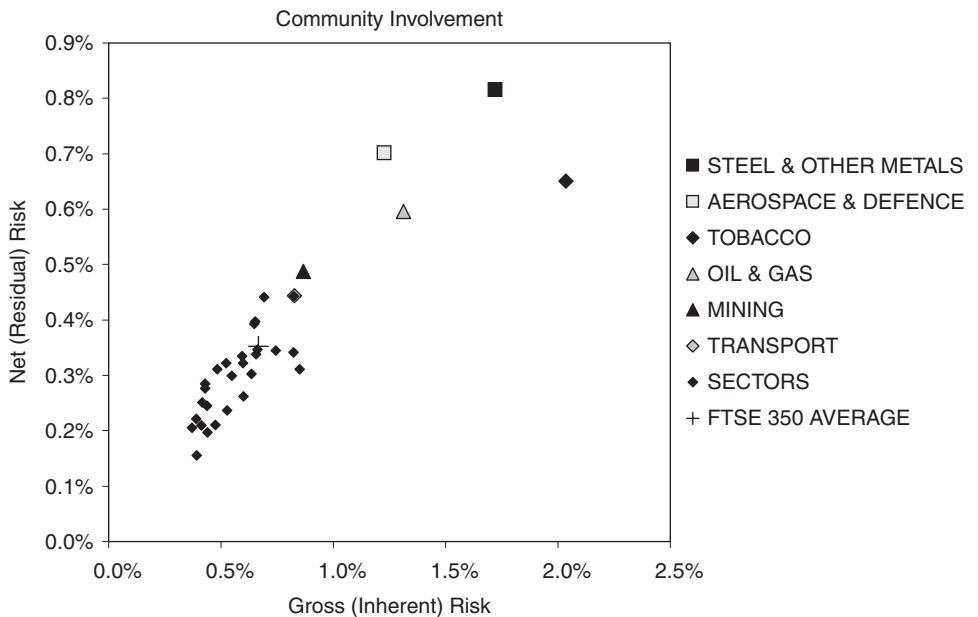
Your involvement in the communities in which you do business is more than an act of charity. Involvement in the community is about giving better definition to the purposes and practices of business in the modern world.

Cause related marketing and other community-related marketing activities are discussed in Chapter 10.

Evidence of the following community involvement can be seen as positive:

- Dialogue with community stakeholders;
- Work placement schemes for local youth;
- Preferential employment for local community;
- Annual time allowance for employee involvement in charity or community schemes;
- Regular donations to charity, civil society and other groups;
- The economic benefits of job creation and training; and
- The protection of the indigenous cultures of work locations.

The following graph shows the social and ethical risk (net) from lack of community involvement by sector.





## Case studies

### Community involvement/investment risks

Positive case studies include any examples of organisations engaging in community investment:

- The London Benchmarking Group (LBG) is a group of over 100 companies around the world who have developed a model to corporate community investment (CCI). Members include multinationals such as HSBC, Vodafone and Turner Broadcasting, as well as major local companies in several countries (see <http://www.lbg-online.net>). They work together to:
  - Benchmark and share best practice;
  - Develop and refine measurement tools; and
  - Improve management and implementation of CCI projects.
- Brewer and soft drinks firm SAB Miller's research identified a local crop, sorghum, as suitable for brewing good quality beer. However, poor farming techniques and undeveloped infrastructure meant that supply levels were low and of poor quality. Therefore, SAB Miller subsidiary, Nile Breweries, created a programme offering technical assistance and finance to small-scale producers. After several years of investment and nurture, this has created a stable supply base of more than 3500 Ugandan local farmers. The result is that Eagle Lager is Nile Breweries' most successful brand, farmers and their families have more sustainable livelihoods, and local communities enjoy a positive knock-on effect of more jobs and spending power;
- Cadbury Schweppes runs the WaterAid partnership aimed at improving access to safe water in Ghana. Evaluation has shown measurable impacts which include freeing up time for work and a reduction in health costs;
- Diageo, the UK drinks group, has run a programme for 10 years called Tomorrow's People. A recent evaluation of Tomorrow's People showed that by helping more than 380 000 people out of long-term unemployment, it saved the UK economy around £450 m through benefits payments saved, additional tax receipts, reduction in health expenditure and reduction in crime;
- Help the Aged in Wales has a list of firms they say are promoting age-positive policies. Locally, they include Asda, B&Q, Marks and Spencer, Safeway, Sainsbury, Tesco and Westbury Homes (*South Wales Evening Post*, 26 January 2004, p. 15);
- David Wilson Homes provided £70 000 so that traffic calming could be introduced on roads in a village where they were planning a housing development (*Leicester Mercury*, 14 February 2002, p. 7);
- Wilson Bowden has trained children close to their developments to stay off building sites as part of a safety initiative. David Wilson Homes have also produced a safety booklet to educate children of all ages about the seriousness and consequences of playing in an active building area (*Liverpool Echo*, 2 May 2002, p. 73);
- Centrica plc (owner of British Gas) has developed an extensive community policy which had key priority areas for involvement. Centrica have developed

a wide definition of what they consider as the community in which they operate. They view all stakeholders as an integral part of their business success:

Stakeholders are people or groups of people who use our services, who supply us with goods, who work for us, who own our shares or who have an interest in Centrica and the way we work.

The group have developed a wide range of community programmes; many encourage the efficient use of energy in the wider community and schools in particular. This sits comfortably with the corporate image they wish to portray and has had a bottom-line benefit to the company as they estimate it has helped retain hundreds of thousands of customers who approve of their approach.

The primary benefits of British Gas's community projects have been listed as:

- Insulated 1500 homes belonging to vulnerable older people, thereby improving living conditions and reducing energy consumption;
- Funded six Help the Aged advice workers;
- Donated £1.5 million in 1999 and a similar amount in 2000;
- Raised £800 000 through fundraising from customers;
- Raised over £220 000 from British Gas employees to date; and
- Helped raise more than £1 million through the Heating or Eating Appeal.
- This partnership is also helping to insulate community buildings and is promoting liquid gas powered vehicles for community groups for their environmental, economic and safety benefits.

## Cultural risk (see Chapter 13)

Organisational cultural issues and cultural due diligence (CDD) are covered in the next chapter. Issues like cultural clashes when mergers occur, outsourcing and offshoring are discussed having regard to the relevance to today's business culture.

## Human resources risk (human rights inside the workplace) (see Chapter 14)

Results relating to human resources show that:

- Poor human resources (internal human rights) risk accounts for a potential loss of business value of 0.7% for the top 500 EU and US companies market value; and
- This risk exposure has been reduced from 1.1% of market value by good risk management techniques (the risk reduction/management factor).

## Human rights risk outside the workplace (see Chapter 15)

Research and analysis results indicate that:

- Human rights (external) risk is 0.3% of market value for the top 500 EU and US companies; and

- This risk exposure has been reduced from 0.4% of market value by good risk management techniques (the risk reduction/management factor).

Assessment of a company is based on the extent to which the management implements its policies to protect employees from the following abuses:

- Child labour, as defined by the ILO Convention 138;
- Forced and compulsory labour; and
- Unethical disciplinary practices.

## Health and safety in the workforce (see Chapter 16)

### *Internal health risks of the workforce*

Research indicates that:

- Internal health risk is 0.7% of market value of the 500 top EU and US companies; and
- This risk exposure has been reduced from 1.5% of market value by good risk management techniques (the risk reduction/management factor).

### *Internal safety issues of the workforce*

Results indicate that:

- Internal workforce safety risk accounts for a loss of 0.5% of market value of the 500 top EU and US companies; and
- This risk exposure has been reduced from 1.1% of market value by good risk management techniques (the risk reduction/management factor).

## Health and safety of the public and customers (see Chapter 17)

### *External health risks to customers and the public*

Results indicate that:

- External health risks to customers and the public is 0.4% of market value of the 500 largest EU and US companies; and
- This risk exposure has been reduced from 0.6% of market value by good risk management techniques (the risk reduction/management factor).

### *External safety issues: general public and customers*

Results indicate that:

- External safety risks are 1.0% of market value of the 500 top EU and US companies; and

- This risk exposure has been reduced from 1.6% of market value by good risk management techniques (the risk reduction/management factor).

### *Historical health liability risks*

Results indicate that:

- Historical health liabilities risk is an average of 1.2% of market value of the top 500 EU and US companies; and
- This risk exposure has been reduced from 1.9% of market value by good risk management techniques (the risk reduction/management factor).

### **Chapter summary**

Consideration of the issues covered in this chapter will help provide support for the development of a sustainable ERM/sustainable and economic risk management system (SERM).

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13

Social and cultural risk management

# 13

## Social and cultural risk management

### CHAPTER OVERVIEW

There are many lengthy publications, manuals and books that address the vital matter of corporate culture. Clearly the comprehensive treatment of such a topic cannot be attempted in this chapter. Instead, as with some other chapters such as Business Interruption and Risk Management (see Chapter 8), selected aspects will be mentioned and prioritised in accordance with the theme and discussion of risk management and corporate governance. Moreover the topical area of outsourcing or off-shoring (mentioned also in Chapter 7) is discussed more fully having regard to the relevance to today's business culture. It should also be noted that much of what has been said in most of the earlier chapters could be described in terms of ongoing and proactive sustainable risk management.

### Background and key concepts

In the context of this discussion at its most basic level, a risk is anything which could prevent an organisation from achieving its business objectives. Those objectives, and the risks that affect them, will apply at different levels, from high level objectives of financial performance and corporate reputation, to the specific objectives relating to particular business units, functions or projects.

It is well understood that the management of risks in a consistent manner requires an understanding of the level of risk which the organisation is prepared to tolerate – in other words, the appetite for risk. This is a key consideration, and will set the basis on which possible responses to risk will be evaluated. The appetite for risk may be driven by a number of different factors:

- The expectations of stakeholders such as shareholders, investors, customers, employees and management in relation to uncertainty and potential adverse consequences;
- The expectations of stakeholders in relation to the organisation's ability to profit from uncertain events and opportunities – in other words, how 'entrepreneurial' the business is expected to be;

- Brand values and market profile;
- Previous experiences in dealing with unexpected events;
- The volatility of the markets in which the business operates;
- The approaches and positioning adopted by competitors; and
- Cultural issues, such as national perceptions of risk and expectations as to how they should be addressed.

An organisation's appetite for risk can be a means of distinguishing it from its competitors, and the adoption of a transparent risk management approach can be a way to demonstrate that difference.

At a strategic level, tolerance of risk will usually depend on the types of risks involved. For example, health and safety issues and regulatory compliance should usually be regarded as matters for which risks should be reduced to a level which is as low as reasonably practical. Conversely, there may be a higher tolerance for adverse financial performance in relation to specific activities, particularly where this may be balanced by the potential for a corresponding 'upside' or a portfolio of other activities.

Similarly, risks arising in relation to lower level business objectives will need to be reviewed separately to assess the tolerance to risk as well the possible effects on higher level objectives.

*A good strategy: part of organisational culture*

There is a story, allegedly true, about John F. Kennedy visiting NASA in the 1960s. The President met one of the employees and asked the man what he did. The man responded, 'I'm helping to put a man on the moon.' The press were intrigued by the response and made an effort to find out what the man's job was. It turned out that he was a janitor.

This is an excellent example of an organisation with a very successful strategy – a clear mission, communicated to all staff and with staff highly motivated to deliver.

## What is strategy?

In order to understand why strategy is important, we clearly need to define what it is (and is not). Strategy is about figuring out:

- Where the organisation wants to get to;
- Planning how to get there; and
- Implementing the plan.

When figuring out strategy, a company needs to take into account many aspects of its business and its environment including its potential customers, its competitors, its own competencies and skills and legal implications. Depending on the company's size and business line it may need to take into account other considerations such as the political and economic environment.



Coming up with the plan is only part of the problem. Arguably the most difficult part of strategy, where most companies fail, is in the implementation.

It is extremely important to emphasise that strategy is *not just a document*. Time and again, companies put significant amounts of time and effort into creating strategy documents, only to put them in a drawer and forget about the contents. If this is the strategy for the organisation then it is highly likely that many people, if not everybody in the organisation, needs to know about it – to be talking about it, basing decisions on it, acting accordingly.

An even more fundamental mistake is where the business strategy is kept ‘safe’ and restricted to a few staff for fear of the competitors getting hold of it. If the strategy is not shared with staff then the strategy is irrelevant because there is very little hope of it getting implemented.

## The strategic process

The strategic process can be broken down into four broad areas, although these will overlap in many organisations:

- First, a company needs to decide on its *intentions*. The intentions may be created by one person, a special strategy group, the board or an outside consultant. These intentions may be written down in a 60 page document. Equally, they may be represented by a few sheets of paper or even just stored in the leader’s head. The key aspect is that there is a *clear intention* about the desired future state of the company in, say, three years’ time which is shared by key members of the leadership team. The ‘intention’ might include:
  - New markets entered;
  - Strategic partnerships formed;
  - New channels to market created;
  - Profits;
  - Revenue;
  - Types of customers being served;
  - New customer service approach; and
  - Products and services offered.
- The second part of the strategy process is for a company to plan how it is going to achieve its intentions. If the intentions are at all significant, the chances are that every person in the organisation will have a role to play in helping the company to achieve its intentions. Every person throughout the organisation is taking actions daily which could be helping or hindering the effort to reach the desired future state of the company. The implication of this is that every person in the organisation needs to have the knowledge, the skills and the motivation to play their part in delivering the strategy.

For example, consider an international manufacturing company with its head office in Australia, a factory in China and a sales and marketing team in the UK. In the absence of a clear strategy and plan, the UK office may be marketing to a high end of the market, while the factory has taken decisions to reduce the quality of product due to cost saving measures introduced by head

office in Australia. If the company has decided from a strategic perspective to target the low end of the market, this needs to be reflected in decisions taken throughout the organisation – sales and marketing, manufacturing, legal, etc. Of course, it is far easier said than done to get the whole organisation in line and delivering to the same goal. The company's processes and culture may require a significant shift in order to achieve strategic intent. Hence, a significant part of the planning process is to find ways to communicate with and engage the entire organisation.

Let us briefly turn to employee involvement in creating strategy. While consulting with people in the organisation is very time consuming and could be risky, there are powerful reasons for getting involvement from people throughout the organisation in creation of strategy. This is for two reasons:

- The intention or plan is of much higher quality – since there will be lots of knowledge held throughout the organisation that is not known by the few people creating the strategy; and
  - Human nature is such that people tend to buy in and understand changes that they have had some involvement in creating, hence implementation is often a lot easier if staff have been consulted during the planning stage.
- The third part of the strategy process is to actually implement the plan. Again, this is all about ensuring that every person in the organisation has the knowledge, the skills and desire to reach the intentions. In reality companies rarely end up where they intended. Senior managers can sometimes think that they have control over an organisation because they have a title that says so, but the reality is much more complex. Every decision taken in every meeting and every action that each person in the organisation makes can either be a positive force, towards helping the company reach its desired future state of being, or a negative force, creating inertia, or even pulling it in a different direction. An interesting way of thinking about this is that the direction that the company actually moves in is the sum of all the forces around the company. This is why strategy is so difficult to implement. How do you change the behaviour of every single person in the organisation from what they are doing today, to what they need to do to implement the strategy? Even if everybody in the organisation is positively motivated towards the intention, if the strategy is not understood by them in a very clear way, that is meaningful in the context of their own particular role, then the strategy will not get implemented.

Motivating staff is far too big a topic to cover here (see also Chapter 14). However, it is worth just pointing out something about the janitor in NASA. In his case, it is quite possible that he didn't actually need to know what the mission was in order to do the tasks required for his job, but knowing the mission clearly gave him a massive sense of pride and motivation, resulting in him doing his job far better.

- The fourth part of the strategy process is reviewing whether the company is actually moving in the right direction. This is frequently forgotten in organisations. If, six months or a year down the road, the company hasn't been making progress then it needs to ask itself why. The company may have been unrealistic in its original intentions. Alternatively, new information may

have come to light or an unexpected change in the market, requiring the implementation plan or even the strategic intention to be modified. In today's changing market, few organisations are likely to create and implement a three year plan without any change in between.

## Aligning strategy

The term 'aligning strategy' is often used; for example, you may hear the term 'aligning IT strategy and business strategy'. But what does 'aligning strategy' mean? Well, the best way to explain it is to give a bad example! A local shop used to have a sign up that said 'The friendliest store in town'. Admittedly, there were some friendly staff, but frequently when I went up to pay with a friendly smile on my face and a warm greeting, I would get nothing in response. No friendliness, just a grunt. So, this is an example of a misaligned strategy. The marketing people are operating on the basis that customers want friendly staff and that the store are supplying them. However, the human resources department and/or the line management clearly are not following this strategy. Most likely they are more driven by a cost-based strategy of recruiting cheaper staff.

So, an aligned strategy is one where each function in the organisation (marketing, sales, IT, product/service delivery) is trying to achieve the same ultimate goal. In complex and changing areas of business, such as IT, the business and functional strategy need to be created together – they inform each other. Amazon is a good example of where new technical capabilities enabled an organisation to create a new and different business model.

Good strategy, well communicated throughout the organisation, permeates the organisation and ultimately informs every single member of staff what they should be doing in their job. If a supermarket's strategy is based around 'pile it high, sell it cheap', then it needs to be communicated right through the organisation, so that the staff in the shop know that their main job is to focus on piling it high and keeping costs down. Another supermarket, meanwhile, might decide that customer service is the name of the game. In this supermarket the supermarket employs more staff and encourages employees to take time to help customers to find the products on shelves when they ask.

## Why is strategy important for your organisation?

Why is strategy important to an organisation? Well, maybe it's not. Strategy is *not* important if:

- The shareholders, the management and the staff are happy with current performance and want to continue in exactly the same way for a number of years;
- There is absolutely no change going on in your industry which might threaten the current business – e.g. no new competitors, no new regulation or legal implications, no change in customer attitudes, no economic change; and

- The shareholders, the management and the staff are willing for the company and income to slowly decline – there is much evidence that organisations without ambitious goals tend to shrink.

If, however, the organisation wants to change and grow in the next two years or there is any potential change to the status quo, then strategy is important. Organisations are far more likely to survive and thrive if they have a clear intention of where they want to get to and they start taking actions today which will take the organisation towards its vision.

## How to create and implement strategy in organisations

Creation and implementation of strategy is a large topic, indeed it is the subject of many text books, so it cannot be done justice here. However, here are some pointers.

Strategy does not have to be a 60 page business plan that takes months to write. Lengthy business plans are appropriate in some circumstances – for organisations wanting funding, for example. If a company is writing a business plan, then it is extremely important to understand why they are writing it – is it to clarify their own business thinking, to create an action plan for the coming year or to give to an external audience? One document will not necessarily serve all purposes.

As has been stated a number of times in this chapter, strategy is about having a clear, shared intention of the desired future state of being and of what the organisation needs to do to get there. In some cases, it can even be done and stored in the leader's head. I have met a few leaders who are extremely clear about where they want the organisation to get to and who will drive the whole organisation using the vision in their head. However, in my opinion, this is an ability that not everyone has and the majority of managers will be far more effective if they use more formal strategy processes.

There are three reasons for writing down the strategy in some form or other:

- First, the process of writing is an important part of clarifying the thought process and communicating, helping members of the strategy team to think through all the issues;
- Second, having a written plan gives the organisation something to drive its actions next week, next month and next year; and
- Third, how will the organisation know in, say, six months' time how much progress it has made if there is no written record?

So, a short written plan is highly desirable – maybe just a few pages outlining the strategic intention and the key action points. The advantage of a short plan is that it is easier to update as the environment changes (as it inevitably will).

Companies tend to create strategy in two ways:

- Where do we want to go next? This is the default way of creating strategy. This happens daily in organisations, where decisions are taken one at a time; and
- Where do we want to be in, say, three years' time?

The second option is far more powerful than the first. The first is much more likely to take organisations down a dead end and does not open up the mind to long-term possibilities. Imagine if you were a supplier of steam engines in the 1950s. It wouldn't have been much use having a strategy that was about building bigger and better steam engines. Instead, it would be better to look forward and say – in ten years' time the steam industry will have declined, so we want to be a manufacturer of diesel or electric trains. How do we start to put in place the changes needed to make this transition?

To answer the question 'where do we want to be in three years' time?' it helps to answer the following first:

- Where are we now?
  - What are we good at? What skills do we have? What resources and contacts do we have? Often, the true strengths of a company will not be the obvious ones and it can take some unpacking to find a company's true source of competitive advantage or potential competitive advantage; and
  - What resources, skills and contacts do we lack? What are we poor at?
- What is going on around us that could influence our choice of course: competitors, regulation, economics, opportunities, threats, etc.?

The management team might delegate some investigative work to collect this information to one member of the management team, to a consultant or a strategy department. However, we believe that the answer to the question 'Where do we want to be in three years' time?' is far more likely to be acted on if all of the key management team have involvement in shaping the answer. Only this way will all the organisational issues really surface and buy-in really achieved for all key players. A strategic intention that is created by one member of the management and presented to the rest for comment is much less likely to get implemented.

Once the organisation has decided its strategic intent, the next step is to create a plan to achieve those intentions. The plan needs to cover all aspects of the business from a high level:

- Attracting and retaining appropriate customers;
- Attracting and retaining appropriately skilled staff;
- Product or service delivery; and
- Legal planning, etc.

Often, at this stage the company may not have all the answers that it needs. For example, what sort of skills do we need to enter the Chinese market? The important point is that the plan includes an action to find out what skills are needed to enter the Chinese market.

Mechanisms for driving the strategy throughout the organisation need to be put in place. One of the most difficult things to do that the action plan needs to address is getting buy-in throughout the organisation, especially if it requires a significant change to staff or if people are demotivated to begin with. One of the most powerful ways to get buy-in is to get the people who are going to do the work involved in decision making for the action plan.

When it comes to implementing strategy, the strategic intent needs to be highly visible to all in the organisation. People need to be aware of it as they go about their daily work – making decisions, producing product and communicating with clients, colleagues and suppliers. Regular management team meetings need to be largely focused on driving the strategy through, rather than focusing on a constant stream of fire fighting as happens in many organisations.

## Strategy review

It is highly likely that at some point something in the company or market will change, maybe a new opportunity or a new threat. The strategy may need to be reviewed on an ad hoc basis. The management meeting is a forum for bringing up new information so that the management team can review the situation and make a decision. The outcome may be that the change is not significant enough to warrant a change in strategy and a decision is taken to carry on with the existing strategy. Alternatively, it may warrant a change.

A formal mechanism for reviewing strategy on an ad hoc basis is desirable since it prevents the situation where a company de facto diverts from its strategy, as typically happens when 60 page strategy documents are written then consigned to the bottom drawer.

### *Strategy*

Strategy is about having a clear intention about what you want to achieve and then setting out to achieve it. If you have ambitions for your business then you need a strategy.

It has already been clearly shown above that the success or failure of a business depends very much on the quality of the decisions it makes. Decisions are made by everyone within the organisation at all levels and range from those involving strategic direction, major investments or acquisitions to those evidently simple tactical judgements made on the shop floor of the business. It has already been seen also that a brand is more than a product – it is a promise. No matter how globally aware consumers become they will always want to carry out business with brands they know and trust – brands that fulfil an actual or implicit promise made by the company. The key to the promise is the most powerful word in branding today: trust. Building and nurturing brand trust have never been more important than now in the climate of suspicion of corporate behaviour. In addition, with competing marketing messages, brand pollution and consumer's propensity to shop around for the best price mean that familiarity and brand awareness are ever more precious. They are critical to building and maintaining sustainable success. The approach to all of this reflects the culture of the business.

## Decisions and risk management

All decisions present different levels of risk: sometimes the risk will be obvious and the decision maker will consider the risk formally or intuitively. At other times the risk will not be so evident and therefore will not be taken into account or prioritised. Clearly in the context of cultural due diligence, one challenge is how to get risk management integrated within the decision-making process so that risk is considered as a normal part of business and its internal due diligence. In this discussion of cultural due diligence it is intended to focus on the importance of risk management being part of that culture to enable successful business alliances. Creating a culture with the objective of ‘no surprises’ does not mean that the company becomes risk averse. Rather, it is free to take risky decisions with comprehensive and intelligent knowledge of what the risks are.

According to many risk managers a managed risk culture can be defined as creating an environment that:

- Enables people to take more effective decisions;
- Allows risks to be fully understood so that calculated risks can be taken; and
- Encourages employees to consider the consequences of decisions and actions that they take.

It is true to say that such a risk management culture can be positive for the generally perceived culture of the business, as well as its brand/s and its reputation.

As has been discussed when considering reputation in Chapter 6, a risk management tool is of particular use to the director of corporate communications because it provides a comprehensive and scientific basis on which to argue for increased focus on reputation management strategies. Given the constituent parts of the overall reputation story – brand, vision, values, media, public affairs and public policy, compliance, governance, regulation, corporate responsibility – a framework for improved coordination of the reputation management strategy is important. The tool is also valuable to the risk director since it provides hard data for inclusion in the company risk register, where it is possible that no entries have been made before, either in terms of categorisation or value. It will also become vital to the company secretary for reasons referred to in Chapter 21.

A value for intangible assets, and related values for the component parts, is of tremendous importance in today’s business climate. The brand and the culture of a business are intangible assets that are of utmost value, yet rarely taken into account. Taken together, the increased visibility which results from the valuing of intangible assets, and the improved understanding of what is necessary to control, mitigate and eliminate the risks associated with a decline in asset values, should lead to strengthened risk management, reputation management and financial modelling procedures. The innovative approach also presents the opportunity to refresh and redefine key parts of business process such as:

- Improved techniques for risk and reputation management;
- The mitigation of threats/disaster recovery planning and crisis management;

- The sourcing value chain and other partnerships; and
- Alignment and incentives for all betterment initiatives, e.g. corporate governance.

More powerful applications of the tool relate to issues such as:

- The implications for strategy;
- Articulating and communicating the corporate character and personality of the company;
- Stakeholder engagement and management by the alignment of internal behaviours and external expectations; and
- Change management programmes.

Broadly speaking a brand is regarded as a particular product or a characteristic that identifies a particular producer. To be a successful brand one of the most important issues facing the board – and the marketing director specifically – is to establish a customer-driven corporate culture. Cultures can motivate and stimulate companies and increase productivity and profit. A positive culture – especially one that espouses CSR and many of the features described in the context of enlightened corporate governance – can be invaluable. Creating a sustainable marketing culture has been described as one of the hardest tasks facing business. It requires:

- Proper training and education;
- Sharing of good practice;
- Awareness and commitment on all levels; and
- Excellent corporate communications.

Marketers of a business also have to think and act as brand champions. Brand strategies include the consideration of the following questions:

- Has a clear philosophy on the corporate brand evolved?
- Has there been a thorough investigation of the brand portfolio?
- Has it been established which brand needs boosting – perhaps by buying brands – which needs extending and which needs pruning or selling?
- Has the management of the brands been incorporated into the organisational structure?
- Is there a logical system for brand naming?
- Has the company tried to establish a financial value for its brands?
- Have the local nuances in new markets been thoroughly investigated to try to decide which brands can travel?

In terms of corporate culture certain questions can form an initial checklist that can impact on several departments:

- Is there a defined strategy for changing the corporate culture?
- Has a corporate identity programme been carried out in place of noticeable corporate cultural change?
- Is there real communication in the organisation or do employees tell superiors what they want to hear?



- What is the first impression from the reception when calls are answered?
- What is the role of the marketing director?
- What is the role of marketing beyond spending on advertising?
- Has restructuring been considered to integrate marketing with sales?
- Do the various departments know what the others do?
- Is there a philosophy of moving staff around to perform different functions?

Change in culture must be focused on:

- Employees;
- Leadership style; and
- Organisational processes and functions.

## Strategic alliances

Bearing in mind those issues of brand and culture, the business world has witnessed many strategic alliances as a way to secure competitive advantage, share costs, leapfrog into new markets or protect existing ones. Such alliances can appear in a variety of forms, from full-blown mergers and acquisitions or joint ventures to cooperation agreements in areas such as licensing, technology and RT&D agreements, long-term buyer/seller agreements and market alliances. They can provide positive advantages, by helping companies to:

- Gain competitive advantage with less risk and expense than going it alone;
- Gain economies of scale from partners in the same sector;
- Share development costs;
- Swap technical know-how;
- Gain a wider presence – this being useful when takeover targets are scarce;
- Overcome cultural and language barriers;
- Enter complementary product lines; and
- Enlarge distribution reach.

Change management is another significant area that requires ongoing business focus. Change has become a constant theme of business life. Cultural, social, technological and economic and political changes are occurring at an accelerated pace. Every day we see different products as a result of competition, new methods as a result of e-commerce (see Chapter 11) new markets as a result of globalisation and different customer needs. The business has to try to cope with these changes by establishing new organisational structures, re-engineering, alliances, mergers, holistic takeover, acquisition, joint venture and so on. Therefore business managers should be alert to all changes in order to meet them effectively. The change in the business environment is creating many new challenges which businesses will have to anticipate and meet effectively, to align their business with changing markets and customer needs. Some of the significant challenges have been represented by 5 Cs: competition, change management, complexity of business, control needs and creativity. In order to manage the issues effectively, efficiently and effortlessly it requires a drastic cultural shift in the way that we approach business.

Not only should business therefore develop a proactive culture as part of its ongoing cultural due diligence, but also it should seek a similar approach in potential business partners and business transactions.

## **Culture clash in mergers and acquisitions (M&A): risk mitigation**

Comment has been made regarding the high failure rate of M&A post-completion despite the traditional due diligence processes. The research data on why some 55–77% of mergers and acquisitions fail in meeting their intended results is absolutely clear; the failures are overwhelmingly attributable to ‘culture clash’ which occurs as attempts to bring the two organisations together are made. This makes merging the two organisational cultures or establishing a new culture for the merged organisation extremely difficult, if not impossible. It is important to understand:

- How to avoid the culture clash, which has been shown to be the major cause of M&A failure; and
- What to do post-merger when expected results have not occurred.

In those instances where the organisations are merged, the ongoing direct and indirect costs of unresolved ‘culture clash’ issues are high, and require the merged organisation to focus on internal issues and problems rather than on the marketplace, the customers and the competition.

## **Cultural due diligence**

The cultural due diligence (CDD) process is a systemic, systematic and research-based methodology for significantly increasing the odds of success of mergers, acquisitions and alliances. It is an until-recently overlooked parallel process to the traditional financial and legal due diligence that is considered absolutely essential to any merger or acquisition.

The CDD process is proactive problem solving in advance. By assessing the characteristics of both organisations’ cultures as soon as possible in the merger process, potential culture clash problems can be predicted, prioritised and focused on in a comprehensive cultural integration plan. Such a plan will guide the integration of the two cultures, or the building of a new culture for the merged organisation in full consideration of the cultural issues and landmines that are a part of the terrain. Bearing in mind the failure rate and the costs involved in every way, cultural due diligence is at least as vital and necessary as traditional legal and financial due diligence in providing an informed basis for executive decision making and planning, and perhaps more so in increasing the odds of success of the merger or acquisition.

Cultural due diligence involves sound leadership and management. It offers decision makers in both organisations:

- Comprehensive, data-based predictions of culture clash problems that will occur within the merger process;

- The relative priority of those problems; and
- Recommendations on how to eliminate their cause or minimise their impact before they occur.

The results of the research in this regard are clear: cultural due diligence is overlooked at the peril of the success of the merger or acquisition.

It is therefore also important that a business develops a positive proactive culture as part of its ongoing due diligence and corporate governance practice before any transactional issues are raised.

## The CDD process

It is important to bear in mind that organisational culture is critical to organisational effectiveness. Also managing the culture is vital to successful business operation. This is particularly important in times of large-scale change (see above), such as an acquisition or alliance. Fiduciary responsibility and due diligence require careful examination of the cultural aspects of any acquisition as a major component of the ability to actually run the operation and achieve the potential synergies.

As in the case of any sound organisational research the CDD process employs both qualitative and quantitative data collection, and includes:

- Interviews;
- Focus groups;
- Workplace observations;
- Documentation reviews; and
- Web-based CDD surveys.

One approach to analysing and organising CDD data is to group the findings within 12 domains of the CDD process, although the data can be organised around the key elements of the business plan, or in a manner that will be of greatest value to the two organisations.

## The model

When performing cultural due diligence it is necessary to gather operational and behavioural data on the relevant domains in both organisations; the one acquiring and the one acquired. Once data is collected from both organisations, this can be contrasted and compared, having regard to potential areas of conflict and/or misunderstanding and of synergy and leverage.

A brief description of each of the 12 domains follows. These descriptions provide a general sense of each area and are not meant to be definitive.

1. **Intended direction/results:** ascertain, from the top of the organisation to the bottom what the company intends to accomplish. What is the business plan about, what is the intent and purpose of the organisation, what results are expected from the business activity of the organisation, and, most importantly, how are these things talked about, described and communicated?

2. **Key measures – what the company measures, why and what happens as a result:** the key measures say a lot about the manner in which the company and its executives and staff are driven, particularly when you also consider the consequences for each measure. A comparison of key measures across the two companies is an important consideration and cultural indicator.
3. **Key business drivers:** what are the primary issues driving the business strategy? Is the focus on competitive edge and, if so, how is that defined – price differentiation, quality, market share, service, reliability or what? This demonstrates how the company views its industry and its subsequent efforts within the industry. If one company defines success in terms of total market share while another defines it as net profit margin, there is considerable room for disagreement around things like what actions are appropriate to correct unacceptable results, or deciding on appropriate new product offerings.
4. **Infrastructure:** how is the company organised, what is the nature of the reporting relationships, how do the staff systems interface with the line systems? What is the nature of the relationship between groups and units in the organisation?
5. **Organisational policies and practices:** what formal and informal systems are in place and what part do they play in the daily life of doing the work? How much flexibility is allowed at what levels in which systems? What is the relationship between political reality and business reality?
6. **Leadership/management practices:** What is the balance between leadership and management approaches with staff? What basic value systems about employees are in place? How are people treated and why? How does the business plan get implemented through the management system? How are decisions made? Who is involved in what, and when?

There are clear behavioural differences between management and leadership functions and both are clearly important in running a successful business. The issue is around which approach is predominant in each area/department of each company. This domain relates primarily to the middle management group but has obvious impact on the next area.
7. **Supervisory practices:** what dynamics are at play in the immediate oversight of the performance of work? Supervisory practices have a major impact on employees' feelings about the company and the work they do. The nature of the interaction between the employee and the immediate supervisor is one of the primary tone-setters for the culture of the company.
8. **Work practices:** how is the actual work performed? Is the emphasis on individual responsibility or group responsibility? What degree of control, if any, does the individual worker have on the work flow, quality, rate, tools utilised and supplies needed?
9. **Technology utilisation:** both in relation to internal systems and equipment, as well as the services and products provided to customers. How current is the technology being utilised? What are people used to in relation to technological support/resources?
10. **Physical environment:** how do the workplace settings differ? Open work spaces versus private offices, high security versus open access, buildings,

furniture, grounds? All can have a bearing on how people feel about work and the company. Changes in these areas, particularly if it is perceived as arbitrary, can result in bad feelings for years.

11. **Perceptions/expectations:** how do people expect things to happen? What do they think is important? What do they *think* should be important versus what they believe the company feels is important?
12. **Cultural indicators/artefacts:** how do people dress and address each other? What is the match between formal work hours and actual hours spent working? What company-sponsored activities exist and what are they like?

These 12 domains cover the relevant issues of corporate culture. However, at least two areas commonly mentioned in discussions of corporate culture may appear to be overlooked, *values and beliefs*, and *myths, legends and heroes*. In actuality, data on these issues is imbedded in the 12 domains. By digging into each domain, underlying *values and beliefs* are uncovered. This is far more effective than simply asking a representative ‘What are the values and beliefs around here?’

The same is true of *myths, legends and heroes*. These are simply the anecdotal versions that give more direct and immediate meaning to the belief systems operating in the company. *Myths, legends and heroes* will present themselves as you delve into the 12 domains, but only if qualitative data gathering techniques are used.

## CDD deliverables

All of the data collected by means of the CDD process is carefully analysed and organised into a number of extremely valuable management tools to be used by executive and senior management in planning the integration of the two organisational cultures into a desired new culture of the merged organisation.

These tools include:

- Detailed cultural profile of both organisations;
- Perceptions of various constituencies of both organisations;
- Details about current culture and the merger;
- Specification of cultural similarities within the 12 cultural domains;
- Specification of cultural differences within the 12 cultural domains;
- Prediction, specification and prioritisation of ‘culture clash’ problems and their impact on the merger;
- Specific recommendations on avoidance and/or minimisation of culture clash problems; and
- Integration road map for implementation of recommendations.

Given this information and these management tools, key decisions can be made early in the merger process that will:

- Minimise culture clash problems;
- Facilitate the optimum integration of the two cultures; and
- Greatly increase the probability of success of the merger.

## Culture, strategy outsourcing and off-shoring: the Indian case study

For some time, the world has been talking about the ‘Indian BPO Success Story’ – which describes the business process outsourcing (BPO) industry that is growing at a phenomenal pace of 59% year on year and contributing nearly a quarter to the total IT exports revenue. Many strategy experts attribute this growth to the inherent advantages that India possesses, i.e. low cost base, vast English speaking population and a highly skilled labour force. Undoubtedly, cost savings due to labour arbitrage continues to be one of the most compelling factors for off-shoring processes to India. In addition to this, rising vendor sophistication, improved process and project management skills and quality standards have given India a pre-eminent position in the US\$275 billion global outsourcing market. However, the real challenge before India lies in its ability to maintain its strengths and build newer capabilities to tackle increasing competition from countries like Ireland, China and Israel, etc.

With the objective to chart a strategic road map for unhindered growth of this industry and to gauge the perception of Indian BPO service providers on various issues, ASSOCHAM conducted the First BPO Industry Confidence Survey in the months of May–June 2003. Coincidentally, this was also the period when domestic and international media highlighted the outsourcing backlash in the US, Australia and European countries and the possible impact it could have on the Indian BPO industry. This nationwide survey evinced a huge response especially from the BPO SMEs. Leading companies like eFunds International, Bhilwara Infotech, 24/7 Customer Access, Transworks, HCL BPO, ITI Limited and Indigo Lever also participated in this opinion poll. Overall, 160 CEOs responded to this survey.

### Research methodology

In planning this survey, the ASSOCHAM BPO Research Team implicitly accepted the potential, opportunity and drivers of the trend to outsource processes to India. The questionnaire survey was specifically modelled to study the underlying issues that could become future threats for this industry. Accordingly, the questions covered the following aspects:

- Short- and long-term impact of:
  - Slow pace of regulatory reforms;
  - Infrastructure bottlenecks;
  - Lack of streamlined approach for branding Indian BPO services;
  - Increasing competition from other countries with similar capabilities;
  - Increasing service level requirements;
  - Geo-political situation in subcontinent;
  - Rising attrition rates/other HR issues; and
  - US and European backlash against outsourcing.
- Level of satisfaction on the human resources and telecom infrastructure in India;

- Acceptability of the government policies/initiatives in this field;
- Future direction of the government's BPO agenda; and
- Overall confidence on the future prospects of this industry.

## Findings of the survey

The survey revealed the following results.

### *Short and long term impact analysis*

**The slow pace of regulatory reforms:** the members of ASSOCHAM BPO Steering Committee have recognised regulatory issues as one of the major concerns for Indian companies in this area. While the government has increased support to the IT/ITES industry, many industry experts point to the tardy pace of these reforms.

Industry opinions:

- Short to medium term (0–2 years) – moderate impact (50%); and
- Long term (2–5 years) – serious impact (54%).

The survey clearly showed that industry is concerned over the long-term implications of slow pace of regulatory reforms. Broadly, the policies/acts pertinent for this industry are:

- Information Technology Act 2000;
- Software technology park policy;
- Foreign investment policy;
- Venture capital investment policy;
- Overseas investment policies (M&A, ADR/GDR, remittance of profits, etc.); and
- Other fiscal incentives.

The government in consultation with industry associations should chalk out a time-bound plan that covers the various loopholes in the above-mentioned policies.

**Infrastructure bottlenecks:** availability and reliability of infrastructure facilities is still a cause of serious concern. However, the government is attempting to strengthen telecom infrastructure and build fibre-optic networks in city centres of software activity, as well as providing uninterrupted power supply. Much of these efforts have drastically improved power availability and telecom density.

Industry opinion:

- Short to medium term (0–2 years) – serious impact (86%); and
- Long term (2–5 years) – very serious impact (47%).

An overwhelming 86% of the respondents view infrastructure as a serious cause of concern in the short term. In the long term, the majority felt that poor infrastructure would have a very serious impact.

**Lack of streamlined approach for branding Indian BPO services:** industry experts have often suggested that India should have ‘umbrella brand’ for IT and ITES (information technology enabled services) industry. The marketing of India as a BPO destination until now has been mostly at the behest of service providers themselves. The industry/government partnership in this field needs to be strengthened. Currently there is lack of a streamlined approach on branding Indian BPO abroad.

## *Data protection laws in India*

One of the key aspects of outsourcing relates to the resolution of any concern that business partners should ensure that the culture is honoured. By way of example, the data protection laws of India must be understood.

Currently there is no statutory legislation in relation to data protection in India. Unlike the UK/EU countries, India has no codified Data Protection Act setting out the rules for processing personal information applicable to paper records as well as those held electronically.

The issue of privacy has, in a very limited way, been addressed under the Information Technology Act 2000 (IT Act). The IT Act provides protection from unauthorised disclosure of information by a person who has secured access to such information in pursuance of powers conferred under the IT Act. The provision is also limited to information accessed and passed on ‘without the consent of the person’ who the information relates to. The provision is thus extremely narrow in its application.

There is, therefore, a growing concern over the absence of data protection laws in India and the impact inadequate legal protection will have on personal data being transferred to India from the western world. Such concern (together with a host of other reasons) is also hindering Indian business process outsourcing (BPO) companies from gaining lucrative contracts in certain key segments such government tenders and contracts. The Indian government has, therefore, been facing tremendous pressure recently to enact an appropriate data protection law to ward off any adverse impact on the Indian BPO industry.

## *Need for such data protection laws*

Today, the largest portion of BPO work coming to India is low-end call centre and data processing work. If India has to exploit the full potential of the outsourcing opportunity, then it has to move up the value chain. Outsourced work in intellectual property rights (IPR)-intensive areas such as clinical research, engineering design and legal research is the way ahead for Indian BPO companies. In the absence of adequate data protection laws, Indian BPO outfits are finding it difficult to move up the value chain and risk being relegated to doing low end work like billing, insurance claims processing and of course transcription. Accordingly, the move up the value chain for Indian BPO entities will greatly be facilitated by enactment of an appropriate data protection law.



## *Data protection legislation*

Further, with the globalisation of business and ease of transfer of information, the requirement to protect the personal/sensitive data of Indians as a diaspora is also being felt. Today Indians who use mobile phones are regularly being inundated with unwanted advertisements, their email boxes are being flooded with unsolicited data and their personal information is being freely traded, or exploited by persons who possess it. Given the lack of an adequate data protection regime there is very little that an ordinary Indian citizen can do to prevent such exploitation.

## *Methods adopted to satisfy concerns over data transfer*

While the absence of adequate data protection laws in India is a serious deterrent, for data flowing into the country in connection with the off-shoring activities being carried out, Indian BPO outfits have alleviated concerns of their customers by attempting to adhere to major US and European regulations either by contracting to adhere to such regulations or by obtaining appropriate certifications.

Most Tier I BPO companies today have certifications that comply with regulations like the Sarbanes-Oxley Act, Safe Harbor Act, GLBA for Financial Services, FDCPA (Fair Debt Collection Practices Act), OCC regulations for banking and HIPAA for healthcare. While most laws and certifications are oriented around verticals, there are laws like the UK Data Protection (DPA) Act and the Sarbanes-Oxley Act, which are laws for data security across different industries. The requirements of such horizontally oriented legislations are overcome by contractual arrangements between the BPO vendor and their customers.

## *Change on the horizon*

A recent study has found that more than 40 countries around the world have enacted, or are preparing to enact, laws that protect the privacy and integrity of personal consumer data. India is not, however, one among them. Given the above stated concerns, enactment of appropriate legislation in other countries and the need for an adequate data protection regime being felt, it is becoming extremely important for India to enact the same if it desires to continue its leading position as the preferred off-shoring destination.

Recognising this need, since the turn of the century there has been talk of India enacting some sort of data protection regime. The first such action was initiated by NASSCOM (the apex technology body of India) when the trade body tried to push through a drafting exercise but it appears that the exercise has not been pursued further.

Recently, there has now been talk of the Indian government's recognising the urgency of the situation and to hasten the process, is considering an amendment to the Information Technology Act of 2000. It is still unclear what the

exact shape of the final legislation will be; however, it is expected that such legislation will be comprehensive. The amendment is expected to come into force later this year or early next year. However, whether or not such a legislation is introduced in the Indian Parliament or the shape such legislation will take will depend on the result of the ongoing elections in India, result of the pending legislations against outsourcing in the US and pressure by the EU to enact the same.

### *Shape that the proposed Indian legislation is likely to take*

It is very important to understand the fundamental purpose of any data protection law and existing regulations in other countries in order to comment on the shape that any proposed Indian legislation would take. The driving force, worldwide, for the enactment of data protection laws has been the protection of personal data and information of citizens and providing a framework that facilitates trade and commerce between countries, while not compromising an individual's privacy. There is no reason to conclude that in the Indian context it is likely to be any different – except that the over-riding consideration of enactment of a data protection regime is to ensure India maintains its pole position as the preferred destination for off-shoring activities.

According to the EU guidelines, EU countries may transfer personal data only after determining that 'the third country in question ensures an adequate level of protection'. It further goes on to provide that the EU shall consider the 'rules of law ... in the third country' to make this determination.

The EU guidelines are an outcome of the OECD guidelines of 1980 which list eight broad principles to be adhered to in protecting personal information of the citizens of the country. They are:

*(a) Collection Limitation Principle*

There should be limits to the collection of personal data and any such data should be obtained by lawful and fair means and, where appropriate, with the knowledge or consent of the data subject.

*(b) Data Quality Principle*

Personal data should be relevant to the purposes for which they are to be used and, to the extent necessary for those purposes, should be accurate, complete and kept up-to-date.

*(c) Purpose Specification Principle*

The purposes for which personal data are collected should be specified not later than at the time of data collection and the subsequent use limited to the fulfilment of those purposes or such others as are not incompatible with those purposes and as are specified on each occasion of change of purpose.

*(d) Use Limitation Principle*

Personal data should not be disclosed, made available or otherwise used except:

- with the consent of the data subject; or
- by the authority of law.

*(e) Security Safeguards Principle*

Personal data should be protected by reasonable security safeguards against such risks as loss or unauthorised access, destruction, use, modification or disclosure of data.

*(f) Openness Principle*

There should be a general policy of openness about developments, practices and policies with respect to personal data. Means should be readily available of establishing the existence and nature of personal data, and the main purposes of their use, as well as the identity and usual residence of the data controller.

*(g) Individual Participation Principle*

An individual should have the right to:

- obtain from a data controller, or otherwise, confirmation of whether or not the data controller has data relating to him;
- have communicated to him, data relating to him within a reasonable time; at a charge, if any, that is not excessive; in a reasonable manner and in a form that is readily intelligible to him;
- be given reasons if a request made under subparagraphs (i) and (ii) is denied, and to be able to challenge such denial; and
- challenge data relating to him and, if the challenge is successful to have the data erased, rectified, completed or amended.

*(h) Accountability Principle*

A data controller should be accountable for complying with measures which give effect to the principles stated above.

Given that the overriding concern for the proposed Indian legislation is to facilitate the growth of the nascent BPO industry, the Indian government can be expected to consider the above principles in enacting any legislation for data protection. Further, the predominant issue that the Indian legislation is likely to address is the protection of the foreign nationals' data, if transferred to the Indian subcontinent. Whether or not the proposed amendment to the IT Act will also cover data of Indian citizens is yet to be seen.

In view of the above, any Indian legislation is likely to put in place a mechanism that will protect against the misuse of personal data that is in one's possession rather than misuse of data that is in one's ownership and the various measures of adequacy that the proposed legislation is likely to address include:

- Widening the scope of data protection to include information collected from foreign citizens;
- Putting in place an obligation on both the Indian government and others to maintain the integrity of that data and providing for appropriate procedures (e.g. enforcement authorities) to ensure compliance;
- Restricting access to data of foreign citizens by statutory and regulatory authorities; and
- Making data theft and misappropriation a criminal offence.

Given the concern of personal data being transferred to India and the growing importance of the BPO industry to the Indian economy there is no doubt that appropriate legislation is required. The question that remains to be seen is what shape the regulations take and how soon consensus is reached to actually enact the laws that are undoubtedly needed in India. One way forward would be for business to deal with the issues in a proactive manner.

## Chapter summary

There is no doubt that cultural risk management – which affects also issues of brand and strategy – is a crucial aspect of risk management and should be considered as an ongoing issue as well as a transnational concern.

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14

Human resources risk (human rights  
inside the workplace)

# 14

## Human resources risk (human rights inside the workplace)

### CHAPTER OVERVIEW

Your employees, including managers and the executive, are the key to long-term success and sustainability. A skilled, well-trained, determined and motivated workforce can overcome just about any challenge the risk environment of the 21st century can throw at it. If treated with dignity, equality and with respect to their rights as humans your fellow employees will assist you to become a sustainable durable organisation.

The emphasis of this chapter is more upon the SERM approach to helping achieve this and a review of the newly emerging risk issues to do with human rights within the workplace like:

- \* Child and forced labour;
- \* Discrimination legislation covering age and disability discrimination;
- \* Freedom of association;
- \* Working hours, pay and conditions;
- \* Discrimination;
- \* Privacy of employees; and
- \* Whistleblowing as a right?

There is some coverage of the more traditional human rights aspects of human resources management, but it is felt that these have been covered in more mainstream management techniques case books. Health and safety rights are covered in Chapter 16 in more depth.

The aspects of human rights legislation that are outside the workplace or often involve subcontractors are covered in the Chapter 15, as is a framework for risk managing human rights issues.

### SERM risk overview

Results relating to human resources show that:

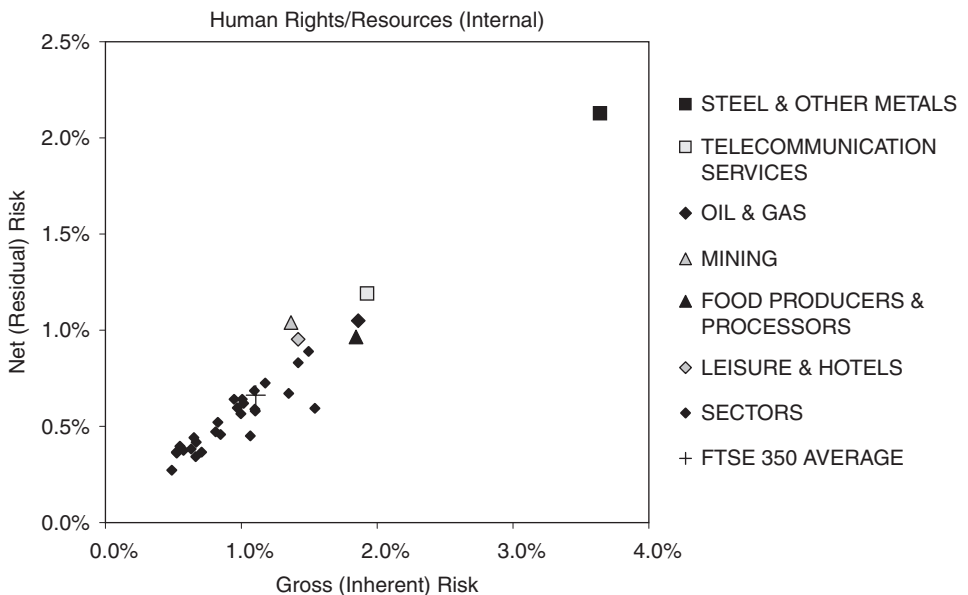
- Poor human resources (internal human rights) risk accounts for a potential loss of business value of 0.7% of the companies' market value (the average net risk of the top 500 EU and US companies); and

- This risk exposure has been reduced from 1.1% of market value by good risk management techniques (the risk reduction/management factor).

There are benefits to be accrued from a proactive policy on this issue:

- Trained workers are productive workers, and also have the skills to complete their tasks therefore avoiding additional stress and health risks (as explored in Chapter 16);
- Happy workers also make productive workers; and
- Reputation is particularly important when the labour market is tight.

The following graph shows the poor human resources (internal human rights) risk by sector.



## Key questions

- How do human rights internally affect risk levels?
- What are the risk management techniques that can improve human resources and the human aspects to the drive for sustainability and the development of a SERM risk system?
- How can employers balance the interests of external stakeholders with internal ones?



### *Terminology*

For the purposes of this chapter human resources risk is a term that is interchangeable with internal human rights and human capital terminologies.

- \* Human capital: the set of skills which employees acquire on the job, through training and experience, and which increase their value in the marketplace;
- \* Human resources: this refers to the individuals within the firm, and to the portion of the firm's organisation that deals with hiring, firing, training and other personnel issues. This article addresses both definitions;
- \* Human Rights Act: a piece of legislation that sets out individual rights and freedoms under law, this can be applicable to members of an organisation's workforce. Many countries have similar rights enshrined into law;
- \* Poor human resources management: extent to which the company's HR policies and practices are found wanting in terms of generating stress, discrimination, harassment, impact on employee privacy; and
- \* Internal human rights: the extent to which the organisation follows codes and legislation with relevance to traditional human resources regulations as well as discrimination, harassment and employee privacy.

## Overview

Every company is dependent upon its staff and management and it is unlikely that any organisation in the future will be able to function without staff. As Peter Drucker notes:

The organisation is, above all, social. It is people. ('Toward the new organisation' in Hesselbein, F. *et al.* in *Organisation of the Future*, 1997)

Indeed a sizable proportion of organisational value, in the form of intangible assets, is thought of as being the organisation's staff. Business writers like Charles Handy estimate that on average employees and intellectual assets are usually worth three to four times more than their tangible book assets (*The Hungry Spirit*, 1997). Research from the UK has confirmed the importance and causal linkage between good human resource management practices and productivity and profitability levels; the *Impact of People Management Practices on Business Performance* (Patterson *et al.* 1997) found that there was a 5% variance in profitability between those with the most satisfied and committed staff and those companies without these advantages.

Factors influencing human sustainability in the workplace, according to Paul Gollan in *Sustainability: The Corporate Challenge of the 21st Century*, Dunphy *et al.* (2000), are:

- Employee engagement, involvement and consultation: increased consultation with employees increases their sense of responsibility and other evidence

suggests that greater consultation and involvement of employees can produce a more satisfied and productive workforce as well as gaining more committed employees, thus producing real financial benefits;

- Career development and organisational learning: there is evidence of links between the level of investment in employees and stock market performance (Bilmes *et al.* 1997) from the Boston Consulting Group's review of 100 German companies. There is also evidence from the UK that those companies that have the Investors in People standard (IiP) have a 1% improved market value over base. Making an investment in staff can provide real business benefits. Investors in People organisations are reported to see a rapid improvement in their overall performance including:
  - Clearer links between operational plans and people development strategies;
  - People development focused on identified business needs;
  - Better understanding of the costs and benefits of developing employees;
  - An increase in employees' skill, competence and commitment;
  - Greater sales, productivity and profitability;
  - Reduced costs and stock levels;
  - Improvements in quality and customer service; and
  - Better communication.

(From <http://www.investorsinpeopledirect.co.uk/>)

- Downsizing and outsourcing: the trends of corporate change and restructuring may have a negative impact upon the long-term sustainability of organisations and an effect on the remaining employees and their morale. Although streamlining operations has benefits for organisations it is viewed that this process can be carried too far in order to temporarily inflate profits, impress shareholders or distract management attention from more structural problems;
- Establishing a work/life balance: a more balanced and rewarding life can have the benefits of more balanced staff, more loyalty and more productivity. A survey by Gemini Consulting found that 44% of respondents (out of 10 300 employees across 10 countries) would leave their jobs tomorrow to move to a job that provided them with more opportunity for advancement (*Gemini Consulting Report 1998* quoted in Dunphy 2000). Work insecurity has also been found to contribute to higher levels of ill-health, disease and mortality; and
- Working with or developing institutions for a sustainable future that support: part-time as well as full-time workers; training and development; and flexibility as well as the encouragement of skilled workers to remain in employment.

## Risk management framework

For an effective sustainable risk management system and risk due diligence procedure you need to take into consideration human rights issues, whether internally, such as health and safety issues and recruitment and human resources procedures, or externally, reviewed in the next chapters, including community and customer-related concerns and risks.

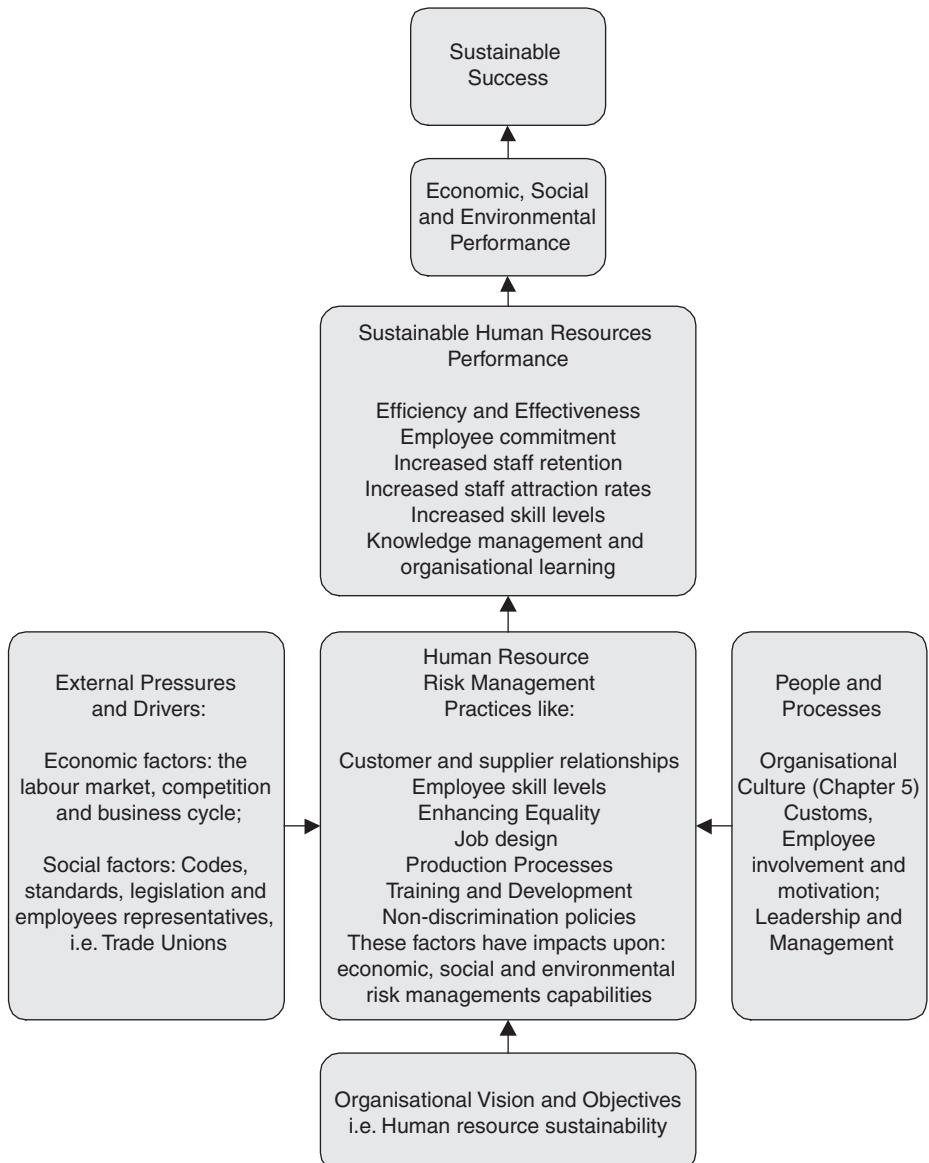
Following the process of identifying corporate vision, key issues, objectives and targets there is the establishment of systems to achieve these as well as the monitoring and reviewing of performance. The first stage is to conduct a due diligence review of the human rights element of the risk management system. This will aim to:

- Identify the extent of your human rights responsibilities;
- The systems and processes in place to manage these issues; and
- A gap analysis to see where improvements could be made.

The review should include:

- An analysis of the extent and scale of the organisation's activities, including indirect operations of business and joint venture partners, suppliers and subcontractors;
- The organisation's human rights impacts to date and the issues that may arise in the future. Internally this could involve looking at the issues of direct relevance to employees like:
  - The activities of the organisation, its business partners, its supply chain and issues like bribery and corruption (Chapters 7, 9 and 10);
  - Collective bargaining, freedom of association, equal opportunities and anti-discrimination measures (this chapter); and
  - The health and safety concerns in the workplace (Chapter 16).
- The workplace human rights issues covered in this chapter such as:
  - Stakeholder and community and indigenous peoples human rights issues (Chapters 9, 12 and 15); and
  - Health and safety concerns for customers, including the positive and negative impacts of products and services (Chapter 17).
- A review of the regulatory requirements, the legislation, codes of practice, standards or voluntary agreements that apply to the organisation's activities and any stakeholder expectations that may exist;
- An assessment of the current systems and procedures that can assist in the facilitation of human rights risk management, with a focus on both internal and external considerations;
- The establishment of strengthened policies and risk management processes for a range of human resource-related human rights issues that will assist your organisation become more 'sustainable', as shown in the diagram below. Businesses should put in place internal rules of operation in compliance with human rights principles; and
- The review should ensure that the organisation's framework is actually assisting with the implementation of a sustainable human rights risk management system by:
  - Putting in place internal rules of operation in compliance with the principles;
  - Incorporating the relevant human rights principles into their contracts and dealings with business partners, suppliers, contractors, subcontractors as well as their own operations;

- Undertaking periodic monitoring to ensure compliance with the stated rules of operation and this could include suppliers, etc., and their application of the principles; and
- There should be risk impact assessments and reparation made to those adversely affected by failures to comply with the risk management system or chosen human rights principles.



(Diagram after Gollan, P. in Dunphy *et al.* 2000)

The role of human resource risk management is important to the success of all other elements of corporate sustainability policies and the smooth working of a sustainable risk management system. It is important that the general HR system acts as an agent for change and supports the sustainability process in an integrated way by:

- Reducing the potential financial costs of getting things ‘wrong’;
- Engaging, involving and motivating staff: independent research commissioned by GreenPortfolio, the environmental relations division of Portfolio Communications, found that being green cited as a key issue for staff, with 60% of respondents citing the importance of environmental credentials to employees;
- Facilitating communications and conveying messages from the board and management to the organisational elements, and operational staff feedback to the management; and
- Developing skills and expertise within the organisation, especially with regards to: risk management, the recognising and taking of opportunities and sustainability awareness.

The following are general examples of good risk management by a business:

- Human resources functions can be improved with computer-assisted recruitment, employee reward and recognition, skill and career development analysis and improved internal marketing and communications systems;
- Selection of technologies and processes that support sustainable personnel and organisational learning and development;
- The provision for formal worker representation in decision making or management, including corporate governance;
- Policies and procedures involving information, consultation and negotiation with employees over changes;
- Training and education programmes to support the continued employability of employees and to manage career endings. Training for staff and executives on issues of sustainability can pay dividends for organisations with increased motivation for efficiencies and innovative capabilities;
- The selection of technologies and processes that support sustainable personnel and organisational learning and development;
- Specific policies and programmes for skills management or for lifelong learning, like the Investors in People standard;
- Equal opportunity policies which can help address workplace harassment and affirmative action relative to historical patterns of discrimination;
- Policies and procedures that seek to prevent all forms of discrimination in an organisation;
- Contributions by the organisation in excess of the minimum requirement in areas like healthcare, disability, maternity, education and retirement;
- Diversity within organisations can have financial benefits: a research example from a 1998 study of S&P 500 companies by academics Amy J. Hillman, Ira C. Harris, Albert A. Cannella Jr., and Larry Bellinger found that ethnic and

gender diversity on corporate boards (one possible indicator of accountability) ‘is associated with superior stock performance’;

- Organisations should not engage in child or forced labour, nor should employees have to leave deposits or identity papers with the company;
- A safe and healthy working environment shall be provided and as far as reasonable practicable the causes of hazards inherent in the working environment shall be minimised;
- Organisations shall not engage in or support discrimination in the advertising of vacancies, or the hiring, compensation, training, promotion, or retirement of employees based on:
  - Caste
  - Colour
  - Disability
  - Gender
  - National origin
  - Political affiliation
  - Race
  - Religion
  - Sexual orientation
  - Union membership
- Organisations shall not engage in: sexually coercive, threatening, abusive or exploitative behaviour towards staff.

Even bad news can be approached in a responsible manner, and if an organisation has to make redundancies these can be made in a supportive manner, providing additional support like job search facilities and retraining prior to the event. Too often we read about staff who receive notification of the termination of their employment from a circulated email.

Company specific examples of best practice include the following:

- In terms of a positive corporate culture, Southwest Airlines in the US makes a priority of valuing both customers and employees equally.

You have to treat your employees like your customers. When you treat them right, then they treat your customers right. (*Fortune*, 28 May 2001)

- Numerous companies now undertake a regular employee satisfaction survey and note the results in their corporate social responsibility report on the percentage of employees that are happy working with the organisation; and
- Taylor Woodrow seeks regular feedback from employees. Their findings include:
  - 42% of employees believed that team morale was good;
  - 68% of employees intend to still be working for Taylor Woodrow in 12 months’ time;
  - 60% of employees would recommend working for Taylor Woodrow to a friend; and
  - 55% of employees believed that Taylor Woodrow offices provide good working conditions (Taylor Woodrow CSR Report 2003, p. 17).

*Employees care about organisations that care*

A survey on employee recognition of corporate responsibility issues by US-based community network Care2 polling nearly 1600 employees found that:

- \* 73% of workers said it was ‘very important’ to work for a company they believe is ‘socially responsible’;
- \* 35% report they have left a company because they believe it was not socially responsible;
- \* 48% of employees would work for less income if the company was socially responsible; and
- \* 40% would work longer hours on the same basis.

The competition for high calibre employees is increasing as the number of jobs at organisations viewed to be socially responsible is exponentially increasing.

## Business benefits of diversity

A benefit for organisations is the diversity of the specific talents that individuals can bring to their organisations. There is also the need to adjust to a labour marketplace with a greater diversity of employees and unleashing their potential to assist the organisation. The flexibility of an organisation to learn and fit their employees is now more of a competitive advantage than trying to get employees to fit an organisational stereotype.

There are benefits to encouraging and supporting diversity. Diversity can support:

- Cost reductions and the avoidance of the costs of non-compliance from discrimination, diversity and human resource law breaches and fines:
  - Texaco settled to pay more than \$175 million to 1400 black employees in a race discrimination class action lawsuit.
- Competitive advantage can be gained from diversity as this helps with the realisation that the consumer market is continuously diversifying as well. There is no average customer and diversified companies can meet these needs more effectively. An example is that language diversity within organisations can facilitate sales and export campaigns;
- Valuing diversity which recognises the changing demands of the consumer market and ensures that your organisation and employees are equipped to meet such demands;
- More effective human resource attraction and retention, gaining a reputation for providing opportunities and therefore an ability to attract the best employees;
- Increased organisational flexibility and ability to gain from new ideas, techniques, processes and change;

- Increased organisational creativity and problem solving; and
- Mirroring the society the organisation is within, providing more diverse thinking, research and increased abilities to spot and utilise niche markets.

Valuing diversity is not just about the avoidance of risks and litigation but the ability to gain the most from your key assets, your staff. This can be achieved by the activities we explore in the following sections of this chapter.

## Human rights standards relating to the workplace

### UN Universal Declaration of Human Rights (UDHR)

This is the primary document asserting the value of human rights and it came into being in 1948. This represents a set of 30 fundamental and universal rights forbidding slavery, racial or sexual discrimination and arbitrary arrest. It also asserts the freedom of speech and freedom of association.

The elements of the nine principles of the UN Global Compact covering corporate behaviour that are relevant to the workplace include:

- Freedom of association and the effective recognition of the right to collective bargaining; and
- The elimination of discrimination in respect of employment and occupation.

The following elements are indirectly relevant and are reviewed in the next chapter:

- Support and respect the protection of international human rights within their sphere of influence;
- Make sure their organisations are not complicit in human rights abuses;
- The elimination of all forms of forced or compulsory labour; and
- The effective abolition of child labour.

### The ILO Declaration of Fundamental Principles and Rights at Work

Adopted in 1998, the ILO Declaration on Fundamental Principles and Rights at Work is an expression of commitment by governments, employers' and workers' organisations to uphold basic human values. All ILO member states have an obligation to respect the principles, the main elements of which are listed below. The Declaration covers four areas:

- Freedom of association and the right to collective bargaining;
- The elimination of forced and compulsory labour;
- The abolition of child labour; and
- The elimination of discrimination in the workplace.



## Human rights at work

The International Labour Organisation (ILO) was established as a specialist UN agency and has adopted over 70 conventions on labour standards and workplace conditions since its creation in 1919.

The key ILO conventions covering workplace human rights include the:

- Equal Remuneration Convention No. 100 (1951): calls for equal pay and benefits for men and women;
- Discrimination in Employment Convention No. 111 (1958): calls for the elimination of discrimination in employment or working conditions on the grounds of colour, national extraction, political orientation, race, religion or social origin;
- Freedom of Association and the Protection of the Right to Organise Convention No. 87 (1948): establishes the right of all workers and employers to form and join organisations of their own choosing;
- Right to Organise and Collective Bargaining Convention No. 98 (1949): provides protection against anti-union discrimination and work-related organisations from acts of interference; and
- Covered in Chapter 15 but related to employee issues are:
  - Forced Labour Convention No. 29 (1930): requires the suppression of forced or compulsory labour (except convict labour);
  - Abolition of Forced Labour Convention No. 105 (1957): prohibits the use of forced or compulsory labour;
  - Minimum Age Convention No. 138 (1973): calls for the elimination of child labour and of employment below the age of the completion of compulsory education; and
  - Worst Forms of Child Labour No. 182 (1999): calls for the prohibition and elimination of certain forms of child labour.

## Social accounting

The Council for Economic Priorities (CEP) set up a social analysis framework SA8000 which is an auditable certification standard based on the six basic conventions of the ILO, as well as the UN Universal Declaration of Human Rights and the UN Convention on the Rights of the Child. According to the framework an organisation:

- Shall not engage in child or forced labour, nor should employees have to lodge deposits or leave identity papers with the company;
- Shall provide a safe and healthy working environment and shall minimise as far as reasonable practicable, the causes of hazards inherent in the working environment; and
- Shall not engage in or support discrimination in the advertising of vacancies, or the hiring, compensation, training, promotion, or retirement of employees based on caste, disability, gender, race or sexual orientation.

## Case studies

With 130 000 individual cases brought against companies each year in the UK there is a raft of legal precedence with which the financial impact upon organisations can be assessed. The scale of the legal actions could be set to increase. In the US there are mass class actions for race and sexual discrimination grounds. Some companies, like Coca-Cola and Ford, are estimated to have settled claims in excess of US\$100 million each.

In the UK there is a worrying trend of reduced or missing contributions to pension's funds. For example, Serco is one of the outsourcing companies which run the Docklands Light Railway. It also had a contract with Regional Airports, which finished in March 2004, after which the airport group discovered Serco had made no pension contributions for the last three years of the millennium ('Pension baggage falls off the Airports' trolley', *Daily Telegraph*, 12 May 2004).

There is a growing trend towards UK companies outsourcing jobs to off-shore locations, like Tesco's switching of 420 IT and invoice processing jobs to India (*Financial Times*, 23 July 2004). The risk management of this issue needs to be strengthened, and there may be increasing calls for UK job protection as there have already been in the US.

Surveillance and harassment of staff may be on the increase and companies need be aware of where the differences between security and surveillance and the invasion of employees' privacy, and where the pressurising of staff, become harassment.

Diversity within the workplace is something to be encouraged and the number of court cases is on the increase within the UK. An application for a breach of the Race Relations Act (1976) (and 2000 Amendment) has been lodged against Reuters plc, with an employee citing lower pay than white counterparts and having been passed over for promotion. The company has said it has a clear policy in place. In the US the scale of the cases is quite different, an example is that Wal-Mart has a sex discrimination lawsuit from more than 1.6 million current and former female employees.

UK bank Lloyds TSB has allowed 17 000 employees to work flexible hours.

## What are the issues?

There are a variety of business compliance issues with regard to risk managing internal human rights, otherwise known as human resources. These issues should be standard place compliance issues (depending on country of location). There is a wide variety of case studies and issues analysed in brief which cannot be covered here as they need detailed country specific risk assessments. Where possible we indicate countries where these issues are stated by Impactt Limited to be of a high risk nature: [www.impacttlimited.com/site/5thanniversaryreport.pdf](http://www.impacttlimited.com/site/5thanniversaryreport.pdf)

Organisations are more vulnerable where knowledge of employees and associates is inadequate. As part of a risk management system staff due diligence checks and performance reviews are vital in the successful running of

any organisation as they access the employee's potential and provide the employer with opportunities for career progression.

Employees can be a source of great risk and are interlinked with all the other chapters of the book. Although employees are expected to act for the benefit of the employers this is not always the case and staff can be responsible for acts of fraud, corruption, bad management, errors like pollution incidents and plain negligence.

What is to be recognised is that staff are also the agents of corrective action and benefit within organisations and it is these qualities that need to be nurtured.

In this section we look at some of the risk issues within organisations as interaction with others always presents both risks and opportunities. We will be looking at a range of emerging risk issues, including age, race, pregnancy, religious and sex discrimination, as well as sexual orientation and gender reassignment (sex change). The framework for reviewing them is based upon the order that they are to be reviewed within the SA8000 standard.

## Child labour

It is to be ensured that no workers under the age of 15 – or 14 for some developing countries – should be involved in working practices. Rather those children found to be involved in such practices should have remediation assistance from the organisations responsible, such as educational assistance (UN Norms Article 6). This issue is reviewed in more depth in the next chapter.

There are an estimated 250 million children under the age of 14 working around the world, 120 million of them working full time. The most serious forms of child labour are when children are exploited, put at risk and/or denied an education and a childhood. Bangladesh, India, Indonesia, Malaysia and the Philippines are examples of high risk countries. Forced and child labour are also covered in Chapter 15.

## Forced labour

There should be no forced labour, or the holding of important documents or identity papers (like passports) by employers or related third parties (UN Norms Article 5 and UDHR Article 4 on slavery and servitude). This issue is reviewed in more depth in the next chapter.

If workers do not have a choice about whether or when they work and are not free to leave their employment it is a case of forced labour. This includes debt bondage and forcing workers to work overtime. High risk countries include China and India.

## Health and safety

There is a general human rights view that organisations should: provide a safe and healthy work environment; take steps to prevent injuries; provide regular

health and safety worker training; offer a system to detect threats to health and safety; make available access to bathrooms and potable water (UN Norms Article 7). This risk issue is covered in more depth in Chapter 16.

## Freedom of association and collective bargaining

Freedom of association means that workers are able to form or join groups of their own choosing, including trade unions. Collective bargaining means that these groups can negotiate with management, on behalf of workers on issues such as pay and conditions (UN Norms Article 9). UDHR Article 23 states that everyone should have the right to join a trade union.

There is a strong correlation between freedom of association and collective bargaining and the reduction of labour abuses. Examples of high risk countries are Bangladesh, Cambodia, China, the Philippines, Sri Lanka, Thailand and Vietnam.

## Working hours, pay and conditions

Wages for many workers around the world are too low to support a decent standard of living. As a result, workers often end up working very long hours. In many workplaces, workers routinely work 12–16 hours a day, seven days a week in peak periods. Often they are not allowed to refuse overtime and are not paid at a higher rate for overtime hours. This way of working threatens quality, productivity and worker welfare. Examples of high risk countries are Bangladesh, Cambodia, China, Indonesia, Malaysia, the Philippines, Sri Lanka, Thailand and Vietnam.

The global guidelines from the UN UDHR Article 23 and UN Norms Article 8 note that organisations should provide workers with a remuneration that ensures an adequate standard of living for them and their families to have a dignified existence. Risk management systems should also try to comply with the spirit of these articles and in more detail with the applicable local laws of countries of operations. There are also the SA8000 guidelines which act as a good benchmark standard and the following should be provided:

- No more than 48 hours' work per week with at least one day off for every seven day period;
- Voluntary overtime paid at a premium rate and not to exceed 12 hours per week on a regular basis; however
- Overtime may be mandatory if it is part of a collective bargaining agreement; and
- Wages paid for a standard work week must meet the legal and industry standards and be sufficient to meet the basic need of workers and their families; with no disciplinary deductions.

If risk management systems are in place they need to be enforced and it made clear to the management and contractors that the standards are to be followed.

This is a difficult activity quite often when the barriers of distance and language are added. This means that audits need to be more thoroughly conducted.

#### *Traditional Ethical Audit*

Traditional Ethical Audits in suppliers' organisations are usually ineffective for checking the quality of conditions because of the coaching of staff and falsification of data and records to meet the auditors' expectations. Rosey Hurst, director of Impactt, an ethical trading consultancy, says, 'In none of the factories we have worked in have we ever been able to get the working hours down to legal limits.'

## Discipline and abuse of workers

Organisations should prevent corporal punishment, mental or physical coercion or verbal abuse of employees, whether by the employers themselves or other employees. There should be systems and methods in place to prevent verbal abuse, bullying, threats, shouting, illegal fines, sexual abuse, beatings and humiliating punishments – all are considered to be examples of inhumane treatment and abuse of employees. High risk countries include China, Indonesia and Vietnam.

## Discrimination

Discrimination is a global issue prevalent in all societies. Elements of society are treated differently because of their gender, race, national origin, religion, caste, class, age, disability, marital status, sexual orientation, political affiliation or union membership. In the world of work, this means that some people have few opportunities to be hired, promoted or trained and usually receive lower wages, poorer work conditions, or their jobs may be less secure. High risk countries are India, Malaysia and Thailand.

The UN Norms note that transnational organisations and businesses should:

... ensure equality of opportunity and treatment, as provided in the relevant international instruments and national legislation as well as international human rights law, for the purpose of eliminating discrimination based on race, colour, sex, language, religion, political opinion, national or social origin, social status, indigenous status, disability, age ...

## The EU provisions on non-discrimination

One of the cornerstones of the provisions of European regulatory developments has been non-discrimination. While non-discrimination on the grounds of nationality (of a member state) or of gender (in work-related situations) has been part of EU policy since the original Treaty in 1957, it was only in the Amsterdam

Treaty in 1997 that the idea of taking ‘appropriate action to combat discrimination based on sex, racial or ethnic origin, religion or belief, disability, age or sexual orientation’ was introduced into the EU’s legal base (see Article 13). Article 13 of the European Treaty (as amended at Amsterdam) creates a competence for the EU to act in discrimination-related issues. The article states as follows:

Without prejudice to the other provisions of this Treaty and within the limits of the power conferred by it upon the Community, the Council, acting unanimously on a proposal from the Commission and after consulting the European Parliament, may take appropriate action to combat discrimination based on sex, racial or ethnic origin, religion or belief, disability, age or sexual orientation.

The EU Council of Ministers adopted in December 2000 a package of three measures as follows:

- Council Directive 2000/43/EC implementing the principle of equal treatment between persons irrespective of racial or ethnic origin. This Directive implements the principles of equal treatment between persons irrespective of racial or ethnic origin in any field and activities of life. It sets a good precedent for future similar actions in the areas of non-discrimination, including non-discrimination on the grounds of age;
- Council Directive 2000/78/EC establishing a general framework for equal treatment in employment and occupation. This Directive establishes a framework for non-discrimination on a larger number of grounds (it adds discrimination on grounds of religion or belief, disability, age or sexual orientation), but in the narrower field of employment and occupation; and
- Council Decision 2000/750/EC establishing a Community Action Programme to combat discrimination (running from 2001 to 2006). The programme will run until 2006, and is structured around three objectives as follows:
  - To improve the understanding of issues related to discrimination through exchange of best practices and information between member states;
  - To strengthen the capacity of organisations working in this field; and
  - To promote and disseminate practices and to raise awareness on these issues.

### *Directives*

It should be recalled and understood that a directive is a type of European Community legislation, which is legally binding. It must be transposed into national law, which means that legislation in the member states must be adapted to fulfil the criteria as determined by the Directive. A Directive can include more or fewer details, giving the member states more or fewer possibilities to adapt national legislation to fit national legal systems. The two EU Discrimination Directives set up deadlines for their implementation by member states.

## Age discrimination

One significant trend of modern day society is that in general people are living longer, and with an increase in life expectancy in most countries it is a significant and growing risk issue that age discrimination is apparent in many organisations.

### *Age discrimination definition*

It has become more and more clear that age discrimination is the basis of and at the root of many of the challenges encountered by older people. With this in mind age discrimination can be described as a difference in treatment and opportunities for citizens solely on grounds of their chronological age. It usually denies equal opportunities and equal access for older people. Age discrimination is based on ageism, which is a set of usually negative assumptions about older people and ageing, which is widespread and widely believed to be true. These beliefs usually – and in many places – justify these discriminatory actions to a large extent. Even where they have been previously dynamic and important contributors to society, this means that older people are commonly viewed as disabled, dependent and troublesome. Moreover these views generally pervade the whole of society.

With this in mind, from the regulatory perspective business organisations that operate in the member states of the European Union will have to keep abreast of developments in European law that affect national requirements.

## The impacts on business

**Financial penalties:** those companies and business organisations that breach the EU laws banning age discrimination as a result of the legislation may have to pay out up to £200 million in the first year following implementation according to various legal experts. They have been considered to be the most fundamental change to employment practices since the 1970s when anti-discrimination race and sex laws were introduced. As a result of these requirements ‘ageism’ will become key to corporate life and practice.

**Changing work practices:** under the legislation certain practices are likely to be outlawed or illegal as priorities, such as:

- Advertising specifically for younger or more mature recruits, using phrases like ‘young and enthusiastic’;
- Demanding that candidates for posts or jobs state their age in their résumé or CV;
- Making ageist jokes in the workplace including staff birthday cards joking about age;

- Practising indirect age discrimination, such as advertising for a person with 15 years' experience;
- Denying training to older workers or employees;
- Compelling or forcing staff to retire before the age of 65; and
- Promoting people on the basis of their age and using age in their salary structure.

**Economic drain:** it is a real concern that a vast resource of talent and skill is allowed to remain dormant within society. An example is that a third of the UK's 50–65 age group are out of work and yet the UK complains about a skills gap. This is not only a waste of money, costing the economy an estimated £16 billion, but it is also a shocking waste of their experience.

**Missed growth opportunities:** there are opportunities to be gained from hiring an arguably more trustworthy, customer friendly and dependable group of employees by developing age positive programmes as in the US and UK home improvement retailing sectors. The UK Employers Forum on Age, an organisation that lobbies against ageism practices, maintains that instead of worrying about the new legal requirements businesses should embrace them. The forum argues that according to current figures age discrimination costs the UK businesses about £30 billion per annum as a result of the neglect of experience and knowledge of more mature people in the workforce and the workplace. They consider that workplace diversity – in this instance age diversity – can eliminate costs by helping a business to reduce its employee turnover and to create a stable and motivated workforce.

## Recent employment law requirements on ageism

### *The UK perspective*

In the UK, age anti-discrimination legislation is being introduced as a direct result of the European Employment Directive 2000. Under this Directive, essentially, discrimination in the employment field on the grounds of a person's disability, age, religion or sexual orientation must be outlawed in all EU countries. The main deadline for introducing this Directive into UK law was December 2003. However, EU countries were able to request a further extension of three years to introduce legislation outlawing discrimination on the grounds of disability and age. The UK government requested a delay of 12 months to introduce legislation to outlaw disability discrimination, and three years to outlaw age discrimination. As a result the new legislation that became law in October 2006 is the latest part of the 2000 Employment Directive, which seeks to outlaw discrimination in the workplace.

It is important to bear in mind that the UK government negotiated an extension on age discrimination until 2006 to prepare businesses for the change. Yet although the government did the same with the Disability Discrimination Act some 80% of UK businesses were unprepared for its implementation. In addition government delay in drawing up the relevant regulations meant that many



businesses did not know about the changes. The draft regulations that were promised by government ministers in October have yet to be published. Accordingly, it is important that small businesses monitor the developments in the coming months either directly or through their advisors. Indeed the delay by the government has been of concern to some lawyers who have noted that the government has been very late in producing consultations and employers have been left up in the air about some parts of the laws. The detail will be most important: ministers will be able to be flexible over the way in which the Directive is implemented and will be able to state exactly what is allowed under the new rules and what will be outlawed (see further below).

It should be mentioned that the UK lagged behind other countries, such as Australia, Canada, Ireland and the United States (see further below), in general as regards the introduction of age discrimination laws. Slowness has been partly due to the dominance of the issues that falls within the European Directive – the retirement age.

### *The European perspective*

It has been noted that the European Parliament has been at the forefront of introducing legislation to help older people. As well as overcoming significant reluctance from the UK government to include age discrimination at work in the Employment Directive, members of the European Parliament have also called for more training for older people in the employment guidelines; and the European Parliament has also approved an important report on healthcare for elderly people. Indeed it was in the face of many of the same demographic challenges that have confronted – and continue to confront – the United States, particularly shrinking numbers of younger workers, that the European Union (EU) decided to combat age discrimination in employment. On 27 November 2000, the European Union Council of Ministers adopted the European Directive on Equal Treatment which required all EU member states to introduce legislation prohibiting discrimination in employment on the grounds of age, sexual orientation, religion and belief, and disability by 2006.

While the process of implementation of the Directive is now taking place in all the member states, some commentators have noted that the progress that has been made has been slow even among those who had not sought any extension or delay. For example, at a conference on the implementation of the anti-discrimination directives into national law in Copenhagen in November 2001 member states were asked to report on the status of legislative initiatives. At that time, only the Netherlands had introduced a bill to comply with the Directive although France reported that it had taken action by passing an amendment to an existing law to add age as a prohibited ground for making employment decisions. As with other aspects of employment law EU law has a dynamic impact on the way that business is carried out and as a priority the other member states will have to take the necessary steps to ensure timely compliance with the Directive's deadline that legislation is in place by 2006.

Nevertheless there have also been various criticisms of the drafting of the European legislation. Some commentators have noted that the loopholes in the Directive – especially when combined with the members states' delays in taking steps to enact legislation – suggest that the EU is a long way from either 'talking the talk' or 'walking the walk' when it comes to eliminating age discrimination.

## *The United States perspective*

As is the case in several other areas of employment law and as regard the various regulatory approaches in this area the experience of the United States can be helpful. In the environmental law field this has been termed a 'transatlantic dialogue'. The term 'ageism' was evidently coined by Robert N. Butler, MD, to describe the 'deep and profound prejudice' against the elderly which is found to some degree in all of us (see Robert N. Butler, *Why Survive?: Being Old in America* (1975)). Mr Butler describes ageism as:

a process of systematic stereotyping of and discrimination against people because they are old, just as racism and sexism accomplish this with skin color and gender ... Ageism allows the younger generations to see older people as different from themselves; thus they subtly cease to identify with their elders as human beings.

As the United States has had federal legislation prohibiting age discrimination in employment for some 40 years – since 1967 – when considering the appropriate European framework the EU turned to the US for consideration and understanding of their expertise and experience. Several US employment experts have commented that perhaps the most important message that they have tried to convey to the European institutions is that a good law is not a panacea for ridding the workforce of age discrimination. It is stark evidence that despite the fact that the United States' Age Discrimination in Employment Act (ADEA) has been in place for so many years, age discrimination in employment remains a pervasive feature of the business community. Indeed, it has been reported that complaints regarding age discrimination filed with the Equal Employment Opportunity Commission in the US (the EEOC) have increased 41% since 1999. In the US one-fifth of all discrimination claims are based on age. Between 1988 and 1995 it has been reported that people claiming age discrimination damages in the US were awarded an average of £114 000 compared with £74 000 for race discrimination and £54 000 for sex discrimination settlements.

Such findings in the US comparison are clearly relevant to concerns in Europe. The question has been raised why complaints over age discrimination have increased. The answer may lie partly in the fact that as a society, Americans simply do not view age discrimination in the same light as they do race and gender discrimination. Age discrimination is not considered as wrong or unacceptable and is viewed more as an economics issue than as a civil rights issue. In other words, in the United States when it comes to age discrimination, experts have commented that people 'talk the talk' but don't 'walk the walk'.

Commentators have indicated that if the United States and Europe hope to address the demographic challenges facing their workforces, both must take more effective action to allow those older workers who want to continue to work to do so.

With that in mind, one interesting issue is how far the European Directive compares with the United States' law. With the exception that the European Directive states that both direct and indirect age discrimination (the equivalent of the US disparate treatment and disparate impact) is prohibited, it has been mentioned by experts that the Directive is not nearly as forceful as the American ADEA in condemning age discrimination. Most significantly, while the Directive permits the member states to continue to enforce mandatory retirement in the United States mandatory retirement has been abolished except for a few very narrow exceptions. In addition, the Directive contains a provision that reads as follows:

Member States may provide that differences of treatment on grounds of age shall not constitute discrimination, if ... they are objectively and reasonably justified by a legitimate aim ... and if the means of achieving that aim are appropriate and necessary.

This provision can be interpreted to provide the member states with almost unfettered discretion to carve out large exceptions to the prohibition on age discrimination.

## Disability discrimination

In the UK the Disability Discrimination Act now has new provisions which will also extend the Disability Discrimination Act's (DDA) protection to people with HIV, multiple sclerosis and all types of cancers, effectively from the point of diagnosis. A recent example is that a cancer patient who lost her job after taking time off for treatment has been awarded more than £17 000 for unfair dismissal.

The penalties can be more than just financial as three senior managers at a UK train company, Virgin Cross Country Trains, found out. They were ordered by an employment tribunal to attend training in disability rights law as the company had already been found to be in breach of the Disability Discrimination Act (DDA) for failing to make reasonable adjustments to enable a train driver to return to light duties after an operation on his knee, the employee was also awarded £41 000 (*Risks*, issue number 212).

## *Genetic discrimination*

The US Congress has debated a proposed privacy bill that would bar health insurers and employers from discriminating against people with a genetic predisposition to disease. This is an emerging risk issue which we will review as more developments become apparent.

### **Case study – the UK Disability Discrimination Act and small business concerns**

#### *Managing the Disability Discrimination Regulations*

In 2003 the Disability Rights Commission (the DRC) put out to consultation (until 30 November 2003) two new Codes of Practice to reflect changes to the Disability Discrimination Act 1995 which applied last year. The Disability Discrimination Act Regulations 2003 (the Regulations) came into force on 1 October 2004, requiring small businesses to make alterations to premises in order to overcome barriers to disabled access. As regards access to all areas and compliance with the recent rules it is therefore important to have asked the question: Are your premises ready?

According to practitioners the Regulations have far reaching implications for property occupiers who are service providers. Since 1 October 2004 employers with fewer than 15 employees were brought under the scope of the Disability Discrimination Act for the first time. This meant that discrimination against workers on the basis of disability became illegal and firms are required to make reasonable adjustments to the workplace to enable access for the disabled. The discussion below outlines the key points of the new rules and the impact on small businesses.

#### *Practical impacts: retailers, etc.*

The Disability Discrimination Act 1995 provides that where a physical feature makes it difficult for disabled people to use the service provided, it is the duty of the service provider to make reasonable adjustments:

- \* Either to remove, alter or provide a reasonable means of avoiding the feature; and
- \* Or to provide an alternative method of making the service available to the disabled person.

As a result of the amendments retailers are required to make premises more user friendly since the Disability Discrimination Act required this by the end of October 2004. However, evidently many retailers have found the law to be confusing. A service provider is anyone who provides a service or supplies goods to the public, such as shops, leisure facilities and the offices of accountants and lawyers. Not only did small businesses come under the Disability Discrimination Act for the first time but shops, restaurants, bars, local authorities and other providers of services must make every effort to ensure disabled people can use their services.

It is important to note that the responsibility to make premises compliant rests on the service provider, not the property owner. Whether you are a tenant or the owner of the building, if you are providing a service on your premises then you are responsible for making the alterations. It is understood that if you are a tenant and in order to comply you need to make alterations which are prohibited under the terms of your lease, the Act provides

that you can make alterations with your landlord's consent. Consent may not be unreasonably withheld, although your landlord can impose reasonable conditions. Moreover, depending on the extent of the works you may also require planning permission and/or other statutory consents.

### *Business risks*

The spiralling costs of complying, and fines for non-compliance, with additional regulation is one of the loudest complaints that has been heard from business. It's a constant challenge staying up to date with business regulations and the penalties for failure to comply can be punitive. Of course ignorance is no defence and business representative groups have now taken a look at the emerging legislative changes and are trying to raise awareness in the business community in general to changes that will impact upon their business.

An example of this is that a UK business pressure group says a guide produced by the Disability Rights Commission (DRC) aimed at helping small businesses comply with changes to disability legislation is ambiguous and long winded. It has been understood that the rules require businesses and service providers to make reasonable changes to ensure that people in wheelchairs, the blind, the deaf and those with other disabilities can access premises. However, the UK Forum of Private Business (FPB) has said that many small businesses have been confused as to how to comply after reading the DRC's compliance guide.

FPB chief executive Nick Goulding said that small firms are not being helped by disability rights groups publicising their intention to launch legal challenges against businesses. The FPB believes that going straight into legal action is ill-advised and unhelpful. Small businesses want to comply with this legislation and understand that there are sound economic and social reasons for doing so.

Some risk management recommendations are that:

- \* Instead of weighing in with a sledgehammer, that companies and disability rights groups should be working with small businesses to produce practical solutions to any problems;
- \* The FPB also advises businesses to consult with disabled customers and define what reasonable steps can be taken to improve disabled access on a case by case basis; and
- \* Read more concise comprehensive, affordable and user friendly publications on the subject, quite often not the official government publications.

## Privacy of employees

This is a newer risk management area which has grown in occurrence and complexity as the ability to establish surveillance systems on staff has increased. The US Congress has started to debate this issue and has looked at a proposed

privacy bill that would bar health insurers and employers from discriminating against people with a genetic predisposition to disease.

There have been recent cases and fines for companies that have engaged in ‘excessive’ invasion of privacy, in one case a security technology firm installed its own cameras in its head office, in order to prevent thefts, they claimed. The problem with this was that the court deemed that although this is a normally valid reason, this was not reason enough to install them in the female shower and changing rooms!

An example of best practice in this field is that of IBM, the world’s largest computer maker, who has pledged not to use genetic data to screen employees and applicants in what it said was the first such move by a major corporation. IBM CEO Sam Palmisano sent a memo to employees announcing the company was revising its policies to prevent the use of genetic information in making personnel decisions. ‘Genetic information comes pretty close to the essence of who you are, it’s something you can’t change’, said IBM’s chief privacy officer, Harriet Pearson. ‘It has nothing to do with your employment, how good your contributions are, how good of a team member you are, so making a policy statement in this case is the right thing to do’ (‘IBM rejects genetic screening at work’, *Risks*, issue number 228 – 15 October 2005).

In part the right to privacy is covered for employees while they are not at work, as Article 12 of the UN Universal Declaration of Human Rights says that there should be freedom from arbitrary interference with privacy, family, home life or correspondence.

## Traditional human resource issues

There is a wide range of employee-related risk issues. In this chapter we only seek to review some of the newly emerging ones that can impact upon your organisation. More ‘traditional’ ones that are vital to the success of any business or other legal form of organisation are:

- Effective recruitment and staff selection programmes that seek to attract and promote staff that have the long-term welfare of the organisation at heart, and have the skills to assist the organisation achieve its aims and objectives;
- Having a skilled and well-trained workforce with established training programmes to continue investment in your key resource, your staff;
- Unfair dismissal procedures are designed to protect both the employer and employee and if undertaken correctly can save the organisations from expensive legal action;
- Management training programmes should include sustainability and sustainable risk management training to ensure that there is an understanding of the long-term objectives of the organisation. This will assist with the management of internal processes and external relationships, as well as ensuring that their subordinate staff are also well trained and motivated; and
- Staff and management training on these risk management issues should also form part of a larger commitment to organisational learning and knowledge

management. This could take the form of online training modules or additional information and resources for staff that wish to progress their knowledge in specific areas of sustainability-related issues. This may include the establishment of programmes that encourage employee participation in the wider community to find out if their organisation benefits or impacts upon local communities and other stakeholder groups.

## *Recruitment and staff selection*

As part of an employee risk management system effective staff screening, interviewing and recruitment processes need to be in place. A cost-effective technique at risk managing staff selection is to increase the thoroughness of background checks as it is estimated that a high proportion of all résumés have some form of inaccuracy or false claim within them; about a third are said to have false qualification claims. This should involve:

- Authenticating qualifications;
- Personal data, such as identity and work records;
- Checking for business, political or interests in other organisations which may raise concerns;
- Verifying employment records and personal, professional and financial references; and
- Doing legal background searches to check for financial irregularities, like bankruptcy or insolvency, and evidence of criminal activity or convictions.

## *Unfair dismissal*

As part of an employee risk management system it is also a requirement to dismiss staff and this should always be conducted in accordance with the grievance and dismissal procedures and the relevant legislation of the country in question. The conditions and grounds for a fair dismissal are still changing and a number of organisations in the UK have been caught out by new age and disability discrimination legislation (defined in the above sections). In one case a cancer patient was dismissed for taking time off for treatment and in a more public example an unfair dismissal dispute cost an airline a lot of lost revenue. British Airways shares fell 2% on 17 August 2005 when a dispute with their staff raged on which was caused by the sacking of workers employed by a caterer contractor (*Financial Times*, 18 August 2005). British Airways demonstrated robust systems and there was a share rebound when their risk management and mediation activities caught up and helped to resolve the situation. The end result was that British Airways gained 3.2% after the airline settled the industrial dispute which had threatened to disrupt travel over an important trading period (*Financial Times*, 24 August 2004). The dispute is said to have cost £20 million as a result of over 700 flights being cancelled and 110 000 passengers being stranded around the world.

## Protection of whistleblowers

The trend in most places is that a worker who is concerned about wrongdoing in the workplace regardless of sector or jurisdiction can usually be quite confident about legal protection if he or she discloses the information to the employer or to an official body provided the disclosure is made ‘in good faith’. This is viewed as the human rights element of this issue, in that it should be a right to report wrong doing and illegal activity.

However, it would seem that any worker who plans to send a story to the press while hoping to keep his or her job would be well advised to take legal or trade union advice before resorting to the whistle. In the UK, for example, if the disclosure does not meet all of the requirements of a protected disclosure mentioned below, he or she could find himself or herself being dismissed and facing a claim for breach of confidence.

The debate over whistleblowing and the protection of whistleblowers has affected commercial and non-commercial organisations across the world. It has been seen that on the whole a worker who blows the whistle on an employer can expect to feel the full force of institutional anger and discredit with the following repercussions:

- Criticism;
- Poor performance evaluations;
- Punitive transfers;
- Job loss;
- Ostracism from colleagues;
- Blacklisting; and
- Stress and health damage.

### *Whistleblowing and governance: an overview*

Over the last few years we have witnessed both real and alleged whistleblowing on organisations both in the private and public sectors, such as Merrill Lynch and the European Commission, as well as in the profit and not-for-profit sectors. Historically whistleblowers have found that they have made a decision that entails all risk and no reward.

A detailed discussion of whistleblowing is clearly not possible or appropriate in this book as it is a subject that deserves much more comprehensive treatment. However, it should be noted that the issue of whistleblowing has arisen, of course, as a risk issue in the well-documented corporate scandals.

A recent example that also involved a large financial penalty for an organisation is that a US Federal court awarded \$1.5 million (£830 000) in damages to a painter who said he was the target of retaliation after he complained about workplace hazards. The employee warned that employees and the public were exposed to dust from lead-based paint and asbestos. He also said hazardous materials were stored and disposed of improperly, and employees were working without the legally required training and safety equipment. He said he was



the target of retaliation by his bosses and was disciplined, isolated and not given job duties (*Risks*, issue number 219, 13 August 2005).

Moreover it is especially relevant in the consideration of all organisations, including charities, bearing in mind the crucial area of professional ethics. If the public or organisations do not protect whistleblowers, it tacitly accepts the risks of being denied important information. Although government ministers have been quick to condemn whistleblowers who raise awkward questions – as in the documented case of the concerns over UN telephone tapping – the regulatory departments have begun to appreciate, and even encourage, whistleblowers.

### *The UK approach: the Public Interest Disclosure Act 1998*

In the UK the Public Interest Disclosure Act 1998 (the 1998 Act) was enacted to protect those who blow the whistle on wrongdoing in their workplace. Essentially, the 1998 Act gives protection to workers when they make a ‘protected disclosure’ (see further below).

The primary objective is to encourage workers to disclose information to their employers so that the employers can take remedial action internally. However, in certain rather restricted circumstances the 1998 Act can also protect workers who disclose information to third parties, including the media.

In any event there are several hurdles that must be overcome in order to establish that a disclosure is a ‘protected disclosure’: these are commented upon below.

### *The scope of the protection*

A worker who makes a protected disclosure is protected in several ways:

- Any confidentiality provision in a contract is void in so far as it purports to preclude the worker from making a protected disclosure. This means that an employer cannot rely on the confidentiality clause in the contract in order to claim that a worker has breached their contract by making the protected disclosure;
- The worker has the right not to be subjected to any detriment on the ground that he or she made the protected disclosure. By way of example detriment in this connection would evidently include any disciplinary action or a failure to promote the worker. Moreover a worker claiming to have been subjected to a detriment on the basis of a protected disclosure can complain to an employment tribunal and, if successful, the tribunal can make a compensation award in favour of the worker. The compensation can include an element for injury to feelings which it has been reported should be assessed in the same way as an injury to feelings in the context of discrimination cases on the grounds of sex or race;
- If the worker is dismissed and the reason or the principal reason is that he or she made a protected disclosure this dismissal will automatically be considered as an unfair dismissal by an employment tribunal; and

- It is important to note that the usual qualifying period of one year's continuous employment and the usual cap on unfair dismissal compensation – currently £55 000 – do not apply in whistleblowing cases. This means that it would be advantageous for a worker to show that he or she had been dismissed as a result of a protected disclosure rather than for any other reason in unfair dismissal cases where the employee has less than one year's continuous employment or where his or her losses exceed £55 000.

The key elements of a protected disclosure are as follows.

### *The subject matter of the disclosure*

A disclosure is protected in circumstances where – in the reasonable belief of the worker making the disclosure – the information being disclosed tends to show that any of the following is occurring, has occurred or is likely to occur:

- A criminal offence;
- A failure to comply with a legal obligation;
- A miscarriage of justice;
- An endangering of the health and safety of any individual;
- Damage to the environment; and
- The deliberate concealing of information tending to show any of the above.

There are many types of information that are capable of forming a protected disclosure. According to commentators, in spite of the name of the 1998 Act there is no requirement that the disclosure should be 'in the public interest' or event that it must affect anyone other than the worker himself or herself. By way of example a complaint by a worker that he or she has been paid incorrectly can be a protected disclosure. Moreover it is not necessary for the disclosed information to be true. The vital point is that the worker reasonably believes that the subject matter of the disclosed information tends to show one of the failures that are listed above.

One caution to be noted is that workers who are relying upon disclosures regarding possible future failures must be careful. In such circumstances a worker must reasonably believe that the failure is likely to occur, not only that it could occur. The stronger test should be noted.

### *The person to whom the information is disclosed*

Once the subject matter falls within the above categories another hurdle must be overcome. The disclosure will only be protected if the disclosure is made to the employer of the worker or to a person who has been designated by the employer. The latter designation may be through the terms of a whistleblower policy. Some workers in the public sector can also achieve protection under the 1998 Act by making a disclosure to the relevant minister. As an alternative the worker can obtain protection by making the disclosure to the relevant 'prescribed person'. A full list of prescribed persons is found in the Public Interest

Disclosure (Prescribed Persons) Order 1999. This lists 40 ‘prescribed persons’ or organisations, including the Audit Commission, the Charity Commission and the Inland Revenue. The clear intention of the 1998 Act is therefore to encourage disclosure within the workplace or, where this is not feasible, to official bodies.

### *Motive of disclosure: ‘in good faith’*

In all cases of a disclosure the disclosure must be made ‘in good faith’. Evidently this means more than just reasonably believing the truth of the information. Therefore where the dominant purpose of the disclosure is some ulterior motive such as personal antagonism towards a manager, then the disclosure is not made in good faith.

### *Disclosure to third parties*

Despite the clear intention of the 1998 Act referred to above there is also some statutory recognition that in certain circumstances it is appropriate for a worker to disclose the information about an employer’s failure or failures to third parties. Since, however, such disclosure could be very detrimental to the employer in many respects, especially as regards their reputation, there are additional criteria or hurdles included in the legislation that must be fulfilled or overcome before any disclosure to a third party is protected. These are as follows:

- The worker must not make the disclosure for the purposes of personal gain; and
- Either the worker must have already made the disclosure to his or her employer or a prescribed person or must reasonably believe that he or she will be subjected to a detriment or that evidence will be destroyed or concealed if he or she did so; and
- The disclosure must be ‘reasonable in all the circumstances’.

The ‘reasonableness’ ingredient is important. The 1998 Act contains a list of matters that a tribunal must consider or have regard to in determining reasonableness. These matters include:

- The identity of the person to whom the disclosure is made;
- The seriousness of the alleged failure;
- Whether the disclosure is in breach of a duty of confidentiality owed by the employer to any other person; and
- Any action taken by the employer or a prescribed person in response to a previous disclosure.

As a result of the above – that is the criteria that must be fulfilled and the overriding need for ‘reasonableness’ – a worker must be extremely careful before leaking information to the press if he or she wishes to claim protection under the 1998 Act. It may be noted, nevertheless, that where the disclosure relates to an ‘exceptionally serious’ failure, the requirements are less stringent. To date,

however, there is not any guidance, whether by statute or case law, that demonstrates what amounts to an ‘exceptionally serious failure’.

## *Global developments*

Following the lead of the UK in 1998 and the US in 2002, many governments across the world, including the Netherlands, Japan, Korea and South Africa, have drafted legislation to protect whistleblowers.

In 2002 the UK’s Financial Services Authority established a hotline that received 276 calls from whistleblowers between May 2002 and October 2003. In the US the SOX legislation (see further below) obliges all US-listed companies to establish ‘confidential, anonymous’ procedures for employees to submit material about ‘questionable accounting or auditing practices’. It also protects whistleblowers from retaliation (see below). Impeding a whistleblower from passing information to enforcement agencies now carries a jail sentence of up to 10 years, as well as large fines. This demonstrates a major departure for a country whose legal culture has emphasised the duty of loyalty to the employer. Evidently Ernst and Young’s annual survey of global fraud has rated whistleblowing above external audits as the second most effective means of detecting corruption. People are now prepared to acknowledge that whistleblowing is about good citizenship (see comments on the US below).

In the UK there have also been other interesting developments in different legislation other than the above that represent the main body of this chapter. Therefore some comment on other legislation is helpful. By way of example, in the Charities Bill it is proposed that auditors of charity accounts will be protected from the risk of action for breach of confidence or defamation when they communicate relevant information to the Charity Commission. Independent examiners of charity accounts will also be protected. In this respect they are protected since they are often able to identify abuse or significant breaches of trust during the audit process. Since the activities of the profit and not-for-profit sectors are often linked and can impact on the governance of either sector some points of governance in the not-for-profit sector are relevant here.

## *The US SOX legislation*

The last five years have seen an unprecedented upswing in reports of accounting and other irregularities at public companies (see further information in Chapter 22). There was a time, a few years ago, when every day seemed to bring with it a new report that a public company was in the process of restating its earnings, seeking bankruptcy protection, fighting criminal indictments, or sometimes all of the above. In the wake of these developments, it was hardly a surprise when the United States legislature took action. On 30 July 2002, President Bush signed into law the Corporate Accounting Reform and Investor Protection Act of 2002, which is now almost universally referred to as the Sarbanes-Oxley Act of 2002 (‘Sarbanes-Oxley’ or the ‘Act’), Pub. L. No. 107–204

116 Stat. 745. Despite its swift drafting and passage, Sarbanes-Oxley will likely have profound implications not just for public companies, but for all companies doing business in the United States; these are discussed in more depth in Chapters 21 and 22.

As regards whistleblowing, one of the lessons of the last 10 years in the corporate fraud arena is that, more often than not, corporate fraud is generally detected from within rather than without. So-called corporate whistleblowers are, accordingly, an integral part of maintaining corporate integrity and such activities must be encouraged and protected. Section 806 of the Act protects whistleblowers from termination and allows them a right of action if they are discharged, demoted, suspended, threatened, harassed, or discriminated against (SOX § 806, 18 USC § 1514A). It should be noted that the Act does not provide for the award of punitive damages to a successful whistleblower. Title XI of the Act, which deals with corporate fraud and accountability, goes further than SOX Section 806, imposing criminal penalties on anyone who retaliates against a whistleblower who provides truthful information to the government (SOX § 1107, 18 USC § 1513).

### *Other recent US initiatives*

The US Federal government has recently been reported as using two new initiatives to tackle corporate fraud. As noted in the UK (see above) a corporate fraud hotline has been created by the FBI, as part of the Bureau's National Corporate Fraud Initiative. Through this expanded intelligence-gathering effort, the FBI has said that it expected to generate four or five new corporate fraud cases each month. Persons with information about possible corporate fraud, including corporate employees, are encouraged to contact this hotline. For individuals whose companies lack internal hotlines, this initiative allows whistleblowing concerns to be taken directly to the FBI.

#### *Useful web links*

The following sites can prove useful for further research on internal human resources and rights issues.

- \* Business and human rights:  
[www.business-humanrights.org](http://www.business-humanrights.org)
- \* Country risk research can be found at Impactt:  
<http://www.impacttlimited.com/site/5thanniversaryreport.pdf>
- \* Global Reporting Initiative – GRI: including a GRI content index and guidelines:  
<http://www.globalreporting.org/reportsdatabase/>
- \* International Labour Organisation:  
[www.ilo.org](http://www.ilo.org)

- \* Labour Start:  
[www.labourstart.org](http://www.labourstart.org)
- \* National Labour Committee:  
[www.nlcnet.org](http://www.nlcnet.org)
- \* United Nations Development Programme:  
[www.undp.org](http://www.undp.org)
- \* United Nations – Universal Declaration of Human Rights (UDHR):  
<http://www.un.org/Overview/rights.html>
- \* United States Department of State, Human Rights Reports (2001):  
[www.state.gov/g/drl/hr/](http://www.state.gov/g/drl/hr/)

## Chapter summary

Your employees, including managers and the executive are the key to long-term success and sustainability. A skilled, well-trained, determined and motivated workforce can overcome just about any challenge the risk environment of the 21st century can throw at it. The workforce is the key to long-term profitability and survivability in an age where traditional competitive advantages are being eroded as all organisations have access to similar resources, like instantaneous communications technologies, such as intranets, the internet and video conferencing. It therefore is increasingly important how well we can communicate as the speed at which we can do it becomes universal.

Staff and management training on sustainability risk management issues should also form part of a larger commitment to organisational learning and knowledge management. This could take the form of online training modules or additional information and resources for staff that wish to progress their knowledge in specific areas of sustainability-related issues. This may include the establishment of programmes that encourage employee participation in the wider community to find out how an organisation can benefit or impact upon local communities and other stakeholder groups.

If treated with dignity, equality and respect to their rights as humans your fellow employees will assist you in becoming a sustainable durable organisation.

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15

Human rights outside  
the workplace



# 15

## Human rights outside the workplace

### CHAPTER OVERVIEW

This chapter focuses upon the relationship between human rights and organisations with particular reference to the human rights risks that may face operations. The chapter identifies frameworks for human rights mitigation and how effective management of human rights risks may bring benefits to business. Topics that are covered include:

- \* Human rights standards;
- \* A human rights risk management framework; and
- \* A review of some of the contemporary risk issues, such as:
  - Child labour;
  - Labour practices: compulsory and forced labour;
  - Working practice;
  - Oppressive regimes; and
  - Indigenous peoples.

### SERM approach

Research and analysis results indicate that:

- Human rights (external) risk is an average of 0.3% of market value of the top 500 US and EU companies; and
- This risk exposure has been reduced from 0.4% of market value by good risk management techniques (the risk reduction/management factor).

How should organisations respond to this level of risk and the human rights challenges?

Broadly speaking a very common approach is that of the view that human rights responsibilities lie solely with states and that their duties only extend to complying with local laws. An anomaly with this approach is that the countries associated with high human rights risks also have few legal frameworks to comply with. It is also an expanding view that respect for human rights, potential damage to reputations and effective management of human rights challenges are becoming a bottom-line issue.

The risk issue of human rights covers a series of rights and freedoms which are considered essential to people's enjoyment of life and respect for their human dignity. There are several methods of categorising human rights, including: civil and political rights (such as the right to life and the protection against torture, and the right to a fair trial); cultural, economic and social aspects where the emphasis is on the material and social cultural welfare of persons such as the provision of housing, clothing and food; and emerging groups rights, such as the right to a healthy environment.

The emphasis on various elements of these varies rights vary greatly from country to country, and although the responsibilities to respect, protect and fulfil these rights primarily lie with states we will follow what are considered to be international norms in this chapter.

The increased influence of human rights is also identifiable in the mounting litigation against multinationals and the serious reputational damage that can be caused. Companies have faced litigation in courts in the UK, US and Belgium alleging complicity in human rights abuses overseas in countries such as Nigeria, Myanmar (Burma), Sudan and South Africa.

Although a risk assessment may not show a high level of risk from the issues included in this chapter it is certain that courts will show an increasing readiness to accept such cases as at least legally admissible and this will lead to increased public attention as a result of the media involvement.

Assessment of a company is based on the extent to which the management implements its policies to protect employees from the following abuses:

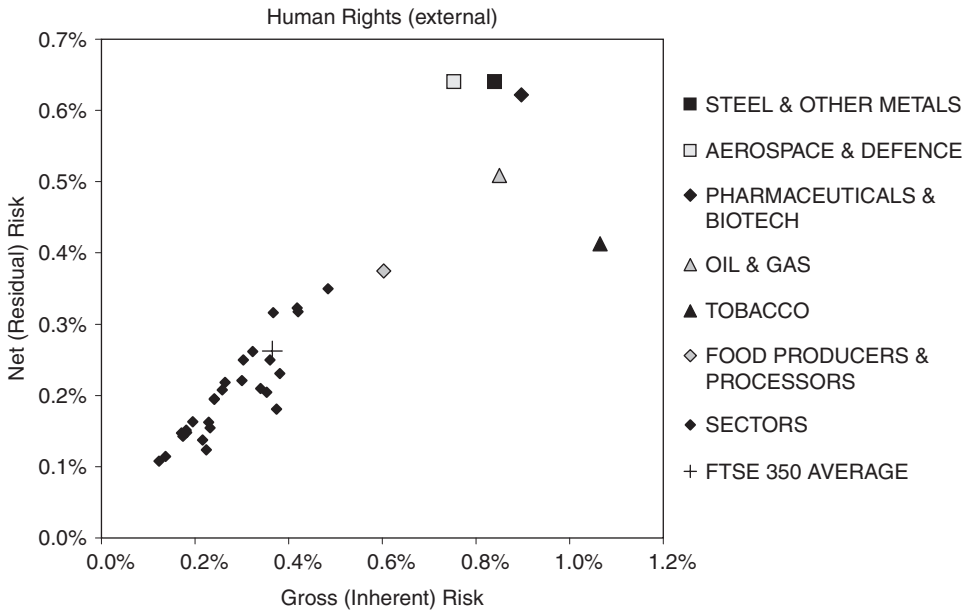
- Child labour, as defined by the ILO Convention 138;
- Forced and compulsory labour; and
- Unethical disciplinary practices, such as:
  - Beatings, floggings and other physical abuse;
  - Threats to the employee's family or relations;
  - Undue verbal abuse;
  - Use of unregulated security forces; and
  - Transgression of indigenous rights.

Organisations may be affected by human rights issues both internally or externally in their 'home' markets or in their foreign operations. The levels of risk increase when active in countries with poor human rights records and in high impact sectors, for example extractive industries and textiles industries as well as those in the graph below.

This rise of the corporation magnifies the fact that business does not operate in a vacuum and that human rights may be directly or indirectly affected by corporate conduct. As such, a degree of responsibility and accountability is increasingly being expected of a business:

At the end of the day, having a strong human rights policy and a sound implementation strategy is about risk management and reputation assurance. There can be no denying that human rights are a bottom-line issue. We need to see more companies adopting human rights principles and being held to account for putting them into action. (Mary Robinson, the former UN High Commissioner for Human Rights)

The graph also shows the human rights (external) risk by sector.



Human rights appraisals can form a critical part of stakeholders' view of organisations as non-compliance with social 'norms' as well as laws can have a major impact on intangible assets like reputations. As mitigation factors can prove quite cost effective it is not always seen that risk management of these issues needs to be a burden upon organisations. This is noted by the Ex US Secretary of State Madeline Albright:

The best companies realise that they must pay attention ... to universal standards of human rights, and that in addressing these needs and standards, there is no necessary conflict between profit and principle. ('Rights groups join companies to state principles', *Wall Street Journal*, 7 August 2001)

The human rights aspects of companies have no entrenched criteria but generally involve responsible treatment of:

- The internal business community (largely covered in the previous chapter):
  - Direct employees; and
  - Equality for employees, including women and those with disabilities in the workforce.
- The external business community:
  - Indirect employees and suppliers;
  - Child labour;
  - Forced labour; and
  - Suppliers.

- The wider community:
  - Ecosystems;
  - Indigenous communities;
  - Local communities; and
  - National communities.

These issues can also extend into the area of customer rights, in that the customer receives what they believe they have purchased and that the item was labelled and described accurately and that the item is fit for purpose or consumption. This is an area of emerging importance and customer groups are finding their voice more and raising concerns about products more often. An example of the new use of technology for this purpose is that a website has been established where all customers of a budget airline can publicise their complaints. The company in question even tried to have the website closed down by applying to the World Intellectual Property Organisation for a case brand name infringement. It was found that there was no evidence of acting in bad faith so the site can remain. Is this an example of the right to freedom of speech?

## The business opportunities

Human rights do not simply bring bad news for companies. Where there is an effective risk management of human rights and by adopting a proactive approach, it may be able to turn human rights risks into business opportunities. The potential benefits include the following:

- Improved risk assessment and management and corresponding reduction in liabilities;
- An improvement in decision-making processes like in the handling of ethical dilemmas; and
- Enhanced relationships with stakeholders including:
  - Improved and potentially more productive business relationships with suppliers and contractors; also a reduced potential for indirect reputational damage from subcontractors and suppliers if it has been clearly communicated that standards are to be met;
  - Enhancement of customer loyalty and brand value;
  - The raising of employee trust levels, increased morale, staff retention and ability to attract quality personnel. There may be the ability of these factors acting as an improvement on productivity;
  - The financial community may allow greater access to capital, or reduced insurance premiums for those organisations that abide by human rights codes and standards and have a history of compliance with international accords;
  - Positive relationship with local communities, governmental organisations and international NGOs, which could lead to the obtaining of licences to operate in areas where they might not otherwise have been able to; and
  - The potential for reduced negative press coverage and even increased levels of positive media representation.

The standards and codes that can lead to the development of a sustainable system of ensuring human rights for the activities of organisations are viewed as follows.

## Human rights standards

There is a wide range of codes, standards, benchmarks, indicators and reporting on human rights issues, but slowly there is progress towards a more common set for organisations to work with. This process will take a while to be developed and adapted to be usable by organisations in the same way it took decades for standards governing the environment, health and safety issues and labour best practice. Some of the main international compacts, laws and agreements are as follows.

### UN Universal Declaration of Human Rights (UDHR)

As mentioned in Chapter 14 this is the primary document asserting the value of human rights which came into being in 1948. It is the foundation of modern international human rights law and represents a set of 30 fundamental and universal rights forbidding slavery, racial or sexual discrimination and arbitrary arrest. It also asserts the freedom of speech and freedom of association. It is perhaps the single most important human rights document produced, due to its global reach, its influence on the creation of other human rights documents and the fact that many people think it has acquired international law status when it is in fact still just a declaration.

The UN is now taking the UDHR and other human rights instruments and is developing them into guiding human rights principles for businesses in the 21st century; the UN Norms on the Responsibilities of Transnational Corporations were adopted on 13 August 2003. The UN Norms are a major step towards placing direct legal obligations on companies although they are presently more of a template of standards against which corporations can measure their own codes and practices. They do not, as yet, constitute legal obligations but the Norms can be viewed as a template for the development of a sustainable system of human rights risk management and a review of the main rights is included in the risk management section below.

### The United Nations Global Compact

This is a voluntary approach developed within the United Nations (UN) and over 1300 companies have signed up to the guidelines launched in 1999 at the World Economic Forum in Davos. The elements of the nine principles of the UN Global Compact covering corporate behaviour that are relevant to this section include:

- Support and respect the protection of international human rights within their sphere of influence (Principle 1);

- Make sure their organisation is not complicit in human rights abuses (Principle 2);
- The elimination of all forms of forced or compulsory labour (Principle 4); and
- The effective abolition of child labour (Principle 5).

## International Labour Organisation Declaration on Fundamental Principles and Rights at Work

- Forced Labour Convention No. 29 (1930), requires the suppression of forced or compulsory labour (except convict labour);
- Abolition of Forced Labour Convention No. 105 (1957), which prohibits the use of forced or compulsory labour;
- Minimum Age Convention No. 138 (1973), calls for the elimination of child labour and of employment below the age of the completion of compulsory education; and
- Worst Forms of Child Labour No. 182 (1999), calls for the prohibition and elimination of certain forms of child labour.

## Regional conventions

There are a wide range of regional and economic grouping conventions and charters. We provide a brief list of regional examples of frameworks for human rights issues:

- Africa: the African Charter of 1981, the Protocol on the Establishment of an African Court on Human and People's Rights of 1998; and the African Charter on the Rights and Welfare of the Child 1990;
- Americas: the American Declaration of the Rights and Duties of Man 1948; the American Convention on Human Rights 1969; and the Inter-American Conventions on: the Prevention and Punishment of Torture (1985); the Forced Disappearance of Persons (1994); and the Punishment and Eradication of Violence Against Women (1994);
- Arabia and Islamic region: the Charter of the Council of the League of Arab States; the Cairo Declaration on Human Rights in Islam 1990;
- Asia: the Commonwealth of Independent States Convention on Human Rights Minsk (1995) covers European and Asian CIS nations who are signatories; for the rest of Asia there has been slow progress on developing a framework that covers the issues we review in this chapter at a regional level; and
- Europe: the European Convention on Human Rights (ECHR) 1950 has led to the implementation of national laws covering human rights such as the Human Rights Act 2000 of the UK. The purpose of the Act is to develop a human rights culture across all sections of society. As such, the Act is becoming increasingly relevant for business, particularly with regard to public/private partnerships and in litigation where all the courts and tribunals are now required to apply the ECHR. There are several others including the European Social Charter 1961 and the 2000 Charter of Fundamental Rights of the EU.

## The Global Sullivan Principles (GSP)

The GSP were developed by the veteran anti-apartheid campaigner, the Reverend Leon Sullivan, in 1977 to get US companies to afford the same rights to their South African workers as their US counterparts, regardless of race.

The objectives of the Global Sullivan Principles are to support economic, social and political justice by companies where they do business; to support human rights and to encourage equal opportunity at all levels of employment, including racial and gender diversity on decision making committees and boards; to train and advance disadvantaged workers for technical, supervisory and management opportunities; and to assist with greater tolerance and understanding among peoples; thereby, helping to improve the quality of life for communities, workers and children with dignity and equality. (Quote from [www.thegsp.org](http://www.thegsp.org))

## The Voluntary Principles on Security and Human Rights

These principles have been developed as a collaborative action by the governments of the US, the UK, the Netherlands and Norway, as well as companies in the extractive and energy sectors and NGOs to guide companies in balancing the needs for safety while respecting human rights and fundamental freedoms. Available at [www.voluntaryprinciples.org](http://www.voluntaryprinciples.org)

## The Ethical Trading Initiative

The Ethical Trading Initiative (ETI) is an alliance of companies, non-governmental organisations (NGOs) and trade union organisations that promote the implementation of corporate codes of practice which cover supply chain working conditions. ([www.ethicaltrade.org/](http://www.ethicaltrade.org/))

## Alien Torts Claims Act

This US law allows organisations to be sued in US courts for human rights violations committed outside the US, like the Sudanese people who sued Talisman and the government of Sudan for alleged collusion with security forces and ‘ethnic cleansing’.

## OECD Guidelines

The Organisation for Economic Co-operation and Development Guidelines for Multi-National Enterprises (known as the OECD Guidelines) and the International Labour Organisation’s Tripartite Declaration of Principles concerning Multi-National Enterprises and Social Policy are endorsed by states but are voluntary codes for companies.

## Social Accounting

The Council for Economic Priorities (CEP) set up a social analysis framework, SA 8000, based on the six basic conventions of the ILO, as well as the UN

Universal Declaration of Human Rights and the UN Convention on the Rights of the Child. The organisations applying for the standard:

- Should not engage in child or forced labour, nor should employees have to lodge deposits or leave identity papers with the company;
- Should provide a safe and healthy working environment and shall minimise as far as reasonable practicable the causes of hazards inherent in the working environment; and
- Shall not engage in or support discrimination in the advertising of vacancies, or the hiring, compensation, training promotion, or retirement of employees based on:
  - Caste;
  - Disability;
  - Gender;
  - Race; and
  - Sexual orientation.

## Risk management and organisational best practice

To be effective a sustainable risk management system and risk due diligence procedure need to take into consideration human rights issues, whether internally, such as health and safety issues and recruitment and human resources procedures, or externally, including the issues covered in the next chapters as well as community and customer-related concerns and risks.

There are a lot of codes and initiatives and it is difficult to figure out which are best practice and which can be practically implemented. So the following framework has been set out to act as an outline process of identifying corporate vision, key issues, objectives, targets, the establishment of the systems to achieve these, and the monitoring and reviewing of performance. The UN Norms at the end of this section can help inform each of the stages of this process.

The first stage is to conduct a due diligence review of the human rights element of the risk management system, this should aim to:

- Identify the extent of your human rights responsibilities;
- Put the systems and processes in place to manage these issues; and
- Perform a gap analysis to see where improvements could be made.

The review should include:

- An analysis of the extent and scale of the organisation's activities, including indirect operations of business and joint venture partners, suppliers and subcontractors;
- The organisation's human rights impacts to date and the issues that may arise in the future. Internally this could involve looking at the issues of direct relevance to employees like:
  - The activities of the organisation, its business partners, its supply chain and issues like bribery and corruption (reviewed in Chapters 7, 9 and 10);



- Collective bargaining, freedom of association, equal opportunities and anti-discrimination measures (Chapter 14); and
- The health and safety concerns in the workplace (Chapter 16).
- The workplace human rights issues covered in this chapter such as:
  - Stakeholder and community and indigenous people's human rights issues (Chapters 9, 12 and 15); and
  - Health and safety concerns for customers, including the positive and negative impacts of products and services (Chapter 17).
- A review of the regulatory requirements, the legislation, codes of practice, standards or voluntary agreements that apply to the organisation's activities and any stakeholder expectations that may exist;
- An assessment of the current systems and procedures that can assist in the facilitation of human rights risk management, with a focus on both internal and external considerations;
- The establishment of strengthened policies and risk management processes for a range of human resource-related human rights issues that will assist your organisation become more 'sustainable'. Businesses should put in place internal rules of operation in compliance with human rights principles; and
- The review should ensure that the organisation's framework is actually assisting with the implementation of a sustainable human rights risk management system by:
  - Putting in place internal rules of operation in compliance with the principles;
  - Incorporating the relevant human rights principles into their contracts and dealings with business partners, suppliers, contractors, subcontractors as well as their own operations;
  - Undertaking periodic monitoring to ensure compliance with the stated rules of operation and this could include suppliers, etc., and their application of the principles; and
  - There should be risk impact assessments and reparation made to those adversely affected by failures to comply with the risk management system or chosen human rights principles.

The UN UDHR framework (<http://www.un.org/Overview/rights.html>) and more specifically for business organisations the UN 'Norms' (<http://www.unhchr.ch/>) are useful tools to help scope the risk being faced. The UN Norms on the Responsibilities of Transnational Corporations can help provide a basis for an assessment of human rights risks such as: the sectors of industrial activity; the location and scale of operations; the product or service offered; the power and influence of the company, the type and location of consumers, the current human rights situation in host countries and the proximity to potential human rights violations.

The main rights with regards to an organisation's sustainable risk management system are outlined below:

- General obligations of individuals and organisations: the recognition that all humans are born free and equal in dignity and rights, have reasoning and

conscience and should behave towards their fellow humans in a spirit of brotherhood (Article 1 of the UNHDR). Businesses are expected to respect, prevent abuses of, and promote human rights. As Article 1 of the UN Norms states, organisations should:

within their respective spheres of activity and influence, transnational corporations and other business enterprises have the obligation to promote, secure the fulfilment of, respect, ensure respect of and protect human rights recognised in international as well as national law, including the rights and interests of indigenous peoples and other vulnerable groups.

- Organisations and individuals shall ensure equality of opportunity and non-discriminatory treatment (covered in Chapter 14) without distinction of any kind treatment for the purpose of eliminating discrimination based on race, colour, sex, language, religion, political opinion, national or social origin, social status, birth or indigenous status, disability or age (UDHR and Norms Article 2);
- Organisations should promote the right to security of persons (covered in Chapters 16 and 17):
  - The right to life, liberty and security of person (UDHR Article 3). Your security arrangements for businesses should observe international human rights as well as the laws and professional standards of the countries in which they operate. This may well be viewed as the protection of staff but also local communities and consumer groups.
- Organisations should not: engage in, nor benefit from:
  - ‘War crimes, crimes against humanity, genocide, torture, forced disappearance, forced or compulsory labour, hostage-taking, extrajudicial, summary or arbitrary executions, other violations of humanitarian law and other international crimes against the human person as defined by international law’ (UN Norms Article 3 and UDHR Articles 3, 4 and 5);
  - ‘Security arrangements for transnational corporations and other business enterprises shall observe international human rights norms as well as the laws and professional standards of the country or countries in which they operate’ (UN Norms Article 4); and
  - Individuals should be afforded fair trials with a presumption of innocence and guarantee of the provision of a defence (UDHR Articles 6–11).
- Privacy: Article 12 of the UN UDHR says that there should be freedom from arbitrary interference with privacy, family, home life or correspondence (viewed in Chapter 14);
- Freedom of beliefs and how they can be expressed: UDHR Articles 18–20 deal with freedom of expression and beliefs;
- Workplace rights (see Chapter 14) or the rights of workers: organisations should:
  - Not use forced or compulsory labour (UN Norms Article 5 and UDHR Article 4 on slavery and servitude);
  - Not use child labour, that they, ‘shall respect the rights of children to be protected from economic exploitation’ (UN Norms Article 6);

- Provide a safe and healthy working environment, as set forth in the relevant national and international legislation, as well as international human rights and humanitarian law (UN Norms Article 7);
- Allow freedom of assembly and association without compulsion and effective recognition of the right to collective bargaining (UN Norms Article 9). UDHR Article 23 states that everyone should have the right to join a trade union;
- Provide workers with a remuneration that ensures an adequate standard of living for them and their families to have a dignified existence (UN Norms Article 8, also UDHR Article 23);
- Ensure that there is equal pay for equal work (also UDHR Article 23); and
- Ensure that there is a reasonable limitation of working hours, and sufficient entitlement to paid holidays to allow rest and leisure (UDHR Article 24).
- Organisations and business enterprises should have respect for national laws and process, including the avoidance of bribery and corruption measures and shall:
  - ‘recognise and respect applicable norms of international law, national laws and regulations, as well as administrative practices, the rule of law, the public interest, development objectives, social, economic and cultural policies including transparency, accountability and prohibition of corruption, and authority of the countries in which the enterprises operate’ (UN Norms 10);
  - ‘not offer, promise, give, accept, condone, knowingly benefit from, or demand a bribe or other improper advantage, nor shall they be solicited or expected to give a bribe or other improper advantage to any Government, public official, candidate for elective post, any member of the armed forces or security forces, or any other individual or organisation’ (UN Norms 11); and
  - ‘respect economic, social and cultural rights as well as civil and political rights and contribute to their realisation, in particular the rights to development, adequate food and drinking water, the highest attainable standard of physical and mental health, adequate housing, privacy, education, freedom of thought, conscience, and religion and freedom of opinion and expression, and shall refrain from actions which obstruct or impede the realisation of those rights.’ This is quite a lot and almost puts business organisations on a parity with governmental bodies in terms of the actions recommended (UN Norms 12).
- Organisations shall respect consumer and environmental protection:
  - Act in accordance with fair business, marketing, advertising practices and ensure product safety and quality (UN Norms 13); and
  - Conduct their activities in a manner which contributes to the wider goal of sustainable development and environmental protection and act in accordance with national laws and regulations and international agreements and standards (UN Norms 14).

UN Norms Articles 15–19 are general provisions on implementation of the article. Other UDHR Articles include numbers 13–15 that note the freedom of movement within the individual’s own nation’s borders, the right to leave, the

right to seek asylum abroad for political crimes and the right to nationality. Article 16 is the right to marry freely; Article 17 the right to own property; Article 21 provides the right to take part in government, to have equal access to public services and to have genuine elections with secret ballots; Article 22 gives the right to social security and the rights that assist the free development of personality within an individual's nation resources.

The UN Norms can also assist in the management of human rights expectations of stakeholders, of the communities, governments and NGOs, local businesses and other interested parties. They can act as a basis for dialogue, providing an opportunity for organisations to engage with stakeholders and to promote common understanding as to the scope and limitations of the human rights issues each is responsible for, and to what extent.

## Best practice in the management of risks

The following are examples of general good company policy in risk management:

- British American Tobacco, the tobacco giant, has been congratulated in public by the government and NGOs for pulling out of Burma; and
- R.J. Reynolds, another tobacco company, note (in their company's Standards of Business Conduct, p. 17) that:

The Company and all its employees are prohibited or severely restricted from exporting to, or entering into transactions with, countries or nationals of countries embargoed by the US government.

- A description of policies, guidelines, corporate structure and procedures to deal with all aspects of human rights relevant to operations;
- Policies that relate to existing international standards such as the Universal Declaration and the Fundamental Human Rights Conventions of the ILO;
- Provision of employee training concerning all aspects of human rights relevant to operations; and
- Evidence of consideration of human rights impacts as part of investment and procurement decisions, including selection of suppliers/contractors and that there are monitoring systems.

## Some contemporary risk issues

New legal risks will emerge as legislation is developed or, in the case of this example, rediscovered. The statute at issue, the Alien Tort Claims Act 1789, was virtually dormant until being revived in a series of court decisions since 1980. To date, major brands including Unocal, Chevron Texaco, Union Carbide, Exxon Mobil, Gap, Coca-Cola, Del Monte, Citigroup, Ford and Nike have been sued under the above act for complicity in human rights violations. The cases form the legal basis for suing multinational corporations in the US courts for human rights violations abroad ('Analysis: Is trying to kill the Alien Tort

Claims Act digging for fool's gold?', *EC Newsdesk*, 13 May 2004). This trend for increased legislative pressure upon organisations is set to increase.

Another trend is that stakeholders are using their collective will in place of effective legislation. Examples of this trend are:

- Shareholder power being demonstrated by the California Public Employees' Retirement System (CalPERS) which is one of the world's largest pension funds and the US's largest public pension fund with assets totalling \$217.6 billion (as of 30 September 2006). In February 2001 they surprised the investment world by announcing they would be withdrawing their funds from Indonesia, Malaysia, the Philippines and Thailand, as they did not meet investment guidelines standards as a result of labour standards and levels of democracy and press freedom; and
- The UK government prefers a more informal approach to these ethical issues at the moment and exerts pressure 'behind the scenes'. For example: human rights activists like Amnesty International and Transparency International allege that companies are not always aware of the conditions of workers overseas; and NGOs are requesting increased disclosure of organisations' labour standards procedures to avoid future criticism from them.

## Child labour

With 192 nation states signing up to the UN Convention on the Rights of the Child (1990) it is perhaps the most widely accepted human rights convention, with the only main recalcitrants being Somalia and the United States. The global support for the protection of children's rights is slowly having a beneficial impact upon the avoiding of their mistreatment but there is still widespread difficulties faced by children, including that of slave and enforced labour.

The definition of child is: any person less than 15 years of age, unless the local minimum age law stipulates a higher age or if the local minimum age law is set at 14 years of age in accordance with developing-country exceptions under ILO Convention 138.

The International Labour Office (ILO) International Programme on the Elimination of Child Labour says child labour, which involves one in every six children in the world, can be eliminated and replaced by universal education by the year 2020 at an estimated total cost of US\$760 billion. In a new study entitled 'Investing in Every Child, An Economic Study of the Costs and Benefits of Eliminating Child Labour', the ILO say the benefits of eliminating child labour will be nearly seven times greater than the costs (see [www.ilo.org/public/english/bureau/inf/pr/2004/4.htm](http://www.ilo.org/public/english/bureau/inf/pr/2004/4.htm)).

What's good social policy is also good economic policy. Eliminating child labour will yield an enormous return on investment – and a priceless impact on the lives of children and families.

This is according to the ILO Director-General Juan Somavia. The ILO says the number of child labourers worldwide fell by 11% between 2000 and 2004, from 246 million to 218 million worldwide, but of these, 179 million – or one in

every eight children worldwide – are exposed to the worst forms of child labour, including work in hazardous environments, slavery or other forms of forced labour, and illicit activities such as drug trafficking and prostitution. High risk countries are thought by experts to be Bangladesh, India, Indonesia, Malaysia and the Philippines.

As part of its sustainable risk management systems an organisation should have a policy which states that it excludes child labour from its operations (as defined by the ILO Convention 138) and the extent to which this policy is visibly stated and applied.

This is also an issue that is more common in the western world than might be expected, whether directly or indirectly through contractors and suppliers:

- The largest fine occurred in Surrey, one of the wealthiest areas of Europe. The courts imposed fines of approximately £34 000 against a very large fast food giant for using under-age staff;
- The Boston Common Asset Management and the First Swedish National Pension Fund (Första AP-fonden), withdrew a child labour resolution when the target company, Marriott agreed to dialogue;
- Labour research reported that in 2001 Woolworths was fined £1200 after breaching UK child labour laws. Four 16-year-old schoolchildren did not have work permits and worked until late at night;
- Recent labour standards reports have found many UK companies struggling to demonstrate effective management of their supply chain labour standards;
- The Russian office of Philip Morris is no longer using teenage girls and boys to hand out cigarettes and promotional trinkets on the streets of Moscow. The change comes after the Anti-Monopoly Ministry tightened regulation of alcohol and tobacco advertising (*Euromarketing* via email, 4 May 2001);
- The ILO report *Labour Practices in the Footwear, Textiles and Clothing Industries* (2000) described the large-scale move to Asia of jobs in these sectors and also found widespread use of child and female labour at low rates of pay;
- It is claimed that the threat of a boycott by US retailers of manufacturers of Bangladeshi companies using child labour would result in 50 000 children being thrown onto the street and a negative impact upon their economy. The truth is estimated to be that children on \$1 a day were replaced by adult workers on \$4 a day instead, resulting in an overall net benefit for the Bangladesh economy;
- In the 1990s NGOs and religious investment groups found that there were extremely low wages being paid to employees in developing world ‘sweatshops’ where the income earned was as low as one three-hundredth of the retail price of the finished item. The threatened boycotts, negative media coverage and shareholder resolutions led to a general improvement in respect to the basic wages received; and
- An *Ecologist* report claimed that an estimated 25 000 children, mostly girls, work an average of 10–13 hours a day for Hindustan Lever.

Two companies that demonstrate best practice by adopting a standard in their industry are Carlson Hotels and Accor Hotels. They have developed a Code of Conduct for the Protection of Children from Sexual Exploitation in Travel and Tourism which contains six elements, including: establishing an ethical policy on CST, training personnel, requiring suppliers to repudiate CST, providing travellers' information warning against CST, and reporting annually on code implementation.

Specific child labour risk management examples are that organisations should:

- Establish policies that clearly state the organisation's view and procedures on child labour;
- Not engage in the employment, supporting or recruitment of those defined as children for the purpose of work;
- Not expose children or young workers to hazardous, unsafe, or unhealthy situations inside or outside of the workplace;
- Set up procedures and policies to communicate the message that child workers are not allowed, to employees and other agents, like suppliers and contractors; and
- Provide adequate support to enable such children to attend and remain in school until no longer a child, thus helping to ensure that there are viable educational alternatives to employment activity.

## Labour practices: forced and compulsory working

Labour practices, including child labour are always headline grabbing, and the labour standards of suppliers is gaining in importance as a business and reputational risk issue. The risk is greater in scope than most people think and it is not only applicable to companies that have employees or subcontractors in Asia.

As part of their sustainable risk management systems an organisation should have a policy which states their avoidance of forced, compulsory and child labour (as reviewed below) and the extent to which ILO Convention No. 29, Article 2 and ILO Convention 138 are applied. There are also numerous issues with regards to excessive compulsory overtime, and employees being made to work unpaid overtime. Some examples of best practice include:

- That organisation should not engage in or support the use of forced labour and have policies to this effect. There should also be no withholding of identity papers by the employer. High risk countries are thought to be China and India;
- The Gap (US) report has won accolades for its honest and transparent reporting. It details exact code violations. For example, between 10% and 25% of its factories in China, Taiwan and Saipan use psychological coercion or verbal abuse. More than 50% of the factories visited in sub-Saharan Africa run machinery without proper safety devices. In response to these issues it revoked contracts with 136 factories in 2004 because of persistent or severe violations. In two instances, it cut off factories when it discovered a problem with an under-age worker (*Wall Street Journal*, 1 May 2004, p. A1);

- UK retailer Marks & Spencer was rated the highest score of 84%, in an Insight Investment research report, for what can be achieved in their management and reporting of labour standards in supply chains;
- US media giant Walt Disney has said it will investigate claims that staff at factories in China making books for the firm are working in unsafe conditions. New York-based campaign group the National Labour Committee (NLC) said factory staff in China's Shenzhen province worked up to 13-hour days for less than the minimum wage; and
- Apple Computer said a report of labour conditions at its iPod plant in China found workers did more than 60 hours a week a third of the time. Staff making the popular mp3 players also worked more than six consecutive days 25% of the time. Apple said the hours were 'excessive' and said its supplier would now be enforcing a 'normal' 60-hour week. The California-based firm said its internal review had found 'no evidence of enforced labour' or use of child workers.

## Health and safety

Health and safety rights issues are becoming more apparent, evidenced by allegations that suppliers of organisations are reducing standards of health and safety to below what would be considered legally acceptable. An example is that it is thought workers employed in China's jewellery trade are developing deadly silicosis, due to working in poorly ventilated workshops (China: Jewellery workers lung payouts fight Risks issue no 229 - 22 October 2005).

There is a general human rights view that organisations should: provide a safe and healthy work environment; take steps to prevent injuries; provide regular health and safety worker training; make available a system to detect threats to health and safety; provide access to bathrooms and potable water (UN Norms Article 7). This risk issue is covered in more depth in Chapter 16.

## Working practices

Working practices like discrimination, discipline, working hours, compensation, and the freedom of association and right to collective bargaining are covered in Chapter 14.

## Oppressive regimes

There is much disagreement over the roles of organisations in countries viewed as oppressive regimes, as there are arguments that this supports or props up the regime, and the argument is that the leaving of western companies from South Africa hastened the fall of the apartheid regime in South Africa. Companies claim conversely that they are 'engaging' with the governments to alter their actions and this is the best way to 'reach' them. So each case and country is usually reviewed on a case-by-case basis.



The general principle to think about adhering to is Article 21 of the Universal Declaration on Human Rights which defines democracy as an essential human right.

Currently the US embargoed countries are Burma (Myanmar), Federal Republic of Yugoslavia (Serbia and Montenegro), North Korea, Syria (certain financial transactions), Afghanistan (pre-occupation), The Balkans, UNITA (Angola) with certain exceptions, Cuba, Iran, Iraq (pre-occupation), Libya and Sudan.

Oppressive regimes are becoming a contentious issue, and companies that operate in them will continue to feel increasing pressure from NGOs and governments. In the US, companies are legally prevented from operating in some countries (like Cuba). President Bush has recently signed the Burmese Freedom and Democracy Act 2003, which states, 'No article may be imported into the United States that is produced, mined, manufactured, grown, or assembled in Burma.'

There are concerns over China as well about the levels of democracy in the country (as exemplified by Tiananmen Square) and Tibet over a range of labour and health and safety issues. These have largely been overshadowed by the large economic benefits the market presents as companies measure the risks to the rewards. This can be seen by the number of media and communications companies who have tempered their otherwise independent editorial stances to gain market share there. It is also to be noted that China has had cause to complain that developed world companies setting up in China have not adhered to human rights issues as well, as numerous companies have denied workers the right to Freedom of Association and the Right to Organise and UN Conventions Nos 87 and 98.

Examples of risks include:

- The Aliens Tort claims Act (ATCA) of 1789 has led to a case alleges a company's complicity in the torture, rape and enslavement of villagers by the armed forces of Myanmar (formerly known as Burma), in connection with an oil and gas extraction project. Unocal owns a minority interest in the project, which it purchased with knowledge that the Myanmar military would provide security for the job (*EC Newsdesk*, 13 May 2004);
- Political pressure and boycotts of firms active in Burma are urging companies there to pull out of Burma. Human rights activists are also releasing their 'dirty lists' of firms doing business in Burma;
- An American oil giant stood trial in California for alleged human rights abuses in Burma; and
- The China National Petroleum Company (CNPC) invested \$1 billion in Sudan while already having \$15 billion in debt. There were several attempts to raise money by initial public offerings (IPOs) which seem to have received ethical risk alerts and boycotts from many investment institutions. CNPC eventually managed to raise funding with the sale of a new subsidiary called Petro China in 2000. This IPO raised only about £3.4 billion which was one-third of the expected amount after large price discounting by underwriters to move the stock;

- One of the main purchasers of Petro China stock was BP who was to receive reputational damage as a result of this, as did Talisman, the Canadian oil company who also faced legal action in the US as a result of operations there.

## Indigenous peoples

The rights of indigenous peoples have been raised to increased prominence by the recent UN International Decade of the World's Indigenous People, which ran from 1995 to 2004. The UN estimates that there are in excess of 300 million people that are considered to be indigenous by virtue of their being descendants of the 'original' inhabitants of a specific geographical area (prior to external settlement or colonisation).

There are numerous pressures upon these peoples as their ancestral lands are being taken over and dominated by external occupation, conquest, or purchase, or they are being forced to move from these areas. This effect is often compounded by business interests in areas that are often rich in natural resources. To help protect and develop the rights of these threatened groups the Commission on Human Rights established the decade of indigenous peoples and the UN Permanent Forum on Indigenous Issues, which is an advisory body to the Economic and Social Council.

The United Nations Declaration on the Rights of Indigenous Peoples was adopted by the Human Rights Council on 29 June 2006, details can be found at: <http://www.un.org/esa/socdev/unpfii/en/declaration.html>

There are numerous other stakeholder groups that express views on how businesses should engage with these communities on issues like economic and social development, culture, resource exploitation, intellectual property rights and the environment. These groups include the Indian Law Resource Centre; Indigenous World Association; International Indian Treaty Council; International Organisation of Indigenous Resource Development; National Indian Youth Council; and the World Council of Indigenous Peoples.

Company case studies include:

- Companies can become involved in the forced relocation of individuals and communities, whether it is in the UK for road building and airport expansions, or large overseas infrastructure projects. An example of this is BP plc's relocation of 127 families to a newly constructed village in Tangguh, Indonesia;
- Britain's Vedanta Resources plc has faced thousands of tribal people armed with bows and arrows protesting against an alumina refinery being set up in eastern India. The protesters, along with environmental activists, marched to the refinery site in the mineral-rich Lanjigarh area of Orissa state, and vowed to stop the US\$874 million project; and
- A positive case study is that organisations can also be proactive in addressing potential risks and even take the lead on these types of issues. An example of corporate progression is that Alcan is advancing corporate practice by launching its own Rights of Indigenous Peoples policy; this is while the UN General Assembly still considers adopting a Declaration on Indigenous Peoples.

*Useful web links*

- \* Business and human rights:  
[www.business-humanrights.org](http://www.business-humanrights.org)
- \* Country risk research can be found at Impactt:  
<http://www.impacttlimited.com/site/5thanniversaryreport.pdf>
- \* Global Reporting Initiative – GRI: including a GRI content index and guidelines:  
<http://www.globalreporting.org/reportsdatabase/>
- \* International Labour Organisation:  
[www.ilo.org](http://www.ilo.org)
- \* Social Accountability International – SA8000 Standard of Human Rights in the Workplace:  
<http://www.sa-intl.org/>
- \* United Nations Development Programme:  
[www.undp.org](http://www.undp.org)
- \* United Nations – Universal Declaration of Human Rights (UDHR):  
<http://www.un.org/Overview/rights.html>
- \* United States Department of State, Human Rights Reports (2001):  
[www.state.gov/g/drl/hr/](http://www.state.gov/g/drl/hr/)



16

Health and safety in the workplace

# 16

## Health and safety in the workplace

### CHAPTER OVERVIEW

All organisations are at risk from health and safety-related impacts upon their businesses. These impacts can be significant and the direct and indirect costs to businesses have been assessed as being 1.2% of the market value of the 500 largest EU and US companies at risk from issues relating to the health and safety of employees. 1.2% are also at risk from associated historic liabilities of organisations and 1.4% are at risk from external health and safety issues covered in the next chapter.

An outline of a sustainable health and safety risk management framework is included at the end of the chapter.

### Introduction

As discussed in Chapter 8 the world collectively breathed a great sigh of relief on 1 January 2000, when the much anticipated and greatly feared Y2K bug failed to bite, and the long predicted worldwide crisis never happened. In the weeks leading up to the new millennium, even those of us who had convinced ourselves that everything was under control and that no crisis would actually occur, had quietly stashed away some extra cash and loaded up a bit more than usual at the grocery store, just in case. In hindsight, many questions are being asked about why we survived the stroke of midnight unscathed. Was it all just a hoax? Was it misinformation? Or perhaps, was it due to the unprecedented planning and testing of computers and computer-related equipment that had taken place in preparation for the new millennium?

Those who believe that the Y2K bug was exterminated by the enormous planning efforts of Corporate America think there is a lesson to be learned from this experience; namely, there is no substitution for good planning. That concept is certainly true when it comes to planning for and managing a crisis in the environmental, health and safety (EHS) arena. Unfortunately, despite an organisation's best efforts, it is almost inevitable that somewhere, sometime, a very

serious EHS accident will occur. Experience has shown that companies caught without a comprehensive EHS crisis management plan suffer both severe public relations troubles and significant legal liability (see also Chapter 8).

## Heightened expectations

Due to the rapid pace of technological advances, a timely response to an EHS crisis is more critical than ever. Because of the widespread availability of electronic mail, cell phones and other forms of immediate communication, there is a growing belief that there is no excuse for delayed response. In the US both the public and regulatory agencies, such as the Environmental Protection Agency (EPA) and the Occupational Safety and Health Administration (OSHA), have raised their expectations considerably. Regulatory agencies have also stepped up enforcement activity in the wake of such accidents. Moreover, computer technology has assured that, not only will a company's EHS crisis make the 11 o'clock news, it will also be posted on numerous websites, complete with all the details and pictures.

These reasons make it an absolute necessity for companies to have in place well thought out, usable and responsive EHS crisis management plans. Because of the myriad complex issues involved in crisis management, it is extremely important that a multidisciplinary team develop the plan. Too many companies make the mistake of having a plan developed solely by lawyers, a public relations firm, or engineers. Such plans are inevitably missing critical elements. Once a plan is complete, it is also important to make certain that all of the players involved in EHS crisis management, from top to bottom, are familiar with it.

This chapter develops these concepts and places them in a practical framework for assessing an organisation's health and safety risk profile. Where appropriate, case studies of aspects of an organisation's risk are included. For example:

- Internal health risks to the organisation – staff and suppliers;
- Historical legacies of health and product liability issues; and
- Internal safety issues – workplace safety.

Issues that are relevant to safety and health risks external to the organisation (risks that can impact upon the general public and customers' health) are covered in the next chapter.

## Background

Globally, the International Labour Organisation (ILO) estimates that approximately 2 million people are killed in work-related diseases and occupational accidents, of which 355 000 are fatal accidents each year.

Occupational accidents kill over 300 people and injure over 1 million people each year in the UK. Financial, legal and strategic, as well as moral, considerations all dictate that health and safety has to be prioritised and proactively tackled in every workplace.

Historically campaigning against unsafe and unhealthy workplace practices is not new, a classic case was that of Annie Besant who published an exposé of labour conditions on 23 June 1888. In an article entitled ‘White slavery in London’ she drew attention to the dangers of yellow phosphorus from fumes and ingestion used in match production at Bryant & May, while other producers did not use the dangerous substance. In response, in 1891 the Salvation Army opened its own match factory in Old Ford, East London, using harmless red phosphorus as a direct competitor. Eventually, in 1901 and after years of campaigning, Gilbert Bartholomew, managing director of Bryant & May, announced it would stop using yellow phosphorus.

More recently there have been a lot of high profile examples of safety accidents and disasters including Stockline Plastics; *The Herald of Free Enterprise* (192 dead); the King’s Cross underground fire (31 dead); Piper Alpha (the world’s worst offshore oil disaster killing 167); the Clapham rail crash (37 dead); Hillsborough (97 dead); and *The Marchioness* (51 dead). These events should be familiar due to their severity and the level of media coverage. It is noteworthy that, although the cumulative impact and level of fatalities from health risks is many times higher, safety risks in general are given much more attention by management and media alike. Safety disasters and health damage can be prevented if steps are taken to ensure an organisation operates safe systems of work within a strong health and safety management culture. Incidents are avoidable, for example in the Ladbroke Grove train crash enquiry Lord Cullen’s summary noted that there was a ‘lamentable failure’ by Railtrack to respond to safety warnings before the incident (BBC News, 19 June 2001, reporting on Lord Cullen’s enquiry ‘Crash report blames lamentable failures’: <http://news.bbc.co.uk/1/hi/uk/396414.stm>).

## The business context

The UK represents and provides an excellent case study of a highly regulated regime. In the UK there is a strong safety culture which has led to the country having the second lowest rate of fatalities at work (per millions of hours worked) in Europe. There has been important health and safety legislation in the UK for a long time and this has meant that health and safety risk management has become embedded in most companies’ internal control systems. The balance of evidence demonstrates that a health and safety risk management system (HSMS) is good business management and improves bottom-line profitability wherever the business operates. This helps to achieve the avoidance of:

- Health and safety incidents, or a reduction in the number of incidents and/or their impact;
- Non-compliance convictions, criminal prosecutions and enforcement notices;
- Enforcement actions for remedial work;
- Civil claims;
- Damage to reputation and brand; and
- Increases in insurance premiums.

- Stakeholder pressure:
  - Customers – demanding safer products;
  - Employee pride and health and safety;
  - Strengthened bank lending criteria; and
  - Removal of cover by insurers and increase in premiums as losses mount – failure to comply with legislation can invalidate insurance cover.

There are the additional benefits of:

- Increased productivity and reduced production resource security;
- Business improvement – injuries and sick leave have long been identified as major costs for companies, but there is also a growing body of evidence which shows that effective occupational safety and health management has a positive impact on a firm's stock market performance;
- Reduced insurance premiums for a reduced claim history and risk profile;
- Reduction in the chances of losing competitive advantages;
- Increased stakeholder value, as shareholders request improvements from larger companies, which in turn request higher standards from smaller suppliers;
- Improvement in customer and staff morale; and
- Meeting increasingly stringent lending criteria.

It is worth mentioning that a company is at risk from health and safety issues irrespective of its size; indeed, the smaller the company the less time it seems to devote to implementing health and safety systems and, therefore, the more likely it is that the company and its directors are found at fault or guilty of negligence, and a smaller company may not be able to afford the same level of legal support which a larger company can.

This applies equally to countries. It is sometimes claimed that high health and safety standards can reduce competitiveness, so that poorer nations 'cannot afford' good health and safety. That has always been a distasteful argument, however, which is now known to be unsound. Recent studies by the World Economic Forum and the Lausanne Institute of Management (IMD) show that the most competitive countries also have the most stringent safety regimes.

## Health and safety risks and trends

### General overview

All organisations are at risk from health and safety-related impacts upon their businesses. These impacts can be significant and the direct and indirect costs to businesses have been assessed as being: 3.8% of the market value of the 500 largest EU and US companies are at risk from these issues. 2.4% of this is internal risk, reviewed in this chapter, and 1.4% is risk to market value as a result of risk to the public and customers, reviewed in the next chapter.

The 2.4% risk to value is due to:

- Internal health risk at 0.7%;
- Internal workforce safety risk accounts for a loss of 0.5%; and
- Historical health liabilities risk is an average of 1.2%.



This risk to organisational value will increase as the amount of legislation, volume of litigation and level of awards increase. There may also be an increased level of stringency as the government listens to their stakeholder groups, primarily the trade union movement.

The following risk issues are considered below:

- Financial risk;
- Operational environmental risks – direct and indirect;
- Legal risks;
- Human health and product risks; and
- Stakeholder risk, including reputation and brand risk (see also Chapter 9).

## Financial risk

All the factors outlined in this section can have a financial bearing upon the organisation (both directly and indirectly). The risk assessment methodology measures a company's exposure to: Health and Safety Executive (HSE) imposed fines; penalties; increased expenditure on safety measurements and training, compliance and other prevention measures; legal costs; increased resource costs and staff time. These factors are combined with a weighting for their sector of activity, and their risk management activities. The resultant figure is the potential financial loss the company could experience from health and safety risk. The average for the top 500 US and EU-based companies is 2.4% of the market value.

The following are some extreme case studies:

- The massive loss of shareholder value at Railtrack (98%);
- British Energy (outcome still pending but shares fell 30% as a result of problems instigated by two plant closures);
- Jarvis, who lost 40% of their value within a week as a result of safety incidents and the retraction of contracts due to health and safety performance;
- The Health and Safety Commission's 'name and shame' policy has resulted in the following headlines: 'Car giant fined £300k for tragedy', 17 June 2003; 'Death firm fined £135 000', 10 December 2003. Also, BP has been fined £1 million for an incident at their Grangemouth site (and has spent a further £30 million on improvements); and
- A company pleaded guilty to manslaughter when an employee fell over eight metres through a fragile roof. The court heard that inspectors from the HSE had previously seen the employee working at another company site without using the correct safety equipment and had spoken to the company about its safety failings. The company was fined £25 000.

Examples of the financial impact on a company arising from health issues include the following:

- Asbestos:
  - BOC plc shares closed down 2.5% at 887.5p after it lost its first asbestos case in the US as the company admitted it was also facing 1200 previously undisclosed claims from asbestos sufferers (*Daily Telegraph*, 14 May 2004); and

- Global car giant DaimlerChrysler must pay \$20 million (£10.3 million) to a retired police officer and brake repairer whose right lung was removed because of cancer caused by asbestos.
- Parkinson's impact: BOC plc shares dropped 7.6% or 68p on 29 October 2003 (*Financial Times*, 1 November 2003) on fears that the company could be exposed to tobacco-sized litigation from Parkinson's sufferers as a result of using welding equipment;
- Workplace cancer: an estimated 32 million people in the European Union (EU) are exposed to hazardous substances at levels which exceed what is considered as safe, and the estimated cost of the resultant workplace cancers costs the EU £46.7 billion a year (*Risks*, issue number 150, April 2004);
- The draft EU law on testing chemicals could impose direct costs on UK industry of £515 million over 11 years. A cost/benefit analysis suggested that the legislation will break even if it saved 18 or more occupational cancer deaths a year. This will reduce the risk of chemical impacts upon people (*Financial Times*, 31 March 2004);
- In the US it has been estimated that total monetary benefits under the Clean Air Act from 1970 to 1990 range from \$5.6 to \$49.4 trillion. The costs of compliance for businesses were estimated at \$0.5 trillion. Studies are available at [www.epa.gov/oar/sect812](http://www.epa.gov/oar/sect812) (*Environmental Policy and Politics*, 3rd Edition by Michael Kraft, Pearson Education (2004)); and
- An extreme example of how health and safety issues and economics are interlinked is from the oil and gas sector, when the world's largest oil platform, owned by Petrobras, sank off the coast of Brazil in April 2001. The economic impact of this environmental disaster was an estimated cost of £600 million to Lloyd's of London, and the currency fell 8% as imports had to rise to cover the loss of output. There was also substantial loss of life and a large oil pollution incident.

## Legal risks

In this section the legal risks are reviewed, including:

- Civil damages;
- Criminal penalties;
- Enforcement and prohibition notices; and
- Other methods of ensuring compliance with health and safety laws.

The legal aspects of health and safety risks are discussed in brief as there is a wide variety of legislation in different countries (director and officer personal liabilities, and issues with regards to manslaughter and corporate killing legislation are discussed in Chapter 4). It is sufficient to note here that there will be an increasing level of national and international health and safety legislation and litigation. The table below (taken from *Corporate Manslaughter and Homicides in the UK* from the website [www.corporateaccountability.org/manslaughter/cases/main.htm](http://www.corporateaccountability.org/manslaughter/cases/main.htm)) shows how few ongoing manslaughter cases in the UK there currently are.

Number of incidents (involving at least one death) which have resulted in conviction	Total number of deaths involved in these incidents	Number of companies convicted	Number of company directors convicted	Number of business owners (i.e. sole traders or partners) convicted
11	16	5	8	4

## Director and officer liability

The average annual pay of Britain's top bosses is approximately £1.5 million but the average fine for a workplace safety offence is £12 194 (according to the magazine *Hazards*, issue 81, January–March 2003, who argue that small fines alone are not an adequate deterrent for Britain's workplace safety criminals. Most company directors believe a senior director should be responsible for safety and over half think they should be criminally liable for safety failings (*Risks*, issue number 145, 28 February 2004, see [www.tuc.org.uk/h\\_and\\_s/tuc-7706-f0.cfm#o4](http://www.tuc.org.uk/h_and_s/tuc-7706-f0.cfm#o4)).

However, there are numerous examples of health and safety prosecutions of directors (from the Centre for Corporate Accountability), some of which are provided below:

- Network Rail, the maintenance firm Balfour Beatty and six senior managers are to face manslaughter, gross negligence and safety charges over the Hatfield train crash (*Risks*, issue number 114, 12 July 2003);
- Two people died after being overcome by dichloromethane chemical fumes which had escaped from the processing area of a paint stripping business. The business owner, a sole trader, was convicted of manslaughter;
- Two directors pleaded guilty to the manslaughter of an 18-year-old labourer who died in April 2000 when a stack of timber fell on him;
- A company, and one of its directors, were found guilty of manslaughter when an employee was hit by a 20-tonne trailer. The trailer became detached from a tractor because it was dangerously loaded and the hitch mechanism connecting the trailer to the tractor was 'badly worn'. The sentence was 240 hours' community service;
- Two farmers were found guilty of the manslaughter of a 16-year-old trainee who died when the JCB potato loader he was operating was hit by a lorry. Birmingham Crown Court heard that 'the JCB should not have been under the control of an untrained 16-year-old with very limited experience ...'. There was also evidence that a health and safety inspector had given instructions that the employee should not drive the JCB until he had received training. One director was jailed for 15 months while his father received a one-year suspended sentence;
- A director was convicted of the manslaughter of a worker with special needs, who was crushed to death when he fell from a cage, which was being lifted on a forklift truck. The director received a 12-month sentence, suspended for

two years. He was also convicted of two health and safety offences and fined £10 000;

- Two directors were convicted of the manslaughter of two employees who died when a lorry driver fell asleep at the wheel. The Old Bailey heard that the lorry driver, and other drivers at the firm, worked very long hours with the knowledge of the directors. The directors were sentenced to 15 months' and 12 months' imprisonment respectively, but both sentences were suspended for two years. The driver of the lorry received a two and a half year prison sentence for the offence of death by dangerous driving; and
- A transport company and its managing director were convicted of the manslaughter of an employee who was affected by cleaning chemical residues. The company had not provided preventive equipment, supervision or adequate training. The sole director of the company at the time of the death, was sentenced to 12 months' imprisonment and the company was fined £15 000.

## Stakeholder and reputational risks

This section is a brief overview of the value stakeholders place upon an organisation with regards to health and safety issues. More detail is provided in Chapter 9.

### *The SERM stakeholder template*

- \* Academic and research organisations;
- \* Business partners, suppliers and trade bodies;
- \* Customers and their representatives;
- \* Direct action groups and NGOs;
- \* Employees and their representatives;
- \* Financial institutions (banking, investor and insurance criteria);
- \* Governmental organisations;
- \* Local and regional governmental organisations;
- \* International governmental organisations;
- \* Journalists and media organisations;
- \* Key competitors; and
- \* Local communities.

Although all stakeholder groups have a part to play in the dynamics of health and safety risks, the stakeholder groups considered below are of particular note.

Employees and their representatives include the trade union movement who are the most vocal supporters for increased legislation to enforce health and safety standards and one of the main instigators of legal actions against offenders.

Financial institutions are improving their knowledge of the risks and liabilities with regards to these issues and there will be more engagement from the financial community as soon as they are confident with their methods of comparing performance. They are, therefore, one of the most vocal supporters in their calls for more transparency and reporting. Some local authority pension funds have started to target certain sectors where there are high levels of health and safety risk, such as the construction sector.

Governmental organisations are using their market power to alter the behaviour of companies, and they have included a company's health and safety track record as one of the criteria for Private Finance Initiative (PFI) tenders. The government have used the health and safety track record of suppliers as a ground for terminating contracts, such as the rail maintenance issue.

There are also moves to strengthen legislation in this area with the Corporate Killing Act, proposed in Frank Doran MP's 10-minute rule Bill which was put before Parliament on 30 March 2004. However, despite a six-year commitment to this Bill, Parliament have so far refused to set a date for its enactment which would then make corporate killing an offence. Cathy Jamieson, the Justice Minister, has said that the Scottish Executive is committed to bringing forward laws to deal with corporate killing (*Risks*, issue number 146, 6 March 2004). An interesting international development, which would worry UK businesses if adopted in the UK, is the US's plan for a 'three strikes and you're out' punishment for corporate crime. The proposed bill would cover illegal financial dealings, consumer and environmental protection, civil rights, union rights and employment laws, and it passed its first hurdle at the start of March 2003 (*Risks*, issue number 105, 10 March 2003).

International governmental organisations (IGOs) are becoming increasingly important in this sphere of UK life as in many others. An example is the European Union Directive 2002/95/EC on the restriction of the use of certain hazardous substances in electrical and electronic equipment. From July 2006, new electrical and electronic equipment (EEE) put on the market may not contain lead, mercury, cadmium, hexavalent chromium, polybrominated biphenyls (PBB) or polybrominated diphenyl ethers (PBDE).

## Risk management best practice

The legal duties of employers in managing health and safety include drawing up a policy statement, developing policies and procedures, implementing these policies and procedures to provide safe systems of work, reviewing progress and reporting on health and safety. The following are the main risk mitigation factors:

- Implementation of management systems: companies that have an occupational safety and health management system (OSH-MS) set up according to the International Labour Organisation Guidelines (ILO-OSH 2001) have both better safety and productivity records;

- Involvement of workers in planning and running the organisation's OSH-MS;
- A functioning, recording, notification and indicator system in order to gain a better picture of the problems and allow follow-up;
- Development of a modern labour inspection system: strengthening it qualitatively and quantitatively;
- Measurable targets for reducing occupational accidents and work-related diseases by targeting their causal factors (say a 20% reduction in the fatal accident rate within the next five years as measured by reliable records). A national profile or an inventory of the present safety and health state is a starting point;
- Gradual extension of the coverage of protective measures, compensation in case of injuries and occupational health services to workers not yet covered; and
- Workplace mapping techniques are an effective tool to identify health and safety problems in the workplace and the measures necessary to resolve them. Body maps, hazard maps and 'world maps' can make sense of problems at work, and can assist in identifying and remedying health and safety problems in the workplace.

As an example of what can be achieved, an official report by the UK's Health and Safety Commission's (HSC) 'Measuring up ... Performance Report 2006' estimates that over 5000 lives have been saved since the introduction of the 1974 Health and Safety at Work Act. However, most of the action on health and safety must be at a local level, but much of the framework should be global, this includes issues such as:

- Profiling the tasks of staff and risk assessments;
- Development, promotion and supervision of International Labour Standards Development of Inspection Systems;
- Development and promotion of codes of practice and other instruments; and
- Technical cooperation.

## Health and safety management systems

The financial benefits of an OSH-MS have been strongly argued, as most studies have seen a positive benefit to an organisation. The company should develop a greater awareness of its legal liabilities for the health of its staff, as well as their safety. In doing so:

- It will help keep ahead of legislation and regulators; and
- There will be improved stakeholder relations, as staff, the community and customer relationships all improve.

The International Labour Organisation's Guidelines on Occupational Safety and Health Management Systems (ILO-OSH 2001) were the result of extended international consultations held over the course of 2000–01. BS 8800 (British Standard) provides guidelines for an effective occupational health system.

The OHSAS 18000 Series of International Standards for Occupational Health and Safety Management Systems is a relatively new international system published in 1999. OHSAS 18001 corresponds to the British Standard BS 8800 and is also designed to be similar in structure and to complement ISO 14001, the Environmental Management System, and ISO 9001, the Quality standard. The primary difference is the ‘risk assessment’ section (which replaces the environmental aspects section of ISO 14001). The specifications require businesses to demonstrate that their systems for managing health and safety proactively seek to eliminate or minimise risks to employees that they comply with all national and international legal requirements and continuously strive to improve their performance in the areas of health and safety.

## Reporting the benefits of management systems to stakeholders

There are numerous, although presently unquantified, benefits from communicating with stakeholders effectively. Business partners and suppliers (business to business (B2B) and business to customer (B2C)), customers, employees, financiers and governmental organisations all want to hear that the organisation’s health and safety risks are understood and effectively managed.

There is an increasing level of guidelines and reporting frameworks for organisations to become immersed in. The main guidelines include the Turnbull Code, the Corporate Governance Combined Code and the replacements for the Operating and Financial Review (OFR). The Global Reporting Initiative (GRI) template for reporting on health and safety performance (see [www.globalreporting.com](http://www.globalreporting.com)) can prove a useful framework.

## Health and safety risk

### An overview of company risk

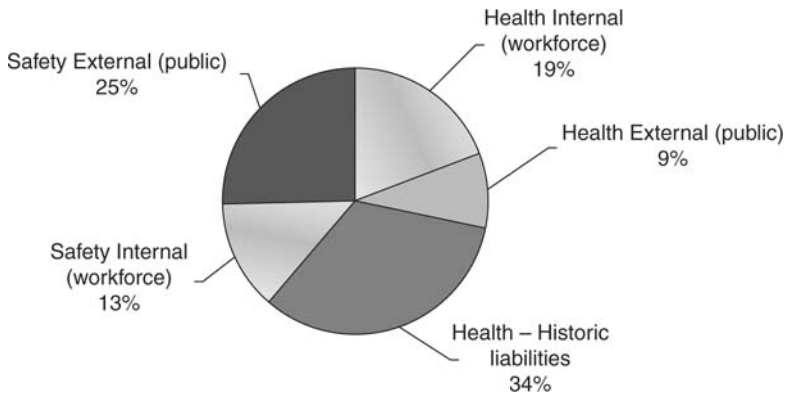
The total health and safety risk exposure of the 500 largest EU and US companies is 4.1% of their value, due to impacts like new legislative direct fines for non-compliance and new regulatory requirements for equipment. The average exposure net health and safety risk is 3.8% of market capitalisation for all health and safety risk of which 1.2% is related to internal issues (this chapter) and 2.6% is due to external factors and historic liabilities (in Chapter 17). This has been reduced from 6.7% of market value by good risk management techniques (the risk reduction/management factor).

## Categories of health and safety risk

The chart below shows the total environmental risk broken down by category.

## FTSE 350 AVERAGE

## Net (residual) risk profile



## Detailed analysis of the risk by category

Health and safety risk	Gross (inherent) risk	Net (residual) risk	Covered in
Health internal (workforce)	1.6%	0.7%	Chapter 16
Safety internal (workforce)	1.1%	0.5%	Chapter 16
Health external (public)	0.6%	0.4%	Chapter 17
Safety external (public)	1.6%	1.0%	Chapter 17
Health – historic liabilities	1.9%	1.2%	Chapter 17
<b>Total</b>	<b>6.8%</b>	<b>3.8%</b>	

The scale of the issue for the UK can be seen by this breakdown of the causes of work-related fatalities. The estimated 300 deaths per year in the UK are only likely to be 5.4% of the total work-related fatalities in the UK, and the largest killing is likely to replicate the figures for the entire established economies at 55% of all deaths. It is also useful to note that the countries which have strong legislative frameworks to prevent accidents only represent 5.4% of fatalities, whereas countries without such an established culture form a much larger proportion of the world's total fatalities (18%). Regulation would appear to have a strong influence upon reducing the levels of serious workplace incidents as a recent UK enforcement drive has led to a fall of 7% on the previous year to 28 605 in 2005/06, compared to 30 451 in 2004/05 (UK Health and Safety Commission).

The table below (see [www.ilo.org/public/english/protection/safework/accidis/index.htm](http://www.ilo.org/public/english/protection/safework/accidis/index.htm)) shows the global estimates of fatalities caused by work-related diseases and occupational accidents in 2002, the most recent year of full data.



<b>World total of work-related fatalities for established market economies (EME)</b>	<b>Work-related mortality, lower limit</b>	<b>% of EME total</b>	<b>% of world total</b>
Communicable diseases	11 176	4	17
Cancer (malignant neoplasms)	164 581	55	32
Respiratory system diseases	16 716	5.5	8
Circulatory system diseases	76 595	26	23
Mental (neuro-psychiatric conditions)	7572	2.5	1
Digestive system diseases	2892	1	1
Diseases of the genitourinary system	1833	0.6	0.4
Accidents and violence	16 170	5.4	18
<b>Total</b>	<b>297 535</b>	<b>100</b>	<b>100</b>

The health and safety priorities are viewed as management of the risks associated with the following:

- Chemical substances, carcinogens, asbestos;
- Stress, overload and pace of work, psychological factors, poor workplace relations and management;
- Communication of information on hazards;
- Ergonomics, repetitive work and musculoskeletal problems;
- Organisational and safety and health (quality) management issues;
- Preventive occupational health services, health promotion; and
- Unforeseen impacts from new technologies.

## Health and safety risk overview by sector

These risks can be viewed in a sector-by-sector format and the graph below maps out the sectors with the highest net risk from issues. It indicates the combined risk profile for all health and safety risks in this chapter and Chapter 17 combining both internal and external risks.

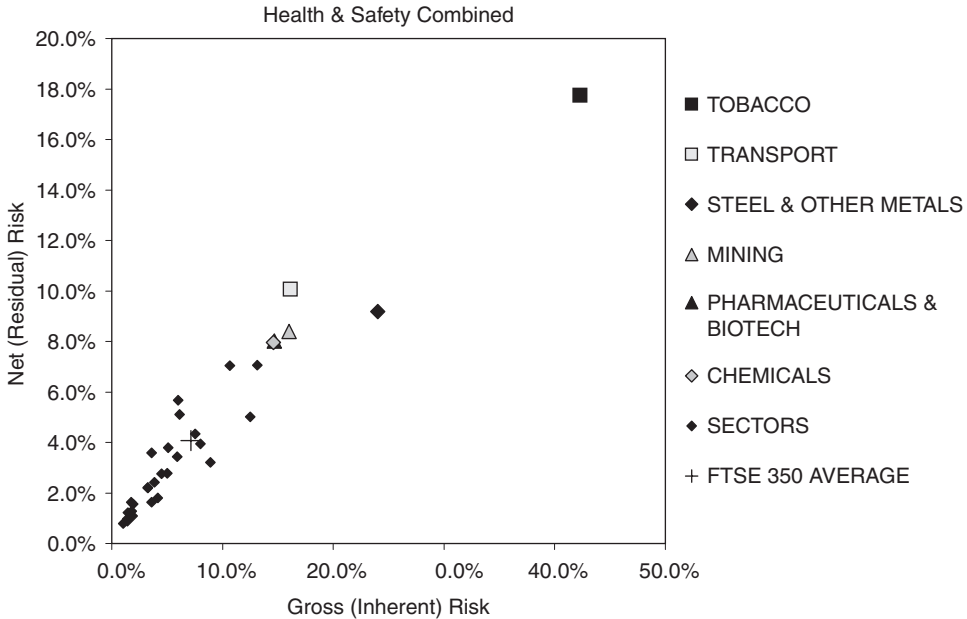
## Analysis of internal health risks of the workforce

Research indicates that:

- Internal health risk is 0.7% of the market value of the 500 largest EU and US companies; and
- This risk exposure has been reduced from 1.5% of market value by good risk management techniques (the risk reduction/management factor).

This category concerns working conditions that have caused an employee to develop an illness or long-term health condition, including all chronic illnesses, stress, repetitive strain injury, lung disease resulting from operation (i.e. mining dust, engineering solvents, etc.).

Even in Sweden almost a quarter of employees (24%) had suffered from a health problem caused by their work in the preceding year. The 16th Swedish



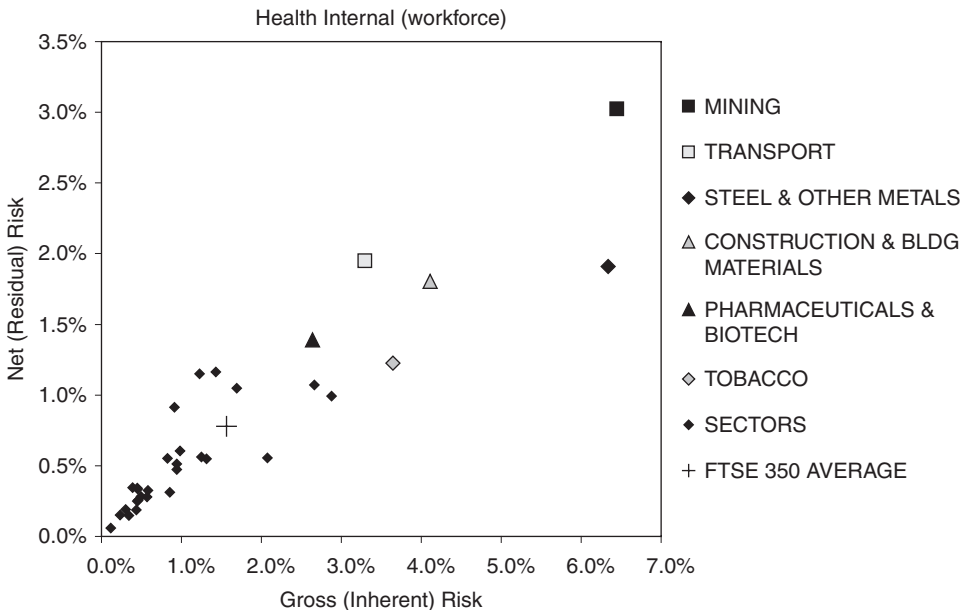
survey on work-related health disorders, published in November 2006, questioned more than 23 000 employees. Roughly 1 in 8 workers in France was exposed to workplace substances that can cause cancer; the SUMER survey 2003 indicates 2 370 000 workers, 13.5% of the total French workforce, were exposed to one or more of a list of 28 workplace carcinogens. (*Risks*, issue number 219, 13 August 2005).

The types of health risk posing a threat to organisations and their staff include the following, listed alphabetically, and most are discussed in more detail further in the chapter:

- AIDS/HIV;
- Asbestos;
- Asthma;
- Back pain;
- Beryllium;
- Biocides;
- Carcinogenic materials;
- Drugs and alcohol;
- Electro magnetic radiation;
- Environmental health issues;
- Latex allergies;
- Lead exposure;
- Lung diseases;
- Musculoskeletal disorders;

- Neutral toxicity;
- Noise;
- Office-based illnesses, like computer and irritable desk syndrome and passive smoking;
- Radiation;
- Risks to new and expectant mothers;
- Skin damage;
- Stress from work;
- Vision impairment; and
- Vocal damage.

The following graph shows the health and safety risk (net) from internal health risks to workforce by sector.



Examples of high workforce health risk, by sector, include the following:

- The most dangerous jobs from the point of view of carcinogenicity:
  - Agricultural workers, chemical exposure;
  - Asphalt roofers;
  - Cutting/sewing workers;
  - Glass and ceramic decorators;
  - Tobacco industry;
  - Insulators;
  - Metal platers and coaters;
  - Hairdressers and barbers;
  - Telephone installers;

- Wholesalers; and
- Sculptors, painters.
- Among possible occupation carcinogens which might be added to the list are solar radiation, passive smoke, crystalline silica, diesel exhaust, radon decay products and wood dust. Mining dust has also helped push the mining sector's risk profile into the top position. The EU also believe that each occupational death from cancer costs an average of €2.14 million (£1.43 million) and the cost for the EU now totals over €70 billion (£46.7 billion) each year (see [www.europa.eu.int/rapid/start/cgi/guesten.ksh?p\\_action.gettxt=gt&doc=IP/04/391%7C0%7CRAPID&lg=EN&display=](http://www.europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.gettxt=gt&doc=IP/04/391%7C0%7CRAPID&lg=EN&display=));
- Electronic industry (chemical liabilities): medical research is highlighting the side effects of the use of chemicals in microchip and circuit board production processes. IBM is also involved in an expensive lawsuit;
- Engineering: the exposure of the UK manufacturing industry to asbestos liability is increasing as new estimates of expected fatalities occur. VT plc increased their provision by £15 million in March 2004;
- Food sectors: these are increasingly liable for the death, disease, serious injury, genetic mutation, birth defects or the impairment of reproductive functions of customers. For example, the concentrations of aluminium and mercury in the UK's diet are increasing according to the Food Standards Agency (FSA) in their Food Survey Information Sheet 48/04 (*ENDS Report*, April 2004, p. 12); and
- Safety industries: over 300 fire fighters who worked at the clean-up site after 9/11 are still on light duty and 69 are no longer working, while 300 more have retired because they can no longer breathe well enough.

## A review of currently emerging risk issues

### *AIDS*

One of the few studies into the direct economic impact of HIV/AIDS upon an economy and organisations is from the Bureau for Economic Research at the South African University of Stellenbosch. Their report entitled 'The macroeconomic impact of HIV/AIDS under alternative intervention scenarios on the South African economy' indicates the following harrowing statistics:

- Almost 3 million people died from AIDS and 5 million became newly infected;
- More than 5 million people in South Africa have HIV, this equates to almost one-fifth of the working age population between the ages of 20 and 64; and
- In the absence of medication (ART) the rate of GDP growth would fall in South Africa from a projected 4.4% to 4.0% for the period 2000–20.

With Africa being a resource rich continent these types of social catastrophes will impact directly and more commonly indirectly upon organisations around the world. One mining company reports that on any one working day almost a quarter of their 24 000 workforce in Southern Africa are either off work ill, caring for a family member or attending a funeral of a deceased relative or work colleague.

The scale of the problem is being under-reported yet there has been an increase in the number of newly reported cases within the developed world and a rapidly increasing rate with the developing world. The relevance to businesses is not always apparent but lessons can be learnt by all businesses, especially in more affected parts of the world.

**Risk management of the AIDS/HIV issue:** the Global Business Coalition on HIV/AIDS is the pre-eminent organisation leading the business fight against HIV/AIDS. Their research (extracted from the *Cambridge Sustainability Research Digest*, July 2006) companies are increasing their activities to address these risks, including:

- In high prevalence parts of Africa 70% of companies are fully subsidising staff access to treatment. Globally 36% of surveyed companies are fully subsidising treatment for direct employees;
- 82% of companies provide workplace information on HIV/AIDS and 41% conduct assessments and surveys;
- 60% had trained educators in place; and
- 55% have expanded prevention programmes to the community.

The mining, food and beverage sectors tend to have the most extensive risk management programmes for this issue.

## *Asbestos*

In the UK observed deaths are over 1700 per annum and will hit a maximum of 2000 per annum in 2010, up from less than 200 in the 1960s. According to the US National Bureau for Economic Research (NBER) at least 600 000 people have now filed asbestos exposure claims in the US. Eighty firms have filed for bankruptcy and insurers have paid out approximately \$32 billion in compensation. The total cost of asbestos compensation is projected to be between \$200 and \$275 billion. The exposure of the UK manufacturing industry to asbestos liability is also increasing as new estimates of expected fatalities occur. The number of asbestos suits against Ford rose by two-thirds in 2003 as the total number of claims reached 41 500.

- ABB the Swiss/Swedish international engineering group have been forced to set aside a reserve of \$430 million to cover asbestos-related insurance claims; and
- A former hairdresser died as a result of years of exposure to asbestos in old hood-style hair-driers, she contracted the asbestos cancer mesothelioma through exposure to dust produced as asbestos linings in the equipment crumbled with time.

## *Back pains*

With more and more of us in sedentary occupations, it is vital that employers prioritise the health of the workforce by investing in thorough risk assessments and swift access to rehabilitation services.

## *Beryllium*

There is an unrecognised epidemic of chronic beryllium disease, according to the renowned UK medical journal *The Lancet*. They say that occupational exposure to beryllium occurs in aerospace, nuclear, military, automotive, electronics and telecommunications industries; in operations in metal machine shops; and in alloy applications, such as tubing for oil and gas drilling, tools and dies, jewellery, bicycle frames and dental appliances. Exposure can result in acute lung inflammation and can also lead to sensitisation and other problems, including cancer (*Risks*, issue number 143, January 2004).

## *Bullying*

A bullied bank worker in the UK was awarded £817 000 after being subject to a deliberate and concerted campaign of bullying by four women colleagues, which led to two nervous breakdowns. The judge described the bank's management as 'weak and ineffectual', adding: 'The managers collectively closed their eyes to what was going on, no doubt in the hope that the problem would go away' (*Risks*, issue number 268, 5 August 2006).

The UK union Amicus says employers are failing to do enough to tackle workplace bullying, after they found 97% of organisations have never quantified the impact of bullying, a problem it says costs UK industry an estimated £2 billion a year in sick pay, staff turnover and loss of production. They report that 1 in 10 workers says they had been bullied (*Risks*, issue number 277, 7 October 2006).

## *Carcinogenic materials*

Cancer in the workplace is on the increase from materials like mineral oils, organic solvents, asbestos, wood dust, diesel exhaust fumes and crystalline silica.

## *Electro magnetic radiation*

Research is still not clear, or quite often conflicting, on these types of risk, but this does not always stop legal action from occurring:

- Verizon: the partially owned subsidiary of UK mobile giant Vodafone is reported to be among companies facing litigation in the US over allegations that mobile phones can cause brain tumours (BBC, 28 December 2000).

## *Environmental health issues*

Environmental risks and human health cannot be easily separated, as there are direct implications for both from environmental activities. For example:

- Agricultural chemical exposure: banana growers are seeking compensation from Dole Fruit, Shell and Dow Chemical for exposure to the pesticide DBCP.

This counts as an internal workforce health issue (for Dole Fruit), external health issues/product liability issue for the makers of the pesticide, as well as a source of damage to the ecosystem and groundwater/drinking water, etc. (see [www.corpwatch.org](http://www.corpwatch.org));

- Pesticide exposure: a team from Harvard School of Public Health found that people who said in 1992 that they had been in contact with pesticides were 70% more likely to develop Parkinson's disease within the next 10 years (Ascherio, Alberto *et al.* 'Pesticide exposure and risk for Parkinson's disease', *Annals of Neurology*, published online 26 June 2006, Digital Object Identifier (DOI) 10.1002/ana.20904); and
- Chemical exposure: for example, it has been found that exposures to the chemicals used by farmers, welders and hairdressers could be implicated in disease development as a study of more than 2.6 million US death records has linked certain jobs to a significantly increased risk of Alzheimer's and Parkinson's disease, early-onset dementia and motor neuron disease (Park, Robert M. *et al.* *American Journal of Industrial Medicine*, 2005).

## *Lead exposure*

People who are routinely exposed to lead at work are 50% more likely to die from brain cancer than people who are not exposed, according to research from the University of Rochester Medical Center study, based on information from the US Census Bureau and the National Death Index.

## *Liquid toxicity*

Women with jobs that involve metalworking fluids may have a higher risk of developing breast cancer, a preliminary study suggests. Among the nearly 4700 women the researchers followed, the risk of breast cancer increased in tandem with exposure to soluble, oil-based metalworking fluids. (*American Journal of Industrial Medicine*, volume 47, issue 2, pp. 153–160, 2005).

## *Lung diseases*

Research suggests there have been a doubling of workplace toxins and therefore a doubling of lung disease risks, chronic bronchitis and emphysema, and chronic obstructive pulmonary diseases (COPD) (*The European Respiratory Journal*, volume 22, September 2003, pp. 462–469). There are a range of respiratory ailments and health risks including well-known ailments like:

- Mining dust: where the UK government alone has paid out £3 billion in compensation for 'Miner's Lung';
- Bakers lung: as a result of historic inhalation of flour; and
- Asthma: organisations that put their workers at risk of contracting occupational asthma are liable to pay fines and costs. One such company was fined more than £30 000 after it was found to have allowed its employees to work

unprotected with rosin solder flux, a substance which has been known for decades to cause asthma. The UK Health & Safety Executive (HSE) brought the prosecution and said the company had failed to take measures to control this risk over a considerable period of time (*Risks*, issue number 231, 5 November 2005).

And some newly emerging risks like:

- Toxic fumes: two major British companies have been named as defendants in a US welding fumes test case that could result in compensation claims running into billions. Manganese welding fumes have been alleged to cause severe damage to the central nervous system, including Parkinson's disease and Parkinson's-like symptoms. There have been 10 000 welding fume cases filed so far and another 50 000 may follow. An example of the impact upon market value is that:
  - Shares in BOC fell sharply by 7.6% (to 821.5p) on 29 October 2003 after a US jury ruled against three gas products companies (the UK's BOC, and Lincoln Electric and Hobart Brothers of the US) that linked fumes from welding rods to Parkinson's disease. One estimate of liabilities is that the current cases could amount to half a billion dollars in losses (*Financial Times*, 30 October 2003). Their shares fell again when it was announced that there was an increase to 9700 plaintiffs in the 150 cases it is facing.
- Popcorn lung: a chemical in butter flavouring, diacetyl, which has sickened hundreds of workers and, it is thought, has even led to deaths. Two large US unions have asked the Department of Labour to set a maximum exposure to and require employers to provide workers with air-purifying respirators;
- Silicosis: 'a disabling, non-reversible and sometimes fatal lung disease', which can cause other problems like lung cancer, pulmonary tuberculosis, airway diseases, autoimmune disorders and chronic renal disease. As a result of its nature it has been added to the lists of top toxic risks at several insurers; and
- Wood dust: an arts and crafts teacher in the UK has been awarded nearly £150 000 compensation due to exposure to wood dust, including medium density fibreboard (MDF), a composite of wood dust and formaldehyde-based resins.

## *Neural toxicity*

Long-term exposure to high concentrations of 1-bromopropane (1-BP), a common workplace solvent and powerful neurotoxin, is highly damaging to nerves, said researchers at the American Neurological Association annual meeting in Toronto. 1-BP is an industrial solvent widely used as a replacement for ozone-depleting chemicals (*Risks*, issue number 178, 16 October 2004).

## *Noise*

Excess noise is one of the most common occupational hazards. Exposure to excessive noise can cause hearing problems, stress, poor concentration, productivity



losses in the workplace, communication difficulties, fatigue from lack of sleep and a loss of psychological well-being.

It can also cause accelerated heartbeat, high blood pressure and gastrointestinal problems. The European Commission have pushed legislation even further by adopting Directive 2003/10/EC (ID 4429). From 15 February 2006, companies should take the following actions when noise levels exceed 80 decibels and 112 pascals:

- Make hearing protectors available;
- Provide information and training; and
- Make audiometric testing available where there is a risk to health.

Where noise exposure of employees, not taking account of hearing protection, exceeds 85 decibels and 140 pascals, companies should take the following action:

- Establish and implement a programme of technical and/or organisational measures intended to reduce exposure to noise;
- Mark, delimit and restrict access to areas;
- Make the use of hearing protectors mandatory; and
- Provide a right to hearing checks by a doctor.

Noise exposure levels of employees, taking account of any hearing protection worn, must be at or below 87 decibels and 200 pascals.

Further requirements of Directive 2003/10/EC include:

- A risk assessment of noise levels where workers are likely to be exposed to risks;
- Elimination of risks at source or reduction to a minimum;
- A transitional period of two years for application of the noise exposure levels to the music and entertainment sector; and
- A transitional period of five years for application of the noise exposure levels to sea transport.

Most industrial activities are confronted with the issue at some stage. Its most serious effect is irreversible hearing loss. It is estimated that each year there are 1 628 000 new cases of occupational noise-induced hearing loss. During 2002 some regulatory developments have taken place which will force the issue of occupational noise exposure back on the agenda for most industrial operators worldwide.

## *Office-based ailments*

- Computer ailments: giving workers the freedom to take regular breaks and to have control over the speed of their work is the remedy to computer-related strain injuries. A study has found, in the journal *Occupational and Environmental Medicine*, that 'Thus, when organising computer work, it seems important to consider both the duration of computer work and the employees' own influence on their speed of work.' The study adds that employers should

allow for physical variation of work tasks to avoid a worker being restricted to just computer work (Juul-Kristensen and Jensen 2005);

- Irritable desk syndrome: this is a reality, say researchers at NEC-Mitsubishi. These new and poorly understood risks are caused by stress due to cluttered desks, poor posture and insufficient time away from computers. This can be mitigated in part by regular breaks and making desks more personal; and
- Passive smoking: in a Californian study researcher Kenneth C. Johnson, of the Public Health Agency of Canada, analysed data from the 20 published studies which had examined the relationship of passive smoking to breast cancer. For all studies combined, long-term second-hand smoke exposure was associated with a 27% increase in breast cancer risk among women who were lifetime non-smokers (Johnson, Kenneth C., 31 May 2005 in *Risks*, issue number 215, 16 July 2005).

### *Repetitive activity injuries*

- A masseuse who worked in an airline's upper class lounge at Heathrow was awarded £109 000 in damages after developing repetitive strain injury (RSI). The court was told that the RSI had been caused by the 'abnormal posture' of massaging seated clients and doing it too frequently;
- A newspaper editor who says she was refused access to the company physio-therapist after developing crippling elbow pain was paid £37 500 in damages for RSI; and
- Barclays Bank plc: an employee was awarded £243 792 after two years of working at a defective workstation left her with RSI (*Hazards*, July 2000).

### *Sick building syndrome*

There are fears that common features of the office environment, such as printers, photocopiers, mobile phones and strip lighting, could have a damaging effect on workers. Britain's biggest insurers are in talks with the government over plans to establish a state-backed fund to pick up the bill for claims from this type of emerging industrial diseases risk.

### *Skin damage*

- Centrica plc: an AA patrolman received £130 000 compensation after developing severe dermatitis which forced him into early retirement (*Hazards*, January 2001).

### *Stress from work*

Up to five million Britons complain of work-related stress each year. A new survey of safety professionals by Croner has found that 79% have taken no action

to implement the HSE's stress management standards and over half (55%) of the survey respondents are actually unaware of the HSE's management standards.

Excessive stress at work is causing an epidemic of depression and anxiety, costing the British economy about £100 billion a year in lost output, according to a report by mental health charity Mind in a report called *Stress and Mental Health in the Workplace (Risks*, issue number 207, 21 May 2005). One in four people in the UK develops mental health problems each year, costing the economy £11.6 billion in lost working days.

Work stresses can also contribute to strokes. This is now recognised in law after an undercover policeman won the right to substantial damages because of his stress-related ill-health.

Pressure to work long hours can damage a worker's mental health (*Risks*, issue number 150, April 2004). One in ten of the workers putting in 48 hours a week or more has suffered some form of physical problem as a result of working long hours and 17% have suffered from mental health problems, such as stress or depression.

The *British Medical Journal* reports that stress-related mental health problems have topped physical ailments as the chief cause of long-term sickness in Britain. Depression and anxiety now account for more claims for incapacity benefit than problems such as back pain (Henderson, M. *et al. British Medical Journal*, 9 April 2005).

## *Vibration white finger*

- Corus, the European steel manufacturer, has had to pay compensation for members with a debilitating occupational disease. Three former employees of Corus' Llanwern Steelworks had contracted vibration white finger (VWF), a condition where circulatory and nervous system damage to the hands can lead to permanent disability (*Risk*, issue number 150, April 2004).

## *Vision damage*

Some occupations have higher risks of damage to eyesight, for example airline pilots (who are more likely to develop cataracts because of their exposure to cosmic radiation) and workers in foundries (who are exposed to increased infrared light from molten metal).

## *Vocal damage*

A combination of germs, dry office conditions, centrally heated offices and jobs that place a strain on employees' vocal chords, e.g. call centres, could prove disastrous for the millions of UK workers who rely on their voices to do their jobs.

## Analysis of internal safety issues of the workforce

Results indicate that:

- Internal workforce safety risk accounts for a loss of 0.5% of market value of the 500 top EU and US companies; and
- This risk exposure has been reduced from 1.1% of market value by good risk management techniques (the risk reduction/management factor).

Examples of safety risks include:

- Accidents;
- COSHH (UK Control of Substances Hazardous to Health Regulations available at [www.hse.gov.uk](http://www.hse.gov.uk));
- Drugs and alcohol;
- Electrical safety;
- Falls from height;
- First aid at work;
- Gas health and safety;
- Risks for new and expectant mothers;
- Road safety;
- Slips, trips and falls; and
- Transport dangers.

Quite often organisations do not see the magnitude of safety impacts upon their business and only when these risks are measured are they fully understood. A recent study by the EU estimates the scale of the economic costs of workplace accident rates, which ‘remain very high’. *The Improving Quality in Work: A Review of Recent Progress Report* says that while accidents at work decreased between 1994 and 2000, there were still 5 million accidents in 2000, leading to 158 million lost working days. The report says around 350 000 workers were obliged to change their job due to an accident. Almost 300 000 workers were affected by varying degrees of permanent disabilities and 15 000 had to give up work (*Risks*, issue number 147, 12 March 2004).

The exporting of incidents is still taking place as the developing world starts from the safety levels we had a century or two ago: an example is that China is now the world’s fourth largest economy and now supplies 90% of the world’s toys and over 20% of Europe’s clothes. The price paid by these low cost production methods are that China’s workplace death rate is 12 times higher than Britain’s.

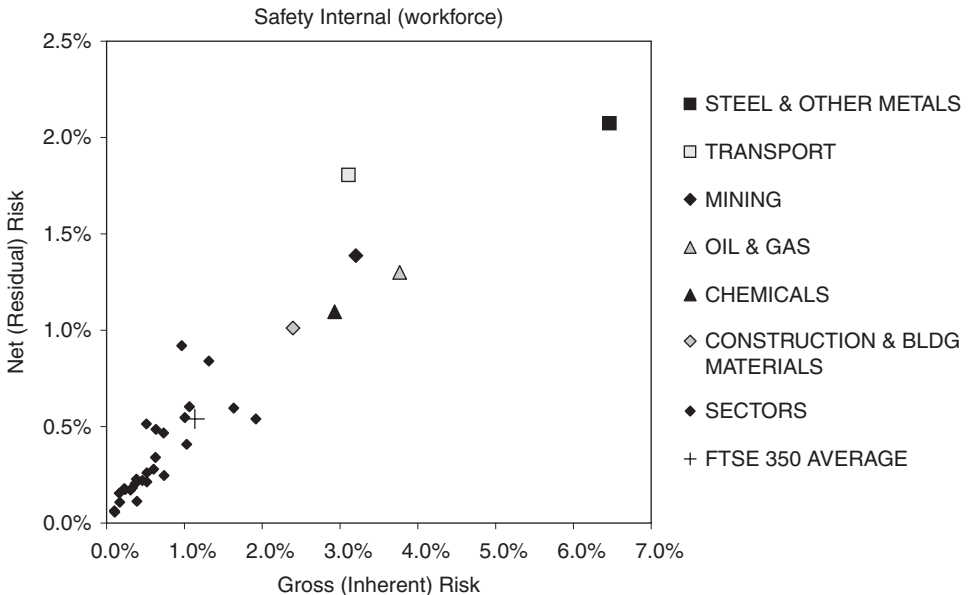
Recently resurgent risks include the following:

- Criminal threats: the issues surrounding call centres are likely to intensify as jobs move overseas from the UK and US. One of the safety issues is the high numbers of undisclosed kidnappings taking place in locations including India;
- Driving for a living can be a hazardous occupation. Every year over 1000 workers are killed in work-related road accidents in the UK, and an additional

7500 suffer serious injury (see [www.tuc.org.uk/h\\_and\\_s/tuc-7946-f0.cfm](http://www.tuc.org.uk/h_and_s/tuc-7946-f0.cfm)). The Department for Transport (DfT) annual road casualty statistics, which for the first time recorded the purpose of journeys, showed work vehicles were involved in over 54 000 crashes in 2005, or 150 per day;

- Explosions and fires;
- Slips, trips and falls account for 12 000, or 15%, of all accidental deaths each year;
- Terrorist threats: London HQ-based companies are at increased risk and companies are more likely to face terrorist attacks because of what they represent rather than where they are located, according to Aon, the risk and insurance consultants. Terrorism insurance cover is on the rise and more companies are purchasing it (*Business Insurance*, 26 April 2004, volume 38, number 17, p. 3). Of 15 industries examined, energy companies were deemed most likely to buy terrorism coverage, with 40.5% of energy firms having done so. The industry least likely to purchase terrorism coverage was construction; and
- Violence: there has been a marked increase in violence in many countries, among the general public, from customers towards staff and among staff as well. In the UK retail sector there was an increase from actual physical attacks from six per 1000 staff in 2002 to seven in 2003. Organisations like the National Health Service and transport systems like London Underground and bus companies have adopted internal training programmes to deal with this increased risk and have also embarked on public education programmes to reduce assaults upon employees.

The following graph shows the internal safety issues for workforce by sector.



Sectors with high workforce safety risks are the steel sector (Corus has had numerous fatalities within the last few years) and construction sector. Other industries that involve working with large volumes of raw or processed materials, e.g. Mining, Oil and Gas and Chemicals sectors, are natural candidates for high safety risk levels. However, it must be emphasised that this is the net risk after taking into consideration all risk minimisation activities. HSE official figures show that the sectors with the highest number of fatalities are the Agriculture and Construction sectors.

Other specific high risk sectors that are not represented as they are not often listed on the stock markets are the agriculture and fishing industries. These sectors need to prepare specific plans for coping with their risks. An example of where poor safety measures led to loss is the three crew members of a Belgian fishing vessel who died when it capsised off the coast of England, but their lives might have been saved if they had been wearing lifejackets.

In the UK there have been renewed calls for increased legal actions against those responsible for safety infringements. There have been quite a large number of acquittals of companies and directors on manslaughter charges, as shown in the table below (see *Corporate Manslaughter and Homicides in the UK* at [www.corporateaccountability.org/manslaughter/cases/main.htm](http://www.corporateaccountability.org/manslaughter/cases/main.htm)).

<b>Number of incidents (involving at least one death) which have resulted in acquittal</b>	<b>Total number of deaths involved in these incidents</b>	<b>Number of companies acquitted</b>	<b>Number of company directors/senior managers acquitted</b>	<b>Number of business owners (i.e. sole traders or partners) acquitted</b>
21	375	11	20	10

## Case studies

- Some can be as extreme as the Petrobas oil platform disaster which cost 10 lives and \$600 million in lost revenue;
- When UK nuclear power generator British Energy stated that they had to shut down two of their main generators due to safety concerns and maintenance after inspections, their shares fell by another 2.7% to 5½p;
- A fire station was destroyed in the UK, by fire, as they had not had a fire alarm fitted to alert anyone (BBC News, 25 October 2006);
- A welder who suffered a horrific hand injury leading to the amputation of a finger has received a £100 000 payout;
- A refuse collection worker was awarded £3.75 million compensation after an accident which left him paralysed;
- Barclays plc were reported in *Hazards* as having awarded £150 000 to a clerical worker who had to have a leg amputated after a fall on an uneven path (July 2000);

- A worker was killed in a boiler room explosion at a British sugar factory just one month after another worker had died at another of the company's plants (*Risks*, issue number 96, 8 March 2003);
- British Telecom were criticised by the coroner, police and Communication Workers Union for their actions in relation to the case of a BT engineer who was killed when she was thrown from the top of a telegraph pole (*Risks*, issue number 96, 8 March 2003);
- BP plc had calls from their president in Alaska to make safety the priority of all 1400 employees in the state where BP has been on probation since 2000 ('Safety record in Alaska gives BP a barrel of woe', *Financial Times*, 7 August 2004). UK multinational BP has been hit by fines of \$1.42 million (£763 000) for safety violations on its Prudhoe Bay oilfield in Alaska;
- Construction workers are dying at a rate of more than two a day on construction sites in the United Arab Emirates (UAE);
- A contract worker died when he slipped and fell into a giant tank of paint at the Ford car paint shop factory in Southampton. A supervisor was charged with manslaughter. Ford Motor Company, Haden Drysis International Ltd and Philip Services (Europe) Ltd are also being prosecuted for health and safety offences;
- In an incident at a British Gas Energy Centre, a worker was left with cuts on his head and a fractured rib after being crushed by a reversing lorry (*Hazards*, July 2000);
- Two workers were burnt to death while cleaning a health club after the industrial chemicals they were using ignited. Leicester Crown Court heard that the men had been using unsuitable chemicals and had not been made aware of the dangers they faced;
- Two men died when a kiln collapsed on top of them. Stoke on Trent Crown Court heard that the two men were sent to demolish the disused kiln without proper instruction and with no previous experience of kiln demolition;
- A worker died when he fell through a roof while carrying out roofing work. Teesside Crown Court heard that the only safety equipment provided were seven safety boards and that the worker had not been provided with safety harnesses or a safety net. An HSE inspector had two months earlier warned the director and company about carrying out high risk roofing work without taking enough safety measures;
- Three people died in June 1999 when a driver fell asleep while driving a van for a haulage company. The prosecution was related to the length of time that the directors required their employees to drive;
- A worker died on his first day at work at Shoreham Docks when the jaws of a crane grab closed around his neck. The Old Bailey was told that the crane operator could not see inside the ship's hold and the person responsible for communication between the crane driver and the worker couldn't speak English. The company was fined £50 000 for health and safety offences;
- In July 1999, Great Western Trains were cleared of the manslaughter of seven people who died in Southall when a train operated by the company went through a red signal. The company subsequently pleaded guilty to health and safety offences and were fined £1.5 million;

- An employee was engulfed in a fireball while working near a furnace. The company was convicted of health and safety offences and fined £50 000;
- Six deaths took place when a heavily laden truck careered down a hill and ploughed into a van. It had been alleged that the truck had grossly defective brakes. The company had previously been convicted of using a vehicle with defective brakes and fined £5000;
- According to the Unilever Social Review 2002, two fatal accidents occurred in Hindustan Lever factories. Following the incidents a major new safety initiative was developed; and
- An employee of Whitbread plc was scalded while emptying a pasta cooker. Allegedly, the incident occurred despite the company having previously been told to make changes to the system of work. The company was fined £5000 (*Hazards*, January 2002).

## *Risk management*

Positive risk management programmes and projects are important, such as drafting a slip-and-fall prevention policy and educating employees about measures they can take to prevent such accidents.

Risk managers should:

- Identify slip-and-fall hazard areas;
- Assess illumination and other factors that can contribute to slip-and-fall accidents, install anti-slip surfaces;
- Take other preventive measures; and
- Collect and analyse claims data regarding past slip-and-fall accidents to see if they can pinpoint specific problem areas and learn from past mistakes.

There is an increase in the training available for these types of risks, with language training for staff who are not fluent or capable in the organisation's local working language and new qualifications to show proficiency on safety matters like:

- The UK Health and Safety Executive (HSE), with the Institution of Occupational Safety and Health (IOSH) and British Safety Council Awards (BSC Awards) have prepared a new workplace hazard awareness course and qualification.

## Analysis of historical health liability risks

This risk heading is covered in more depth in the next chapter. In summary the results indicate that:

- Historical health liabilities risk is an average of 1.2% of market value of the 500 top EU and US companies; and
- This risk exposure has been reduced from 1.9% of market value by good risk management techniques (the risk reduction/management factor).



These issues are relevant to staff, but usually occur when the employees have already left the company or retired. So although historical liabilities affect the employees of the staff this issue is viewed in the external health and safety risk section.

## *Employees*

Through working for the company a member of staff has developed a disease, disability or impairment as a consequence of the company failing to take action to reduce the risk of personal injury to the employee.

## *Public*

Negative health consequences are experienced by individuals as a result of using the company's product or service. For example, a pharmaceutical company which failed to conduct adequate tests to ensure safety of their product.

## **A sustainable health and safety risk management system**

Positive indicators of risk management include:

- A publicly stated health and safety policy;
- Line responsibility for health and safety (board, committee or at business unit levels);
- A formal joint health and safety committee, with a proportion of the workforce covered by such a committee;
- A publicly stated health and safety management system to monitor performance;
- Monitoring the workforce sickness rate, examples include the following:
  - McCarthy & Stone have installed a scheme of internal fines. The fines are triggered by poor health and safety performance, reported either by the enforcement authorities or the group's health and safety advisors as part of their regular inspection process. They have also surveyed the group's older offices throughout the UK to ensure compliance with the Control of Asbestos at Work Regulations 2002 (SI 2002 No. 2675); and
  - Taylor Woodrow seeks feedback from their employees: 55% of its employees in the UK believed that they provide good working conditions (*CSR*, 2003, p. 17).
- Tougher enforcement and extension of rules: organisations can extend their internal policies to all premises or countries of operation. An example is that UK telecoms giant BT is to ban its 100 000 workers from smoking in its offices and vans across the world;
- Acknowledge good performance: ensure that good performance is recognised by management with appropriate remuneration and reward systems. Any incentives have to be appropriate but there should not be any inappropriate rewards for encouraging unsafe behaviour. An example of this unwise practice

is that of a European retailer who offered crates of beer to workers at a distribution depot who raised their work rate to a level seen to be in excess of a 'safe' rate;

- Establish policies for new and emerging risks like stress and bullying. Recent research shows only 3% of organisations have a zero tolerance policy towards bullying. Examples of best practice for combating stress are available from: <http://www.hse.gov.uk/stress/experience.htm> and samples policy templates from: <http://www.hse.gov.uk/stress/stresspolicy.pdf>
- Employers could do more to help support workers who are suffering from mental health problems. The British Occupational Health Research Foundation (BOHRF) says counselling could help staff to stay in work. An outline of the stress management standards looked at the six key areas of work that, if properly managed, can help to reduce work-related stress. They are available from: <http://www.hse.gov.uk/stress/standards/index.htm> and an outline of the process is below:
  - Demands: includes issues like workload, work patterns and the work environment;
  - Control: how much say the person has in the way they do their work;
  - Support: includes the encouragement, sponsorship and resources provided by the organisation, line management and colleagues;
  - Relationships: includes promoting positive working to avoid conflict and dealing with unacceptable behaviour;
  - Role: whether people understand their role within the organisation and whether the organisation ensures that they do not have conflicting roles; and
  - Change: how organisational change (large or small) is managed and communicated in the organisation.
- Simple provision of the correct equipment for tasks can save lives and liabilities. In France only 39% of workers exposed to crystalline silica had respiratory protection, a SUMER survey in 2003 found (*Risks*, issue number 219, 13 August 2005); and
- Variations in type and durations of tasks can improve performance and reduce health hazards. Employers should allow for physical variation of work tasks to avoid a worker being restricted to just computer work.

### Hints and tips

#### *Anticipating new risks*

Work organisations are rapidly changing, calling for a dynamic approach towards occupational safety and health and accident prevention. This can only succeed if there is a strong management commitment and a high level of employee involvement that incorporates accepting responsibility.

#### *Information and participation*

Information is an important element of management in general but especially so in the management of change. Information and communication

campaigns can be very efficient in dealing with uncertainty and can help to improve job satisfaction and avoid risks.

Participation in risk analysis and training has a positive influence on attitudes, which are often the bottleneck in accident prevention. The workforce can learn to look at its work activities in terms of safety. This can lead to the identification of hazards and risks at a very early stage, which in turn can help to anticipate new risks as working conditions change rapidly. In one supermarket chain, accidents fell by 50% after a participatory project.

#### *Performance measurement of prevention*

The cost/benefit analysis of prevention is not easy. Nevertheless, it has been generally accepted that rapidly changing risks at work can be tackled effectively only when everybody in the company approaches them proactively. Prevention is being seen as the result of economic considerations and as an investment in a company's innovative capacity and future prospects. Management systems try to integrate performance measurement of prevention to achieve a higher safety level.

#### *Life-long learning*

Efforts have to be made to increase people's ability to handle risks. Life-long learning is becoming more important if employees are to sustain their employability as well as their health and safety. Temporary, fixed-term and part-time employees have less access to training and often perform tasks requiring fewer skills, so they have less opportunity to learn on the job. They are also less informed about the risks of their jobs. This poses a problem for occupational safety and health (OSH) management and also for human resources management. Life-long learning can help to anticipate changes.

#### *Promoting safety*

Companies, governments and sector organisations have been looking at other ways of promoting health and safety. Two important developments are the use of:

- \* A criterion for purchasing products and services; and
- \* A marketing element for promoting the sales of products or services.

#### *Marketing strategy*

When it comes to safety, marketing techniques have rarely been used. As safety is not a product but a value, social marketing strategies can offer ideas to motivate people to change their attitudes, to show companies how improving safety can improve profits, and to convince politicians of the overall benefits of an integrated safety policy.

Globalisation provides an opportunity to promote safety. A company with a poor safety and environmental record puts its public image at risk.

It is very bad publicity when negative effects of globalisation are splashed across television screens and newspapers.

The concept of corporate social responsibility (CSR) can provide a structure for promoting safety; a lot of global companies have already shown their willingness to set high safety goals. Many have already achieved lower accident figures.

Multinationals are in a position to export good practices established in one part of their operations to other parts in other countries and to set common safety standards. Similarly, they may specify safety requirements for their procurement and contracting activities throughout the company. Details of how one branch has solved a particular safety problem can be passed on to others.

### *Company values*

Companies that embrace social values and act conscientiously according to their mission statements seem to generate a positive outlook and a high level of employee involvement. A coherent policy – starting with a mission statement and realised through concrete initiatives, programmes and actions, both within and outside the company – can mobilise employee commitment.

This exercises a positive influence on the safety culture as a whole and even on the individual risk-avoiding behaviour of employees. The French Bouygues Group has produced a ‘Human Resources Charter’ and a ‘European Social Charter’ ([www.bouygues.com](http://www.bouygues.com)). The company has lower-than-average accident rates.

### *Community approach*

The idea of the ‘community approach’ is to change the attitude of the entire community in several domains at the same time (professional environment, private life, leisure activities, education, etc.) in order to create a ‘safety attitude’. Successful experiments using the community approach have been carried out worldwide. These concepts can be transposed to other cultures and are very useful for small companies.

### *Conclusions*

Safety promotion and marketing can help to raise awareness among different groups of users, who are less familiar with safety matters and so have to be convinced of their own needs. Examples include:

- \* Employees and the general public who should become aware of the importance of a ‘safety attitude’;
- \* Industry should abandon the illusion that bad-case scenarios will not happen to them; and
- \* Politicians need to be aware of their social responsibility for developing regulations.

*Useful websites*

- \* BSi – British Standards Institute: this site provides free downloads of OHSAS 18001 and 18002 amendments as well as a basic guide to implementing an occupational safety and health management system: <http://emea.bsi-global.com/OHS/Standards/index.xalter>
- \* ILO – International Labour Organisation: ILO Guidelines on health and safety can be downloaded from this site: <http://www.ilo.org/public/english/protection/safework/managmnt/guide.htm>

Examples of best practice for combating stress are available from: <http://www.hse.gov.uk/stress/experience.htm> and sample policy templates from: <http://www.hse.gov.uk/stress/stresspolicy.pdf> and the stress management standard from: <http://www.hse.gov.uk/stress/standards/index.htm>

*Useful weblinks*

## International organisations

- \* APOSHO – Asia-Pacific Occupational Safety and Health Organisation – <http://www.aposho.org/>
- \* CAREX – International Information System on Occupational Exposure to Carcinogens <http://www.ttl.fi/internet/english>
- \* IBAS – International Ban Asbestos Secretariat <http://www.btinternet.com/%7eibas/index.htm>
- \* IEA – International Ergonomics Association <http://www.iea.cc/>
- \* ILO – International Labour Organisation <http://www.ilo.org>
- \* ILO-CIS - ILO-International Occupational Safety and Health Information Centre <http://www.ilo.org/public/english/protection/safework/cis/about/index.htm>
- \* ILO-SAFEWORK - ILO-InFocus Programme on Safety and Health at Work and the Environment <http://www.who.int/pcs/>
- \* IPCS – International Programme on Chemical Safety - WHO <http://www.who.int/pcs/>
- \* ISO – International Organisation for Standardisation <http://www.iso.org/iso/en/ISOOnline.openerpage>
- \* ISSA – International Social Security Association <http://www.issa.int/>
- \* WHO – World Health Organisation [http://www.who.int/occupational\\_health/en/](http://www.who.int/occupational_health/en/)



17

Health and safety of stakeholders  
and customers

# 17

## Health and safety of stakeholders and customers

### CHAPTER OVERVIEW

The total external health and safety risks organisations face are measured by the SERM system as 2.6% of the average market value of the top 500 US and EU companies. This has been reduced from 4.1% by risk management activities. This is broken down into:

- \* External health risks to customers and the public at 0.4% of market value; and
- \* External safety risks are 1.0% of market value.

Historical liabilities are 1.2% of market value.

We review a case study of specific sectors, an overview of the tobacco sector and an in-depth view of the food sector's complex health and safety issues surrounding their products. The food sector now has to contend with recent issues of concern like:

- \* Food security;
- \* Food authenticity;
- \* Common and emerging pathogens;
- \* Microbial contamination of vegetable salads;
- \* Salmonella contamination in chocolates;
- \* Toxicity of food additives – Sudan red dye;
- \* Bad practice in the dairy industry;
- \* Carcinogenic acrylamide in food;
- \* Contamination from packaging;
- \* Antibiotics in honey;
- \* Genetically modified crops; and
- \* Nanotechnology contamination.

### External health risks to customers and the public

The results of SERM research indicate that:

- External health risks to customers and the public is 0.4% of market value of the 500 largest EU and US companies; and

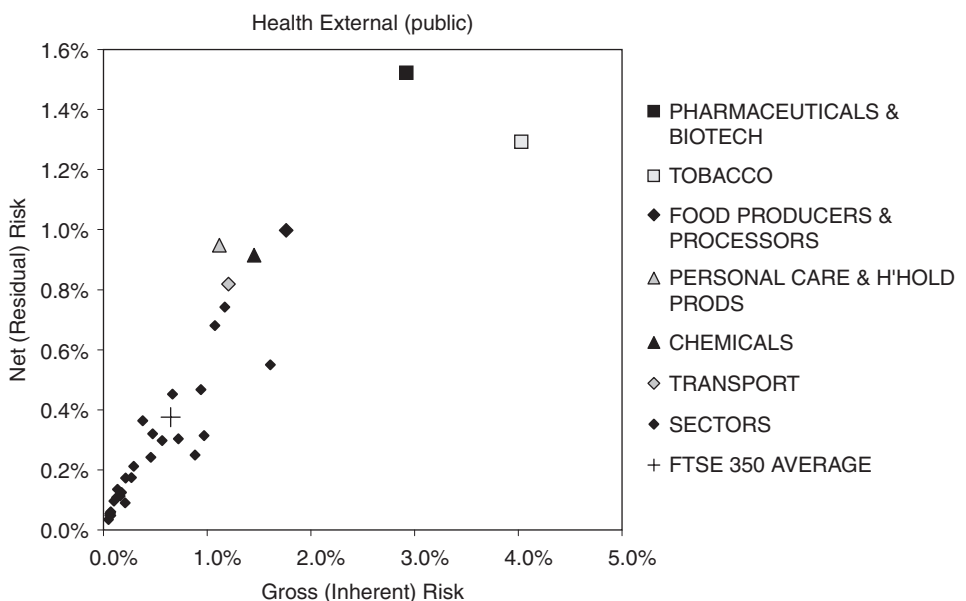
- This risk exposure has been reduced from 0.6% of market value by good risk management techniques (the risk reduction/management factor).

This chapter concerns members of the public suffering adverse illness as a result of exposure to the company's products. In particular, the extent to which use consumption, storage, and/or disposal/treatment of the company's products and services entails the generation, depletion, or use of:

- Ozone depleting substances (listed in Annex A, B, C and E of the Montreal Protocol);
- Persistent organic pollutants (POPs) (listed in Annex A and B of the Stockholm POPs Convention);
- Substances subject to the Rotterdam Convention on Prior Informed Consent (PIC);
- Hazardous chemicals/materials according to the Basel Convention (Annex I, II, III, and VIII);
- Endangered species listed in CITES (Convention on the International Trade in Endangered Species in Wild Fauna and Flora);
- Greenhouse emissions covered by the Kyoto Protocol;
- Radioactive substances;
- Limited natural resources; and
- Significant hazards or nuisances such as regulated pollutants, dust, and noise, etc.

Data on product risk is often not provided by companies. However, such data is specified by Global Reporting Initiative (GRI) Number SO8.

The following graph shows the health and safety risk (net) from external health risks to customers and public by sector.





Examples of sector risks include the following:

- Air travel and deep vein thrombosis (DVT): the first case was reported in a medical journal in 1946. In 1986, another medical study showed that pulmonary embolism was the second leading cause of in-flight or post-flight deaths at London's Heathrow Airport between 1979 and 1983. Only recently, however, have DVT sufferers been encouraged by the US Supreme Court ruling which held an airline liable for the death of an asthmatic passenger who was seated near the plane's smoking section (*Wall Street Journal*, 12 May 2004). Since most airlines don't have a firm policy on instructing passengers to stretch their legs, plaintiffs' lawyers argue that passengers who suffer from DVT as a result of sitting in an airplane can sue the carrier, claiming they weren't warned about the potential hazards (*Wall Street Journal*, 12 May 2004). Geroulakos of Ealing Hospital, London, presents additional evidence in the *European Journal of Vascular Surgery*: 'Long flights raise risk of strokes, warn doctors' (*Sunday Telegraph*, 28 March 2004);
- Automobiles and parts: Mitsubishi's 2.5 million vehicle recall has devastated their bottom line. Another car manufacturer, Jaguar, have recalled all pre-June 2003 luxury cars (in April 2004); a total of 68 000 vehicles, the cost of which is being borne by the supplier of the parts in question (ZF are the makers of the gearboxes) or ultimately their insurance company;
- Construction: house builders have sealed up houses tighter in order to prevent energy loss, but they may have compromised air quality too much, according to the US Environmental Protection Agency. The air that is breathed indoors may be two to five times more polluted than the air outdoors (*The Denver Post*, 15 February 2004);
- The agriculture sector's external health and safety problems (BSE/vCJD; foot and mouth; Salmonella; and SARS) may be due to several key factors:
  - The people: there were no individuals ultimately responsible (the government blamed the farmers; the farmers blamed the government and so on). This has been partially addressed by the establishment of the bodies like the UK's Food Standards Agency (FSA);
  - Policies: the only policy was a short-term economic one (encouraged by EU subsidies) to maximise output at the detriment of all other considerations;
  - Processes: there are few brands in farming and the lack of brand building processes means the farming sector is less concerned about individual organisation's reputational loss (the sector consists of tens of thousands of companies), thus their risk management processes are also less developed;
  - Performance: this overall performance has led to thousands of farmers going out of business, incomes being slashed and a diversification of the remaining businesses. Farmers are investing in creating stakeholder value again, by going to meet the customers direct (e.g. farmer's markets). There has also been a change of direction in the government with the introduction of grant schemes to support farmers who wish to have a lower impact of the environment;
  - Examples of incidents include: human health – the European Community banned imports of North American beef which it argues had been fed with

growth hormones which it viewed as not safe to eat. The US and Canada took the EC to court and were compensated for lost trade but the EC still imposed a ban; and

- The European Commission banned four antibiotics as additives to animal foodstuff on the basis that this would pose a risk to human health by increasing resistance to antibiotics being transferred to humans through the food chain. This was an application of the Precautionary Principle in practice, as discussed in Chapter 18.
- The food production, processing and retailing industry is susceptible to changes in consumer preferences as well as the health and quality issues of the products' production. An example of rapid changes in the marketplace is that UK drinks producer Britvic lost nearly a quarter of its value in a day after it warned that trading had been affected by a customer switch away from sugary carbonated drinks (which it produces) towards water and fruit-based drinks (*Financial Times*, 3 March 2006);
- Mobile communications industry: 'Mobile phones reduce sperm count, say experts' is a sample headline that can fill tabloid papers with fear mongering but the quote came from one of America's top three hospitals in this instance. The research suggests that men who use a mobile for over 4 hours a day had a 25% lower sperm count than men who never use a mobile. In the past 10 years, the UK sperm count has plummeted by 29% but the causes are not yet known;
- Retail sector: the staff of suppliers from countries like China face different standards of health protection. This is in part an exporting of the costs of health and safety to other organisations indirectly. An example is that:
  - Workers employed in China's jewellery trade for export to the US and Europe are developing deadly silicosis as a result of poorly ventilated workshops, campaigners have warned. An alliance of groups including China Labour Bulletin, the Hong Kong Christian Industrial Committee (HKCIC), the Hong Kong Confederation of Trade Unions and others have been raising the profile of this issue and say there has been extensive misdiagnosis of the issue which hides the extent of the problem ('China: Jewellery workers lung payouts fight', *Risks*, issue number 229, 22 October 2005).
- Tobacco: smoking will no longer be allowed in offices, factories, shops, pubs, restaurants, private members clubs, public transport and work vehicles used by more than one person in England from 1 July 2007. Health Secretary Patricia Hewitt announced that it was a triumph for public health:

Thousands of people's lives will be saved and the health of thousands more protected ... This legislation will help to prevent the unnecessary deaths caused every year from second-hand smoke and will provide a more supportive environment for smokers who wish to give up.

## Historical examples

- Product safety – radioactivity: radioactive materials were seen as beneficial for a long while, as anything that energetic must have energising properties,

it was thought. Radioactive materials were even placed into toothpaste and laxatives and people could even bathe in therapeutic radio active springs. Now the truth is known and even Marie Curie's research notes from the 19th and early 20th centuries have to be kept in lead boxes;

- Product safety – lead: in 1921 General Motors Research Corporation discovered that the inclusion of lead tetraethyl reduced the knocking associated with the combustion engine. Lead was also used in food containers as solder, on fruit as a pesticide, as a lining for water pipes and water tanks to supply and soften water, and as additions to toothpaste. With lead being a strong neurotoxin it was not long before the first symptoms of its inclusion in products was when staff producing the additive began dying. It was also found that atmospheric lead had almost not existed prior to industrialisation and only started to become a risk management issue with the US Clean Air Act of 1970 and its eventual removal from petrol (in the US) in 1986. Lead has also been banned in paint in the US, but 44 years after Europe banned it. There has even been a raft of new class-actions lawsuits against paint manufacturers and toxic paint use; and
- Product safety – CFCs: when refrigerators were first made they were very dangerous if they leaked. On one occasion over a hundred people were killed in a hospital in Ohio in 1929. The replacement miracle gas saved many lives but endangered them in another way as the replacement chemical gases were CFCs of ozone destroying fame. A kilogram of CFCs can annihilate 70 000 times its weight in atmospheric ozone and each molecule contributes as much greenhouse gas heating potential as 10 000 time carbon dioxide molecules. Apparently 27 million kilograms may still be used each year, even after the introduction of the Montreal Protocol limiting or removing their use.

## Company case studies

- Boots Company plc: it has been reported that Boots Essential Styling Mousse contained phthalates, chemicals suspected of endocrine disruption and reproductive toxicity. According to the autumn 2000 issue of *Women's Environmental Network News*, Boots' disposable nappies were found to contain traces of tributyl tin (TBT) in parts of the nappy adjacent to the baby's skin. TBT is an endocrine disruptor potentially effecting human hormones. The *Food Magazine's* investigation into sugar in baby biscuits criticised Boots' Teddy Bear Biscuits for their 37% sugar content, which would be damaging to newly emerging baby teeth (*ENDS Report*, November 2002);
- British Energy: after two safety scares British Energy closed a nuclear plant. They ran into credit problems and are surviving on a £400 million government bailout, which is being challenged in the European courts;
- Glaxo Wellcome (now GlaxoSmithKline plc): their Ulverston plant was third on Friends of the Earth's top 10 sources of cancer-causing chemicals. According to an *Ecologist* report the same plant emitted 773 tonnes of carcinogens in 2001, which translates into 10% of the total carcinogens released by large factories that year (*ENDS Report*, August 2000);

- House of Fraser: the company was found to have been selling goods made from PVC, which has adverse effects on human health and the environment;
- Jarvis: suffered a 40% share value loss in about a week;
- John Lewis Partnership plc: Friends of the Earth placed the company on their 'red' warning list due to the presence of brominated flame retardants and alkyltin in their duvets and their refusal to answer FOE's questionnaire and address the issues raised (August 2000);
- The operator of the Sellafield nuclear reprocessing plant has been fined £500 000 following a radioactive leak. About 83 000 litres of acid containing 20 tonnes of uranium and 160 kg of plutonium escaped from a broken pipe into a sealed concrete holding site;
- Marks & Spencer plc: Friends of the Earth and Ethical Consumer (2001) reported that M&S were one of the worst offenders among nine supermarkets in terms of pesticide residues on fruit and vegetables. Sixty-three per cent of fruit and vegetables contained residues. In response, M&S said they would prohibit 79 pesticides and set targets to reduce residues. They have since gone on to become an award winner for their organic food as well;
- Mothercare plc: Friends of the Earth placed the company on their 'red' warning list due to the presence of brominated flame retardants and alkyltin, phthalates, alkylphenols and bisphenol in their plastic toys, cots and prams, and failure to respond to letters from Friends of the Earth;
- Railtrack: suffered a 98% loss of shareholder value;
- Safeway plc: Safeway came eighth out of 21 British cosmetics companies surveyed for their responses to the presence of chemicals potentially harmful to health and the environment in their products (*ENDS Report*, November 2002); and
- Wyeth: a Texas jury in Beaumont awarded \$1 billion to the estate of a deceased woman after finding that a diet drug from Wyeth caused her death. About \$100 million was actual damages while the remainder was punitive damages, although the damages are likely to be reduced to single figures. There was a loss on the day as Wyeth was down 23 cents at \$39.27. In after-hours trading, it fell almost 4% to \$37.75.

## Risk management

Positive methods of risk management include having policies and systems for managing upstream and downstream impacts, including supply chain management as it pertains to outsourcing and supplier environmental and social performance, and product and service stewardship initiatives.

Stewardship initiatives include efforts to improve product design to minimise negative impacts associated with manufacturing, use and final disposal. Examples of practical risk mitigation by companies include the following:

- Wilson Bowden provides training for children living near their building sites and they are urged to stay off building sites as part of this safety initiative (*Liverpool Echo*, 2 May 2002, p. 73);

- **Hazardous substances:** Philips notes that in line with the requirements of the EU Directive on the restriction of hazardous substances in electronics, the company has phased out its use of lead, mercury, hexavalent chromium, cadmium and two classes of brominated flame retardants: polybrominated biphenyls (PBBs) and polybrominated diphenyl ethers (PBDEs); and
- **Obesity:** companies are beginning to respond to the calls for regulation and litigation with altered product ranges. Indeed McDonald's recently announced its healthier eating products, like salads, had improved its own profitability waistline ('McDonald's gets a lift from healthier eating', *Financial Times*, 15 July 2004).

## External safety issues: general public and customers

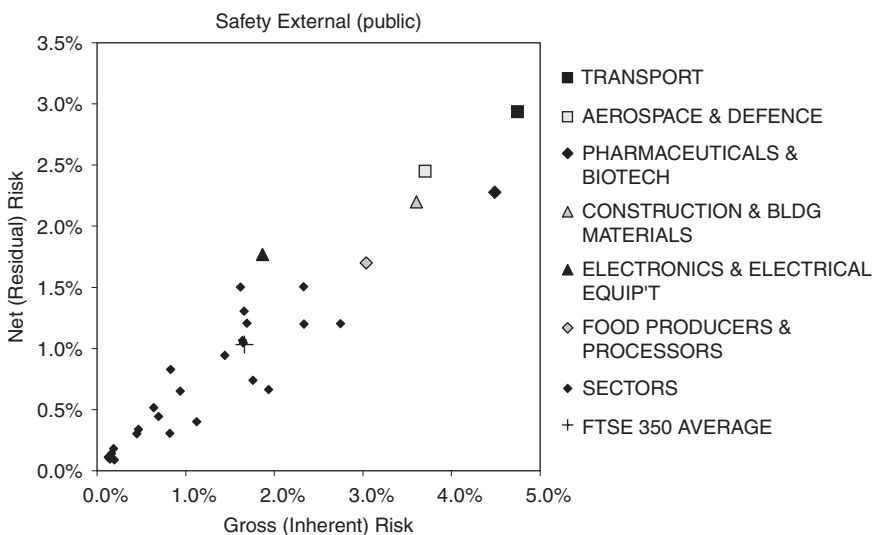
The results of SERM research indicate that:

- External safety risks are 1.0% of market value of the top 500 US and EU companies; and
- This risk exposure has been reduced from 1.6% of market value by good risk management techniques (the risk reduction/management factor).

This covers incidents resulting from a company's operations or products which cause members of the public injury, disability or impairment. It focuses on accidents resulting from negligence rather than disease caused by the use of harmful substances.

For example, a fuel company transporting petrol to a company bought the least expensive and wrong size fittings for the taps on the lorry tanker. Over time the nozzles wore down, leaked petrol, caught fire and exploded, resulting in the deaths of two employees. Ten members of the public were killed instantly and 30 were injured.

The following graph shows the external safety risks for customers and the public by sector.



An issue of increasing importance is that of terrorism, which is also deemed to be a business continuity threat (see Chapter 8). For example, the Turkish stock market (the ISE National-100 index) crashed 7.4% and the stock market closed to prevent further losses after bombs killed 27 people in Istanbul on 20 November 2003. The UK bank HSBC fell 1.3% as its Turkish headquarters was one of the main targets of these bombs, and British Airways fell 3.1% after the Turkish bombings, while Lufthansa fell 2.3%; SAS, the Swedish carrier, lost 1.5% and Air France-KLM 1.3%.

## Case studies

### *Transport sector*

The transport sector has to deal with large numbers of passengers travelling at speed and often across hazardous terrain as part of their business model so a safety risk is understandable. There are increasingly important or emerging issues though like terrorism, sabotage, staff suitability and facilities and vehicle vandalism. Some transport sector issues are:

- Terrorism:
  - Transport systems and air travel suffer more adversely than most sectors to terrorist activity, for example the Madrid bombs also had the impact on British Airways shares losing 8% to 284.5p due to its close contacts with the Spanish airline Iberia;
  - Holiday groups also suffer as people are less willing to travel and UK holiday firm First Choice also lost 4.2% as a result of the Madrid bombs amid fears that tourists would steer clear of European holiday destinations. Online travel agents Lastminute.com suffered a 17.2% fall as a result of the Turkish bombings, Intercontinental Hotels fell 2.9%, First Choice lost 3.6% on this occasion;
  - Carnival, the US Caribbean cruise operator, has also been affected by perceptions of risk and fell 7.3% over the week after announcing concerns about further al-Qaeda activity on its business model (*Financial Times*, 7 August 2004);
  - The age of Air Transport's fleet planes can be over double that of their rivals. The average age of their planes can be 17 years. The British Medical Association (BMA) warns that the airline industry is not doing enough to safeguard passengers' safety, and that as a general rule staff are not trained well enough to deal with crisis. It is estimated that 1 in 1400 passengers requires medical attention on flights; and
  - Jarvis shares were over 300p in 2003 before poor track maintenance was blamed for a rail crash in the UK at Potters Bar, an area for which Jarvis held the contract. This involvement could well have initiated a cascade effect, which led to the loss of maintenance contracts, loss of reputation with contract awarding bodies and then a string of profit warnings, with share value falling below 30p in July of 2004 and as low as 7.39p in July a year later.

## *Food sector*

The food sector has had a large number of difficulties with its supply chain and environmental health issues: for example, BSE/vCJD in cattle and humans; foot and mouth affecting the UK pig herd; Salmonella, SARS and Asian flu in poultry; toxicity from the levels of pesticides in fruit, vegetables and farmed fish; contamination of tuna and other fish with high levels of mercury and other heavy metals; and general issues such as the large-scale nitrate pollution of water, or the overapplication of antibiotics, which is reducing human resistance to infectious diseases. We explore some of the emerging food sector risks in the extensive case study at the end of this chapter.

## *Pharmaceutical sector*

Pharmaceutical companies have a high-risk high-reward business model wherein their market premiums help meet the high level of product liability claims that have been surfacing. Where the products themselves are supposed to confer health benefits there are added threats to reputation if the products are deemed to have the perceived opposite or detrimental effects upon the customer. This is particularly true within the pharmaceutical sector and examples are:

- The BBC reported that GlaxoSmithKline's anti-depressant Seroxat causes serious withdrawal symptoms in 85% of users trying to stop using the drug. Some users had been led to self-harm and even suicide. It was alleged that GlaxoSmithKline neither warned about these dangers, nor accepted responsibly (BBC, October 2002);
- When it was thought that the drug group Merck might be liable for the death of a man who had been taking its painkiller drug Vioxx it affected the value of its own shares and those of others in the sector, as Shire Pharmaceutical and GlaxoSmithKline of the UK fell by 0.9 and 0.8% respectively on hearing the news (*Financial Times*, 23 August 2005); and
- More worryingly the *British Medical Journal* reported on the 2 July 2004 that adverse drug reactions may be killing as many as 10 000 people a year in Britain and costing the National Health Service more than £400 million (reported in the *Financial Times*, 'Thousands killed by bad drug reactions', 2 July 2004).

## *Oil and gas sector*

In response to events like Piper Alpha there has been extensive investment in safety measures to reduce reoccurrence and the UK Offshore Operators' Association now note that incidents have fallen by 50% since the disaster.

Other specific examples include the following:

- BP's misfortunes have led to an evaporating reputation as a series of mishaps in BP's US operations have left many wondering if it was all just green wash; and

- An explosion kills 15 and injures 170 at a refinery in Texas City; allegations surface of propane price fixing; corrosion in the Alaskan pipeline causes a leak and shuts down production in Prudhoe Bay, Alaska; problems with underwater joints on the Thunder Horse deep-sea drilling project in the Gulf of Mexico delay production. The August 2006 terrorist alerts at Britain's airports cost the biggest airport operator, BAA, over £13 million in additional security costs that month.

### *Other case studies*

- Courts plc were red listed by Greenpeace as their sofas were likely to contain bio accumulative and toxic chemicals, such as brominated flame regulators, organotin and endocrine disrupters (January 2004);
- HSBC Holdings plc were reported as having had their chief of building security at their Argentine headquarters charged with the murder of an unarmed demonstrator in December 2001 (*The Guardian*, January 2003);
- Scottish & Southern Energy plc were reported by the Environment Agency as being involved in a pollution offence involving polluting a public drinking water supply with leaking oil. The total fine amounted to £10 000;
- A civil lawsuit in the US could now hold gun dealers accountable for crimes committed with weapons they sell. This is as a result of the death of a seven-year-old who was killed by a gun sold to a re-supplier who illegally sold it on the black market. The victim's mother claims the gun dealer created a public danger by 'recklessly' selling the gun (*Insurance Journal*, 21 April 2004); and
- The tobacco sector's health issues are well known (see the next section of this chapter for a case study), but the safety risk aspects of their products are also becoming relevant. Tobacco products are alleged to be responsible for nearly one in four fire deaths in the US, which works out at 800 to 1000 fatalities a year. Litigation cases have begun and the first has resulted in a \$2 million settlement for a lady after the parked vehicle she was in caught fire after a cigarette accidentally fell on the seat of the vehicle (*Personal Injury Verdict Reviews*, 22 December 2003).

### Risk management

Examples of positive programmes and projects are:

- Staffing levels are said to be key to airport security and that airline pressure to speed up security checks could compromise security;
- Virgin Atlantic was held up as a successful case study in the field of passenger safety by BBC1 News, 30 May 2004;
- Traffic calming by Wilson Bowden in Ravenstone: David Wilson Homes has provided £70 000 so that traffic calming can be introduced on roads in the village (*Leicester Mercury*, 15 February 2002); and
- Noise pollution: Redrow Homes (Midlands) Limited of Flintshire have taken appropriate risk action to ensure there is no reoccurrence of the fines they



had to pay in respect of noise pollution. This involves the company warning subcontractors that they will lose their jobs if there are any further early starts (*Birmingham Evening Mail*, 3 March 2003).

## Analysis of historical health and safety liability risks

The results of SERM research indicate that:

- Historical health liabilities risk is an average of 1.2% of market value of the 500 top EU and US companies; and
- This risk exposure has been reduced from 1.9% of market value by good risk management techniques (the risk reduction/management factor).

The following are some illustrative examples of risks and risk management.

### *Employees*

Through working for the company a member of staff has developed a disease, disability or impairment as a consequence of the company failing to take action to reduce the risk of personal injury to the employee.

### *Public*

Negative health consequences are experienced by individuals as a result of using the company's product or service. For example, a pharmaceutical company which failed to conduct adequate tests to ensure safety of their product.

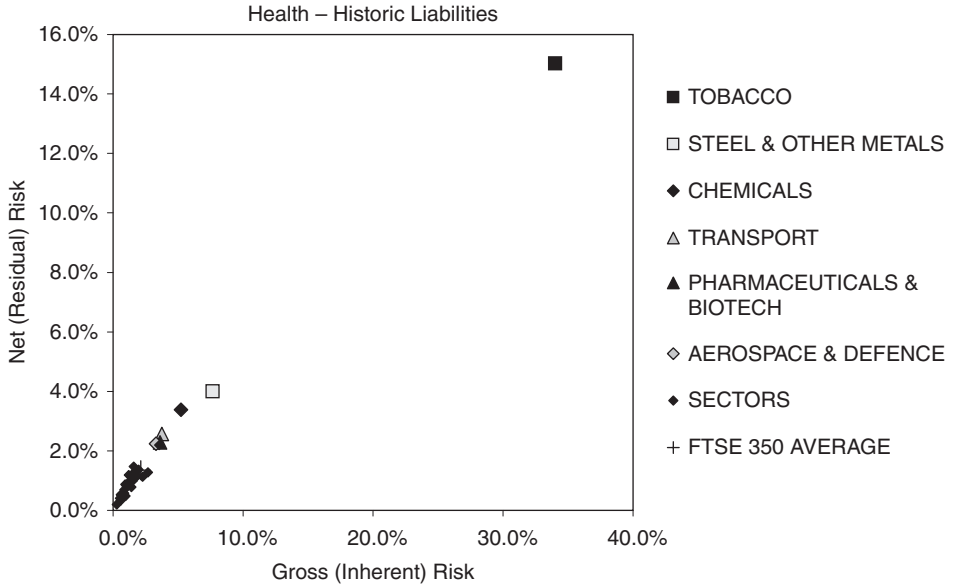
This risk category excludes liabilities which have an environmental impact (e.g. an impact which extends beyond the company's site). Such liabilities are covered in environmental incidents (present) or environmental historic liabilities (past).

It does include, however, liabilities arising from the manufacturing process which affect the workforce (e.g. asbestosis), and liabilities arising from the company's products.

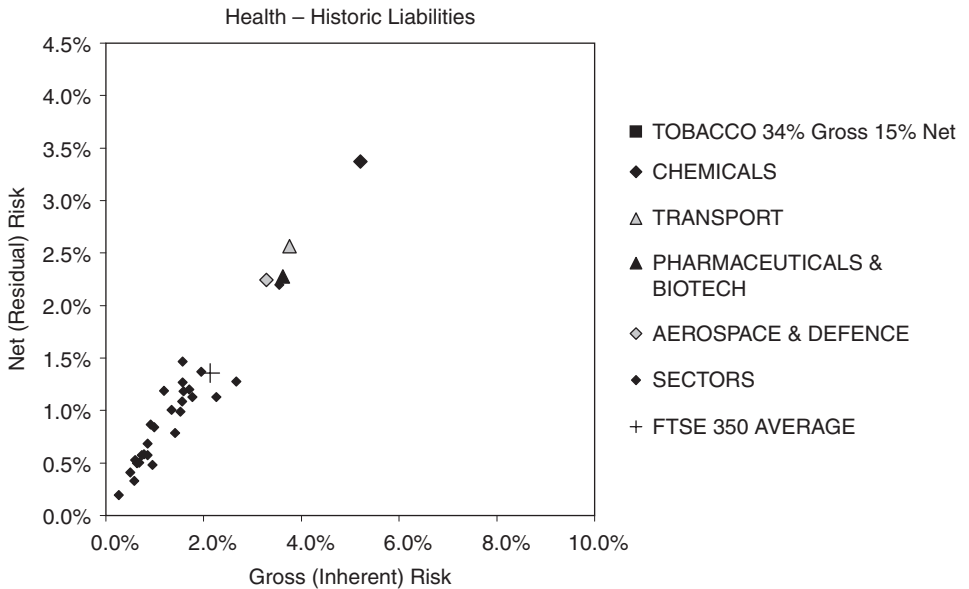
The WHO (World Health Organisation) says prevention is the way to reduce the historical liabilities of the future, as the true extent of the risks faced are unknown. For example, the long-term impacts of pollution upon the brains of children in many parts of Europe, who are suffering more damage from environmental risks than previously recognised, are only just being discovered. The WHO claims lead continues to be a menace: up to 30% of urban children show high levels of lead in the blood in some places. It says the emphasis should be on following the precautionary principle, putting safety first. Other threats to children's health include methylmercury, dioxins, furans, PCBs, pesticides, nitrites and nitrates, and benzene. Dr Roberto Bertollini of WHO said:

For too long, policy-makers have retrospectively pleaded, 'If only we had known earlier what we know now.'

The following graphs show the historical health liability risk by sector.



The same data with tobacco removed shows increased detail for the other sectors.



Other examples of issues which affect sectors include the following:

- Land contamination liabilities, especially if they affect human health (as covered in Chapter 19);

- Asbestos: global legislation like the UK Control of Asbestos at Work Regulations 2002 (SI 2002 No. 2675) requires employers, owners or occupiers of non-domestic premises to ensure that the risks posed by asbestos are properly managed. Assessments are usually needed to be undertaken to identify whether asbestos is present on or in the premises and, where present, or is likely to be present, those responsible must:
  - Compile a written risk assessment;
  - Prepare a written plan identifying those parts of the premises concerned; and
  - Identify in that written plan those measures to be taken to properly manage the risk.
- These documents must be periodically reviewed, and failure to manage this risk can lead to a criminal prosecution of both the company and the company's officers. Examples of sector liabilities are:
  - The aerospace and defence sectors, engineering and construction sectors are all affected by this. In the UK, observed deaths are over 1700 per annum and will hit a maximum of 2000 per annum in 2010, up from less than 200 in the 1960s. The US National Bureau for Economic Research (NBER) estimates that at least 600 000 people have now filed asbestos exposure claims in the US. Eighty firms have filed for bankruptcy and insurers have paid out approximately \$32 billion in compensation. The total cost of asbestos compensation is projected to be between \$200 and \$275 billion; and
  - The exposure of the UK manufacturing industry to asbestos liability is also increasing as new estimates of expected fatalities occur. VT plc has already increased their provision by £15 million in March of this year. The number of asbestos suits against Ford rose by two-thirds in 2003 as the total number of claims reached 41 500.
- The scale of the potential liabilities is still vast and for just the UK this has been researched by Actuarial Professionals who find that the number of Britons suffering from asbestos-related diseases will peak at roughly 2000 a year within the next 10 years, at a loss of nearly £8–20 billion pounds sterling over the next 30 to 40 years ('UK asbestos deaths rising', *Claims*, December 2004, volume 52, number 12, p. 13);
- Food producers and processors are facing obesity litigation for poor diet and physical inactivity, which accounts for about 400 000 American deaths each year. It is also estimated that taxpayers foot half the \$75 billion a year and that in the next few years it will become the number one killer in the US. There are product recalls every day as companies have a legal obligation to recall products which are deemed unfit for the purpose. Coca-Cola has had the Dessani water recall and subsequent deletion of that product line in the UK. They had a large-scale product recall of products made at their Belgium plant, which is alleged to have cost \$100 million. There are now regular headlines such as:
  - 'Revealed: how food firms target children' (*The Guardian*, 27 May 2004). Dramatic extracts such as 'Children will die before their parents' can be read in the criticism of the food industry which has been given three years

to redeem itself (the report can be read at [www.parliament.the-stationery-office.co.uk/pa/cm/cmhealth.htm](http://www.parliament.the-stationery-office.co.uk/pa/cm/cmhealth.htm)).

- Food producers and processors are being encouraged to follow the market trends which can include increased demand for home-grown food produced to the highest nutritional and animal welfare standards. David Miliband, Britain's Secretary of State for Environment, Food and Rural Affairs, said at the Oxford Farming Conference, 'The food sector is increasingly driven by consumer questions about quality, health and environmental impact as well as price ... Consumers want more information on where their food has come from and how it has been produced, and higher standards of nutrition and animal welfare.'; and
- Paint liabilities are becoming like asbestos litigation, the ramifications of the verdict could be widespread and affect not only other paint manufacturers and pigment makers, but also landlords with poor maintenance records, painters, distributors, and others in the supply chain that produced the lead-based paint used in millions of buildings across the United States. Legal experts note that the link between lead paint and individual cases of developmental impairment will be difficult to prove, which is why many other cases filed at the state level have failed, and it is unclear whether the Rhode Island verdict will survive the appeals process and affect the tort system in the way that asbestos has.

## Case study – tobacco sector

We undertake an exploration of some of the risk impacts that the tobacco sector has suffered. First, the very nature of the product has a highly noticeable impact upon society. The estimated annual death toll from tobacco-related products is 435 000 deaths in the US and 400 000 in the EU of which 100 000 per year are in the UK. The US Department of Justice is pursuing a \$289 billion lawsuit against the tobacco industry, on top of a previous settlement for \$320 billion. This will affect the UK tobacco giant BAT plc more than the other UK-based tobacco companies as they have limited or no exposure to the US market.

Analysts at Charles Stanley say of the liabilities in the tobacco sector: 'BAT's shares have always stood at a discount to those of Imperial Tobacco and Gallaher because of the risks posed by US litigation', and that this effect will be reduced by BAT's pushing these liabilities onto Reynolds America, a new holding company forged by bringing its US operations together with those of RJ Reynolds Tobacco (*Financial Times*, 29 October 2003).

There are other liabilities that become apparent over time, however, and the same tobacco company started to suffer in other geographical areas as British American Tobacco fell 1.1% at the start of a lawsuit, brought against it by British Columbia seeking C\$10 billion in healthcare costs at the Canadian Supreme Court (*Financial Times*, 9 June 2005). The effect of litigation like this is not always immediate and Credit Suisse First Boston changed its recommendation of the tobacco sector a few days later (on 16 June 2005) from 'overweight' (holds more than the sector's proportion of the index) to 'neutral' (holds the

same as market proportion) as they said that current valuations did not reflect the risks from changes in taxation, regulation, litigation or competition. BAT fell a further 2.2%, Imperial Tobacco lost 1.6% and Gallaher 1.1% as reported in the *Financial Times* on 17 June 2005.

There is the increasing likelihood of a reduction in passive smoking and air pollution for the general public as smoking bans gather pace. Ireland outlawed cigarettes in all its restaurants and pubs in 2004. It is now illegal to smoke in virtually all workplaces, closed public spaces and on public transport, with fines of up to €3000 (£2000) for transgressors (*Risks*, issue number 150, April 2004).

The Justice Department is suing the industry for allegedly conspiring to deceive the public about the dangers of tobacco products/smoking and the addictive properties of nicotine and how these can be boosted. The US government is also claiming that the companies gained \$280 billion through fraud.

New research suggests that a workplace smoking ban could almost halve the number of heart attacks. The study looked at the impact of a smoking ban in the US town of Helena, Montana ('Reduced incidence of admissions for myocardial infarction associated with public smoking ban: before and after study', *British Medical Journal*, Richard P. Sargent, Robert M. Shepard, Stanton A. Glantz, published online, 5 April 2004 (*Risks*, issue number 151, April 2004)).

Filters in (Philip Morris) cigarettes may release potentially harmful fibres into smokers' lungs, new research claims. Scientists say the tobacco giant has known of the possible defect for 40 years, but marketed the cigarettes anyway. Researchers from the US Roswell Park Cancer Institute said that as people smoked the filters released plastic-like cellulose acetate filter fragments and carbon microparticles. The report is published in *Tobacco Control*, a subsidiary journal of the *British Medical Journal*. Philip Morris brands include Marlboro, Peter Jackson and Alpine (*Herald Sun*, Melbourne, Australia, 13 March 2002, p. 25).

The following are some product liability cases against the tobacco sector:

- Boeken case: the jury awarded the plaintiff \$5.5 million in compensatory damages and \$3 billion in punitive damages, later reduced to \$100 million;
- Bullock case: the jury awarded the plaintiff punitive damages in the amount of \$28 billion, later reduced by the trial court to \$28 million;
- Engle case: the \$145 billion punitive damages award in Florida's Engle class action, which was overturned, was the largest such award in US history;
- Lukacs case: a verdict was reached for compensatory damages in favour of the plaintiff against Philip Morris USA and two other tobacco companies. The jury awarded Mr Lukacs \$37 500 000;
- Williams-Branch case: the plaintiff, the wife of a deceased smoker, sued Philip Morris USA for fraud and negligence. The jury entered a verdict against Philip Morris USA on the fraud claim and awarded the plaintiff \$800 000 in compensatory damages and \$79 million in punitive damages, which the trial court later reduced to \$32 million. The appellate court later reinstated the award of \$79 million in punitive damages;
- A French health insurance fund went to court to try to force four tobacco companies to pay for medical treatment for ailing smokers. The branch of the

Primary Health Insurance Fund based in the northwest French city of Saint-Nazaire is targeting Altadis, Philip Morris, RJ Reynolds and British American Tobacco;

- Philip Morris has been ordered to pay \$150 million to the estate of a woman who died of lung cancer after smoking their low-tar cigarettes. According to the jury, the company bore 51% of the responsibility for the smoker's death, with the smoker bearing the rest of the blame for choosing to smoke (*CSR*, 23 March 2002); and
- There are cases in the US on behalf of former asbestos manufacturers and affiliated entities against domestic tobacco manufacturers. These cases seek contribution or reimbursement for amounts expended in connection with the defence and payment of asbestos claims which were allegedly caused in whole or in part by cigarette smoking.

### *General examples*

- Bayer AG and product liability: a product liability suit against the German drug giant Bayer AG began with an additional 1400 more plaintiffs waiting in the wings. The company shares started to plunge, falling over 25% in the trial's first few days. The plaintiff's representative was publicly predicting that his and other Baycol litigation could cost Bayer a stunning \$50 billion before it was over. To date, it has settled 2312 cases for \$872 million (*Wall Street Journal*, 3 May 2004);
- BOC plc, already facing thousands of legal claims from Parkinson's disease victims in the US, have now lost their first asbestos case there. The industrial gases giant admitted they were also facing 1200 previously undisclosed claims from asbestos sufferers in America. The shares closed down 2.5 at 887.5p, despite BOC announcing a better than expected rise in profits in the six months to 31 March, 'Asbestos ruling dampers BOC'. *The Daily Telegraph*, Christopher Hope. Field: 14 May 2004. BOC also have 8525 claims relating to an alleged link between fumes from welding rods and Parkinson's disease;
- Jarvis: the main issues raised were the quality of rail safety work and Private Finance Initiative (PFI) contracts behind schedule. They have issued a profit warning, lost their chairman in November 2003 and their CEO Andrew Sutton in February 2004. Shares fell by 40%;
- Jarvis: safety problems are thought to have started their slide in reputation which has cost the company millions. A quote from *The Observer* (12 October 2003) helped pre-empt the losses that Jarvis experienced:

Jarvis has lost new work worth tens of millions of pounds because its reputation has been battered by rail crashes and derailments, say government officials.

Jarvis had bid for a dozen PFI projects but failed to make the top two in any of them, thus missing work valued at £1.1 billion. They issued a profit warning some four months later. Maybe as a result of these occurrences Jarvis cut 83 rail signalling and maintenance jobs in March 2004 due to a downturn in demand. Shares fell 6.5p on the day of the announcement;

- Rio Tinto admitted responsibility for the Capper Pass contamination in June 2000. Over a five-year period in the mid-1980s, children aged 12–15 living in West Hull villages were confirmed to be suffering from cancer, allegedly from exposure to chemicals such as arsenic, lead, cadmium and radioactive polonium-210 in the Rio Tinto mines. Seven of them have since died. A report (prepared by the prosecution) documents another 400 cases of contamination by the smelter; and
- Royal & Sun Alliance Insurance Group plc was reported in *Hazards* as refusing payouts to asbestos victims who had worked in the Clyde shipyards. Allegedly, Royal & Sun issued certificates from 1972 to 1977 to Turner and Newall illegally excluding asbestosis (January 2002).

## Risk case study – emerging food health and safety issues by Raj Patel

(Research Fellow at the Centre for Chemical and Bioanalytical Science, Royal Holloway, University of London, Egham, Surrey, United Kingdom)

The food sector has had a large number of difficulties with its supply chain, human health and safety and environmental health issues: for example, BSE/vCJD in cattle and humans; foot and mouth affecting the UK pig herd; Salmonella, SARS and Asian flu in poultry; toxicity from the levels of pesticides in fruit, vegetables and farmed fish; contamination of tuna and other fish with high levels of mercury and other heavy metals; and general issues such as the large-scale nitrate pollution of water, or the overapplication of antibiotics, which is reducing human resistance to infectious diseases.

The list is wide and increasing, and in this case study we explore some of the newly emerging risks that the sector is facing. It is argued that there are structural problems in the agricultural and food industries that can emphasise quantity over quality. It is to be noted that there are few brands or reputations in the food producing sectors compared to the global players in the food processing and sales categories. Usually if there are no brands there is weaker responsibility for outcomes. A lot of the UK's food health issues resulted in thousands of farmers believing it was the UK government's responsibility to protect quality and the government thought it was the farmers' duty. There was a void, or rather avoidance of accountability that has been partially resolved by the establishment of a Food Standards Agency to counteract this stakeholder miscommunication.

The market mechanism for the production and processing of food has been a heavily regulated one as since the first English food law was proclaimed by King John of England (1202) prohibiting the adulteration of bread with such ingredients as ground peas or beans, the complexity of risk managing food provision has increased immensely with regulation not far behind. In the contemporary world the World Health Organisation says hundreds of millions of people worldwide suffer from diseases caused by contaminated food: <http://www.who.int/archives/inf-pr-1997/en/pr97-58.html>

We review some of the key risk issues in the food sector and see just how more complex the health and safety issues surrounding food products have become and how it has to contend with issues explored in the rest of this section, including:

- Allergenicity;
- Antibiotics in honey;
- Carcinogenic acrylamide in food;
- Common and emerging pathogens:
  - Microbial contamination of vegetable salads; and
  - Salmonella contamination in chocolates.
- Contamination from packaging;
- Food authenticity;
- Food security;
- Genetically modified crops;
- Bad practice in the dairy industry;
- Nanotechnology contamination;
- Toxicity of food additives – Sudan red dye; and
- Bioterrorism.

Food trends are:

- Increasing global demand for food as populations increase and become more urban;
- Globalisation of the food supply and travel;
- Pressure to intensify food production industries in developing countries (trying to meet the needs of export markets);
- Further spreading of food-borne diseases and increased risk issues with regards to: additives; allergenicity, antibiotic resistance; authenticity and new risks of genetic modification and nanotechnology contamination;
- Socio-economic changes:
  - Disposable income;
  - Increased mobility of people;
  - Increased exotic trips leading to exotic tastes;
  - Increased gap between rich and poor countries;
  - Decreased household sizes; and
  - More adventurous eating, ‘ethnic foods’, in industrialised countries.
- There is a centralisation of the processing of human and animal foods, and of a more concentrated distribution of food into the hands of a few global operators like Unilever, Nestlé, Wal-Mart, Carrefour, Cargill, Tesco and Metro. In the UK £1 in every £7 spent in UK shops is spent in Tesco.

## New food safety threats

### *Recent concern: allergenicity*

Dairy firms face crisis over EU safety checks:

- The dairy industry in the UK in crisis after EC concerns about the methods used to detect harmful levels of antibiotics in milk;



- EU will carry out a nationwide inspection of the dairy sector;
- EU acted after a random inspection of a small cheese maker, Bowland Dairy Products, found ‘serious breaches’ of EU food safety rules;
- The inspection found evidence that the firm had collected out-of-date milk that had tested positive for antibiotics to manufacture cheese;
- Antibiotics degrade in milk during storage and pose no problems in production of cheese and yogurt; and
- However, the breakdown products can be allergenic.

### *Recent concern: antibiotic residues in honey*

- European Rapid Alert System for Food and Feed (RASFF) has reported contaminated honeys from: Argentina, Australia, Bulgaria, China, Germany, Hungary, India, Italy, Mexico, Romania, Slovakia, Spain, Turkey, Ukraine, Vietnam.

The antibiotics in honey, which come from the treatment of bee diseases and antibiotic residues in honey, is an international problem.

Issues for the regulators:

- No MRLs available for antibiotic residues in honey;
- New antibiotics are also being reported, e.g. tylosin;
- 20 to 30% of honey on the market is contaminated with antibiotics; and
- Problems for the regulators:
  - Assess safety and toxicity;
  - Licence or not? and
  - Provide information to the consumer to make an informed choice.

### *Recent concern: carcinogenic acrylamide in food*

- Acrylamide forms in certain foods, particularly plant-based foods that are rich in carbohydrates and low in protein, e.g. potatoes, during processing or cooking at high temperatures;
- It is known to cause cancer in animals and was first confirmed to be found in food by the Swedish National Food Authority in 2002; and
- It is formed when a natural amino acid called asparagine reacts with certain naturally occurring sugars such as glucose. This only happens when the temperature during cooking is high. This varies with properties of the product and the method of cooking.

How to minimise exposure? An example of advice from regulators – Health Canada’s advice:

- It is not possible to determine recommended maximum exposure levels or to set daily consumption limits for specific foods containing acrylamide;
- Research indicates that french fries (chips) and potato chips (crisps) contain the highest levels of acrylamide;

- Have fried or deep-fried foods and snacks such as french fries and potato chips less often. Occasional consumption of these products is not likely to be a health concern;
- Choose a balanced diet containing a variety of foods that are low in trans fat and saturated fat, and rich in high-fibre grains, fruits and vegetables;
- Industry and regulators are responding as a precaution by changing production techniques to lower the levels. However, acrylamide is present in many foods. Dealing with a few foods has no effect – everything must be changed;
- Food cooked at home and in restaurants is a big challenge, and a significant source of acrylamide exposure. Changing cooking habits can lower acrylamide intake; and
- Research to fully understand:
  - The nature of the low dose hazard to humans; and
  - The impact of any proposed interventions. Are there any unintended consequences to public health?

### *Recent concern: common and emerging pathogens*

The spread of food-borne diseases is being affected by a number of factors and threats which include:

- The intensification of food-animal production in many countries;
- Prion-caused transmissible spongiform encephalopathy;
- Recognition that non-symptomatic food animals can harbour organisms pathogenic to humans;
- Pathogens of importance becoming resistant to standard antibiotic therapies;
- Infectious diseases visibly crossing borders; and
- Ever-increasing opportunity for chemical contamination of foods (industrial accidents, e.g. Chernobyl), dioxins in chickens, chemicals from packaging, etc.

The food-borne illnesses in the US have an estimated annual cost of \$6.9 billion:

- Bird flu (see the case study in Chapter 8 on business interruptions);
- Campylobacter (*Campylobacter jejuni*): the sources are the intestinal tract of animals and humans and non-chlorinated water. It contaminates raw chicken at an incidence rate from 30 to 100% and is now the No. 1 cause of bacterial food-borne illness. Human infective dose is as little as 400–500 cells;
- *Salmonella* spp.: there are approximately 2000 species and all are pathogenic. Again it is found in the intestinal tract of animals and humans. An infectious dose in humans can be as low as 10–15 cells for *S. typhimurium* and *S. enteritidis*. It is the No. 2 cause of bacterial food-borne illness:
  - Salmonella contamination in chocolates.
- *Listeria monocytogenes*;
- *E. coli* 0157 (*Escherichia coli* 0157:H7) ESBL: *E. coli* has also taken at least 57 lives in the UK since 2004: and
  - Most *E. coli* are harmless;
  - 0157:H7 rare form of *E. coli*;

- Source: intestinal tract of animals and humans; and
- Low infective dose.
- BSE, dioxin, pesticides, antibiotics, etc.

An example of how modern processes can increase the risk levels is the fruits and vegetables sector:

- The products are eaten raw and known to be vehicles for transmitting infectious diseases; and
- Many pathogenic bacteria, parasites and viruses have been isolated from raw fruits and vegetables, fruit juices, etc.

Examples of recent impacts of these risks include the:

- *E. coli* contamination in vegetables from Yemen; Saudi Arabia stopped all imports including animal products; and
- *E. coli* contamination of pre-packaged vegetable salads in the US.

### *Recent concern: contamination from packaging*

Packaging and food contact materials, i.e. ITX contamination in foods:

- ITX, a colour stabiliser used for printing offset colours on food packaging, hit the headlines in connection with contaminated baby milk products in November 2005;
- The milk, which was packed in drink cartons, contained traces of ITX and was phased out as a precautionary measure. The packaging producer also reacted, stopping the production of packaging with ITX containing ink;
- The European Food Safety Authority has stated that ‘on the basis of the very limited data available, the presence of ITX in food is undesirable but is not likely to present a health risk at the levels reported’;
- ITX is a photoinitiator in UV-cured printing inks used on some food packaging. During routine analysis of liquid infant foods, low levels of ITX were detected, and the European Commission informed; and
- Food manufacturers and packaging manufacturers have worked together to substitute the packaging.

### *Recent concern: food authenticity*

A related issue to that of security is the authenticity of food products as food counterfeiting and alteration is now very big business. Labelling regulations and consumers are demanding assurance of the origin of products because of safety, religious, health, taste or moral preference.

There should be increased moves to identify food products, i.e. what meat species go into mechanically recovered meat and methods to distinguish between processed and recovered meats. There are a range of methods that can

be deployed including DNA testing techniques (PCR, ELISA, Proteomics and metabolomics).

Risk management methods for fingerprinting and profiling food include:

- New technology arising from the metabolomics sector;
- Fingerprinting: empirical approach for characterising food products;
- Identification of marker compounds;
- Methods: NMR, FT-IR, LC-MS, GC-MS, NIR; and
- Food verification methods: QA, brand protection, security.

Examples of testing include:

- Current methods for detecting the presence of gelatine in foods and beverages include estimation of hydroxyproline (Hyp), an amino acid found in substantial quantities in collagen. However, some plant and algae proteins also contain Hyp, making interpretation of results at trace levels difficult; and
- Recent work at RHUL (Patel *et al.*, 2004 and 2005; Neubert *et al.*, 2004) has demonstrated that mass spectrometry (MS) can be used to detect characteristic biomarker peptides derived from gelatine present in animal feeds.

### *Recent concern: food security*

Threats to the US food supply include terrorists, extortionists, unhappy employees, protesters and hoaxes which cause economic damage, say the US Food and Drug Administration (FDA) and the Food Safety and Inspection Service (FSIS) (Sorrells, E. *Security Management*, August 2006).

To protect against these sorts of risk, new food-protection and biosensor technologies are needed to protect the food supply chain. Biosensors that are capable of identifying a range of biological material, including chemical compounds, proteins, metabolites, nucleic acids and living organisms should be developed and deployed.

The public would seem to back these moves as an example is that a recent study by the University of Minnesota finds that protecting the US food supply requires a greater federal commitment, according to public opinion. The study sampled 4200 residents nationally and over 50% of respondents think terrorists will strike within the United States within the coming four years (Meyers, M. *Minneapolis Star Tribune*, 22 March 2006).

### *Recent concern: GM crop production*

Various international bodies like OECD, the FAO/WHO, and the EU have designed strategies for the safety evaluation of genetically modified foods or food ingredients. Public acceptance is low, especially in the EU even though 81 GM crops have been approved worldwide and there is 'new' production and supply chain issues with regards to food and feeds of potato, tomato, papaya,

sugar beet; melons and rice. There have been numerous contamination scares and cross-border trade disputes as a result of these products.

### *Recent concern: nanotechnology*

Nanomaterials are already being integrated into hundreds of products, including: computers; food wrappings; sports equipment, stain-resistant fabrics and an array of cosmetics and sunscreens. Preliminary studies suggest that most of these products do not pose significant risks in their bulk form or embedded in the kinds of products that so far use them. But the same cannot be said of the particles themselves, which can pose health risks to workers and possibly food producers and processors and they may cause health or environmental problems as discarded products break down in landfills.

There are concerns that tiny particles from the products might cause respiratory, cardiac and immune problems and that the implications have not been properly assessed. The more general risks are explored in Chapter 11. Some of the possible human health hazards of nanotech that have been identified or suspected, from a food health and safety perspective, include:

- Researchers at the New Jersey Institute of Technology found that nanoparticles of aluminium oxide stunt the growth of roots on several crops, including soybeans and corn, mainstays of the US food supply system;
- Some carbon nanospheres and nanotubes behave differently than conventional ultrafine particles, causing fatal inflammation in the lungs of rodents, organ damage in fish and death in ecologically important aquatic organisms and soil-dwelling bacteria;
- Their ability, identified in animal studies, to clog airways, trigger intense immune-system reactions and ‘toast’ living cells; and
- And a California team working with laboratory-grown cells showed that carbon nanotubes specifically activate ‘cell suicide genes’ (extracts from ‘Toxic warnings for nano industry’, *Risks*, issue number 256, 13 May 2006).

### *Recent concern: toxicity of food additives*

An example is the Sudan red dye scare of February 2005. There were conflicting governmental stances on the issue at the time, as the contrasting comments of the UK and Canadian governments below suggest:

- ‘At the levels present the risk is likely to be very small but it is sensible to avoid eating any food known to be contaminated. There is no risk of immediate ill health’ (UK FSA website, 25 February 2005); and
- ‘Sudan I and IV, red dyes, are not permitted as food colours in Canada. There have been no reported illnesses associated with the consumption of these products. Sudan I has been shown to cause cancer in laboratory animals. These findings could be significant for human health, but further research is needed’ (Canadian Food Inspection Agency, February 2005).

The risk is still prevalent as the following types of dyes have been found in food since the original scare in many more products from many different countries than originally thought:

- Sudan I, II, III and IV, Sudan orange G, Sudan red 7B, Sudan red B, Sudan red G, Sudan black, para red, rhodamine B, butter yellow, orange II, toluidene red.

In response to this issue the EU has helped implement control mechanisms in many exporting countries.

## **Bioterrorism – a real threat to food supplies and public health by Vijay Sardana**

In one attack, a radical group released Mediterranean fruit flies in California. The fly attacks more than 250 varieties of fruits, nuts and vegetables. A similar attack with a corn or soybean pest could devastate South Dakota's agriculture industry.

According to the US Centers for Disease Control and Prevention (CDC), a bioterrorism attack is the deliberate release of viruses, bacteria, or other germs (agents) used to cause illness or death in people, animals, or plants. These agents are typically found in nature, but it is possible that they could be changed to increase their ability to cause disease, make them resistant to current medicines, or to increase their ability to be spread into the environment. Biological agents can be spread through the air, through water, or in food. Terrorists may use biological agents because they can be extremely difficult to detect and do not cause illness for several hours to several days. Some bioterrorism agents, like the smallpox virus, can be spread from person to person and some, like anthrax, cannot.

### **Are we taking bioterrorism threat lightly?**

There are interesting developments in the trade negotiations in various parts of the world. On one side we are negotiating to promote a free trade regime to promote trade for prosperity around the world and on the other side we are not willing to discuss problems of productivity, disease outbreaks and issues of concerns to public safety with the same enthusiasm. Every argument in world trade is based on long-term benefit of trade to the stakeholders in future but there is no solution to how to handle immediate food safety concerns and biosecurity issues and their devastating implications on people's lives. In the name of capacity building only lectures are offered, very rarely tangible goods like technologies, systems, equipments are distributed around the world to stop the flow of unsafe foods.

### **Trade interests and threatening food supplies security**

Let me give some examples. In the last few years, the suicides by thousands of farmers (regarding the consumption of pesticides) have gone up in various parts

of India due to financial distress. These were headlines a few months ago but now it has become a routine matter for administration and for the media as well. The lives of farmers and their family members and the act of committing suicide is of no news value anymore, either for media or for policymakers. It is described as a problem of administration. Many NGOs are blaming this on badly developed genetically modified seeds, wrong chemical formulations to control disease outbreaks, etc. If this is the state of affairs in a so-called protected economy, how is the free trade environment going to bring relief to these farmers, where survival of the fittest is the rule, similar to the law of the jungle? Who is going to protect the livelihoods of the vulnerable people? Suppose somebody deliberately supplies the wrong seeds and the wrong crop protection chemicals? Authorities will take it as a routine case of adulteration or spurious seeds, and terrorists will deliberately destroy the food security of the nations. There is no solution, only assumptions, hope and hypothesis are provided. In this free market scenario, and there is a demand to limit the role of government interventions in trade, is it difficult to introduce genetically modified plants or any biological agent in the name of biopesticide or biofertiliser by a well-planned act of bioterrorism? Who is controlling the quality and product integrity in the agriculture input sectors. The spread of unwanted weeds and new infections from imported fresh fruits and vegetables is now a common issue in food systems.

## Biosecurity in food production is not an agenda for domestic supplies

The damage to crops due to disease is considered as a normal activity in agriculture. The cause and frequency are generally not evaluated by anyone in the system and there is no concern even if there is a sudden disease outbreak in the agriculture production system, unless it has trade implications like bird flu. No one is willing to discuss the disease outbreak in any crop which is not of trade significance. It means quality in trade is more important than the quality of food for daily requirements for our own citizens. That is why there are extensive plans to control quality and safety of food produced for exports but the same enthusiasm is not visible for domestic supplies.

What is more worrying is that the policymakers, those who are not aware of the biosecurity risks and implications, are deciding the fate and future of biosecurity systems. The budget allocation for the biosecurity is considered a wasteful expenditure, that is the quarantine stations and quality control laboratories are poorly managed, understaffed and rarely upgraded to meet the emerging challenges.

## Short-sighted trade diplomacy will spread the biosecurity threat

The recent outbreaks of bird flu and mad cow disease have clearly indicated that hazards don't respect borders. There is a global campaign to protect countries

from these outbreaks. Interestingly, many developed countries are developing series of tests and procedures to control the quality of food entering into their territories from other countries, but when it comes to trade they force other governments to reduce the quality and food safety standards so that they can supply inferior products to other markets. All sorts of diplomatic, trade and political tools and techniques are used to gain market access by diluting the food safety systems developed by nations.

## Consumers Ignorance is the Incentive for bioterrorism acts

On the other hand, very often consumers complain about feeling unwell after consumption of certain types of foods from certain locations, but they take this lightly and either go for home remedies, or OTC (over-the-counter) drugs to suppress the symptoms. There is hardly any attempt by the consumers and medical administration to conduct systematic investigations and coordinate the details with other agencies to develop a pattern.

Based on above examples, sometimes it raises doubts as to whether we are really serious about the welfare of people by ensuring safe food.

## Incentives for the promoters of bioterrorism

In last few years, we've had serious outbreaks of computer viruses worldwide. Billions of dollars and a huge quantity of very vital data and analyses were wiped out because of these virus attacks. Who were the creators of these computer viruses and who benefited from these attacks? One IT professional commented that today computer network security is now a well-developed industry and no one can rule out the possibility that the solution providers may have encouraged the problem creators. Do you really need government permission or a licence to produce a computer virus? In fact it costs nothing more than a PC, which will not cost more than US\$500.

A few weeks back in one seminar where issues related to bird flu were discussed, suddenly someone asked who will benefit the most from the bird flu scare; the answer was the company that makes the vaccine. Someone else commented, let us have a look at who the board of directors of this company are, other biotechnology-related activities of the company and let us also monitor the company's share price.

## Bioterrorism is a good business model

In fact, food safety and bioterrorism risks are now part of an 'investor's idea' of how to make good money with least investment. It means that food safety and bioterrorism can be profitable ventures, but where is the market. It also means someone will work hard to create a market. Should we expect some bioterrorism attack in the near future?



Historically, there have been at least five acts of agroterrorism in the United States and 17 worldwide. In one attack, a radical group released Mediterranean fruit flies in California. The Medfly attacks more than 250 varieties of fruits, nuts and vegetables. A similar attack with a corn or soybean pest could devastate South Dakota's agriculture industry.

## Agroterrorism the immediate bioterrorism threat

Let us take a case of agroterrorism; it is one of the dimensions of bioterrorism. Agroterrorism is 'the malicious use of plant or animal pathogens to cause devastating disease in the agricultural sector. It may also take the form of hoaxes and threats intended to create public fear of such events.'

From a BBC article on the subject: when Tommy Thompson stood down as US Health Secretary in 2004, he delivered a stark warning. 'I, for the life of me, cannot understand why the terrorists have not attacked our food supply, because it is so easy to do', he said.

In the same article, Larry Wein from Stanford University describes the scenario of poisoning a milk tanker with 10 grams of botulinum toxin, concluding: 'If we didn't realise what was happening, half a million people would drink this milk ... most of these would be poisoned, roughly half of them would die.'

A terrorist attack on the food chain on that scale has never happened. The purported ease with which such an attack could be executed is controversial.

The experience in India also indicates that unchecked imports of wheat during the food crisis of 1970 also introduced many weeds which were not present in India. This has impacted not only the growth rate of agriculture but also the cost of production has gone up.

What is more tragic is that when the India government issued tenders to import wheat to meet the shortfall, all the supplying countries, including developed countries, started lobbying the India government to reduce the quarantine standards so that they can participate in tenders.

## Lessons from modern bioterrorist incidents

According to the information available from various sources, in 1984 followers of the Bhagwan Shree Rajneesh attempted to control a local election by infecting salad bars in 10 restaurants with *Salmonella typhimurium* in the city of The Dalles, Oregon. The attack caused about 751 people to fall ill (no fatalities). This incident was the first known bioterrorist attack in the United States in the 20th century.

The 2001 anthrax attack was instrumental in focusing on a broad-based bioterrorism threat. In September and October of 2001, several cases of anthrax broke out in the United States, caused deliberately. This was a well-publicised act of bioterrorism. It motivated efforts to define the scope of biodefence and biosecurity, where more limited definitions of biosafety had focused on unintentional or accidental impacts of agricultural and medical technologies.

## Ricin attack incidents

There is the possibility of using naturally produced toxins to damage human, plant or animal life, like incidents that occurred in 2003. Use of castor seed extracts for poisoning is well documented by various agencies in various parts of the world.

## Limitations of bioterrorism

Bioterrorism is inherently limited as a warfare tactic because of the uncontrollable nature of the agent involved. A biological weapon is useful to a terrorist group mainly as a method of creating mass panic and disruption to a society.

## How to prevent the act of bioterrorism?

There is no option but to follow precautions. Precautions can be introduced through awareness, education and regulatory changes. Unfortunately as a society, we are not aware of the implications of innovations in this serious matter. After long debate, we have started educating people about AIDS and how to stop its spread. On similar lines, we must educate people about the emerging threat of bioterrorism. Public awareness and education are the key to preventing biosecurity disasters.

On the other hand, the existing agriculture regulations and food regulations need to be revisited. Uncontrolled genetic engineering can be as disastrous as uncontrolled nuclear technology. The only difference will be the seen at which we can notice the disaster and its implications. We have seen the implication of nuclear disaster in Second World War that is why we are concerned. We have seen the Sept. 11 accident due to act of terrorism, which is why there is global movement against terrorism. We have seen natural disasters and disasters due to industrial accidents like Bhopal gas leak, etc., which is why there is concern about them. But we have not experienced the disaster due to bioterrorism that is why we are taking it lightly, are we waiting for disaster to happen.

## Options before us

Let us learn from past mistakes and focus our energy in prevention, because in the case of bioterrorism it will be very difficult to control the disaster because there may be self-generating and multiplying agents like insects, pathogens, viruses, etc.

## *Develop a forewarning and countering system*

Planning may involve the development of biological identification systems.

Most biological defence strategies have been geared to protecting soldiers on the battlefield rather than ordinary people in cities. During Iraq it was quite

visible, the way the US army was planning to counter biological warfare. The tragedy is that financial cutbacks by policymakers have limited the ability of the institutions to develop the tracking systems for disease outbreaks. Finance ministers may be thinking that outbreaks will generate more tax revenues from the sale of medicines, equipment and related services so why spend on prevention. Some outbreaks, such as food poisoning due to *E. coli* or Salmonella, could be of either natural or deliberate origin. Generally, governments will say it was natural to prevent embarrassment.

In Europe, disease surveillance is being organised on a continent-wide scale and is needed to track a biological emergency. The system not only monitors infected persons, but attempts to discern the origin of the outbreak. Precautionary principle is one such approach towards GMOs and food safety issues.

Researchers are developing devices to detect the existence of a biological threat:

- Tiny electronic chips that would contain living nerve cells to warn of the presence of bacterial toxins (identification of a broad range of toxins);
- Fibre-optic tubes lined with antibodies coupled to light-emitting molecules (identification of specific pathogens, such as anthrax, botulinum, ricin); and
- Plants as sensors to create genetically modified plants as an easily producible early warning system. The plants would be modified to change colour when in contact with a predetermined chemical or biological agent, and would be distributed in public places to provide a monitoring grid capable of detecting the spread of a contaminant.

Contingency plans for rapid action to a bioterrorist attack include:

- Setting up local emergency rooms and offices to immediately deal with the outcome in case of an attack by competent people;
- Performing mass decontamination on victims or potential victims (persons suspected of harbouring contamination that they might knowingly or unknowingly spread to others);
- Quarantine to prevent the spread of disease, or temporary quarantine for decontamination;
- Instruction and training for local communities;
- Protective clothing for military personnel; and
- Locating persons buying biological warfare materials.

## Emerging threats need innovative solutions

Once the biological agent has been identified, it can be fought through vaccination of people before they are exposed. However, vaccines are not considered to be a perfect solution. A bioterrorist could develop novel, possibly artificial, pathogens against which conventional vaccines would be useless.

Consequently, some suggest that researchers should look for ways of developing vaccines quickly enough for them to be created, mass produced and distributed after an attack. This would require significant progress in DNA

sequencing so that an unknown pathogen's genes could be decoded quickly. The resulting sequences could help in the development of a DNA vaccine.

Another major issue with vaccines is that they sometimes have dangerous side-effects, and hence a massive inoculation programme may result in deaths and illness which would be unnecessary if no biological attack occurs. This concern has been raised with modern anthrax vaccines. The 1976 swine flu scare highlights the dangers of the mass-vaccination approach. The same issue is debated to counter bird flu.

A conventional approach will not work; as a society we have no major experience about bioterrorism so let us not assume that government and related agencies will be in a position to manage. The war against bioterrorism will require an unconventional approach and will need citizens' cooperation. Are we ready? Do we have systems in place? Or will we decide when we are faced with a crisis? Think of AIDS. Prevention is better than cure, definitely in the case of bioterrorism.

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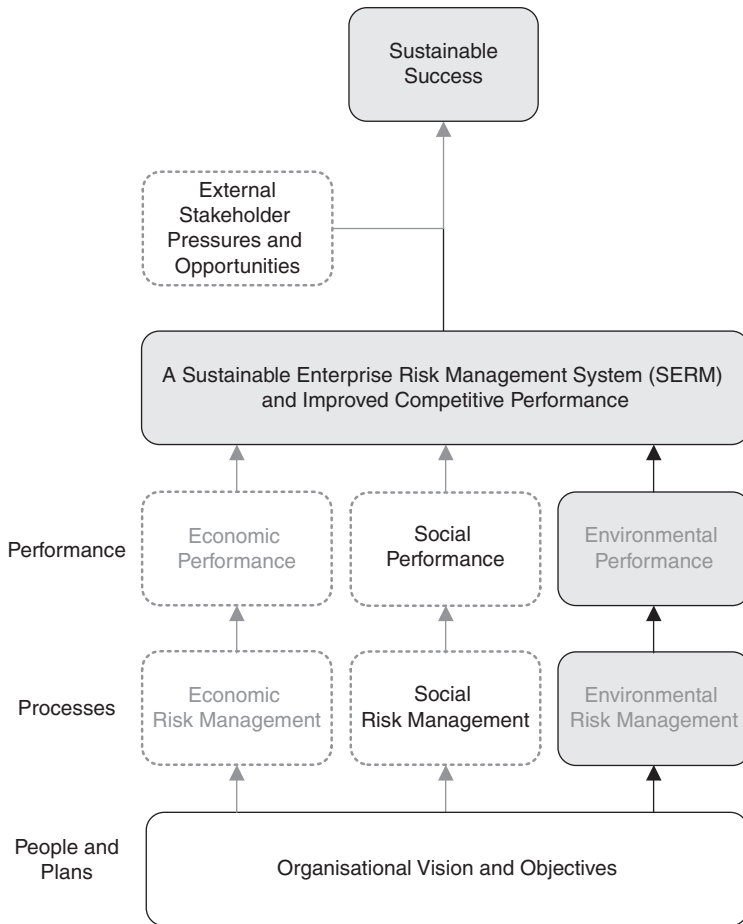
# PART D

## Overview of the Environmental Aspects of Business Risk

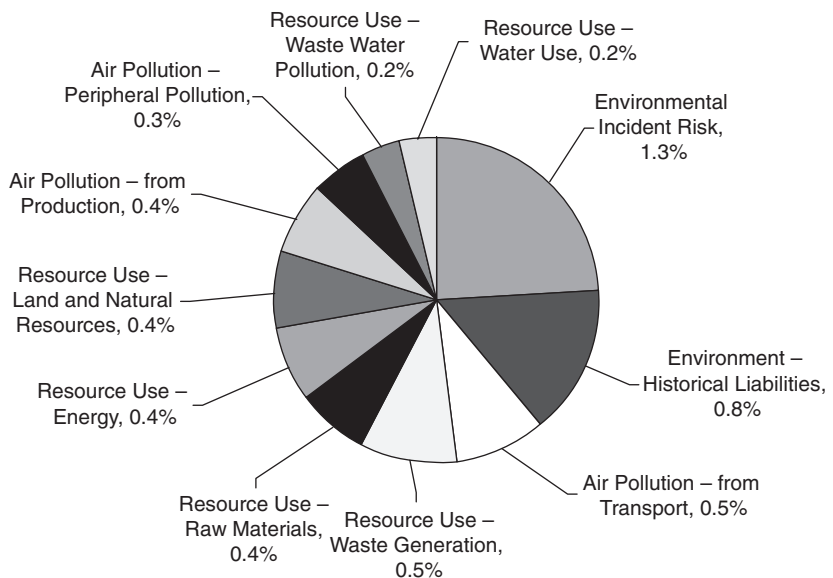
The term 'sustainability' often means a paradigm shift towards a greater understanding of things in relation to natural processes, which are more durable in their efficient use of resources and inputs and outputs from systems. There is a review of how to reduce the 5.4% average risk to organisations from these issues.

We cover the key environmental aspects of risk which include:

- Environmental risk management systems (Chapter 18); and
- Aspects of environmental risk (Chapter 19):
  - Environmental incidents and accidents;
  - Air emissions from production and transport;
  - Resource use and waste emissions; and
  - Water use and pollution.



The net risk to market value from these issues is outlined in the pie chart below.





18

Environmental risk management



# 18

## Environmental risk management

### CHAPTER OVERVIEW

This chapter considers the background surrounding the legal framework and trends that can be identified around environmental risk management and operational risks. Chapter 19 looks at the environmental risks that emanates from the use of inputs and the consequences of outputs from organisations' processes and the risks and legislation covering these.

Almost everything that any organisation does has an impact upon the environment – from energy use to disposal of waste, from compliance with discharge consents to the management of its transport fleet. The resulting figure is the total potential financial loss the company could suffer if the environmental risk was to materialise is 5.1% of the average market value of the 500 top EU and US companies.

The most appropriate response to environmental risks is to integrate some form of environmental risk management into an organisation's risk management system. Evidence suggests that such an approach can improve profitability. This is achieved by resource efficiency, production cost savings and the avoidance of litigation. Additionally, the opportunities are large; as well competitive advantage can be achieved by the development of less environmentally damaging products and processes. Increasingly, business leaders are realising the benefits of having an environmentally positive reputation in the public and political arenas.

## Environmental due diligence and risk management

International, regional and national environmental laws and regulations assign financial responsibility to real estate owners, operators and others for clean-up costs associated with contaminated soil, water and other pollutant discharges. In addition to regulations and legal actions, public perception has become a powerful motivator for property owners and managers to fully understand and manage their liabilities associated with environmental contaminants. Environmental due diligence and risk management are vital proactive steps for corporations wherever they are either side of the Atlantic.

Environmental risk management can help to achieve the avoidance of:

- Environmental and health incidents (or a reduction in the number of incidents and/or their impact);
- Non-compliance convictions, criminal prosecutions and enforcement notices;
- Enforcement actions for remedial work;
- Civil claims;
- Damage to reputation and brand;
- Increases in resource costs and insurance premiums; and
- Stakeholder pressure:
  - Increasing demands by business partners/customers for environmentally responsible suppliers;
  - Customers – maintaining the goodwill of brand value;
  - Employee pride and health and safety;
  - Strengthened bank lending criteria; and
  - Removal of cover and increasing premiums by insurers as losses mount (failures to comply with legislation can invalidate insurance cover).

## The new environmental environment

We are in an era of environmental reason where governments are also learning how to create incentives for companies to innovate and improve environmental performance, quality, and management. Innovation can reduce the use of power, natural resources and production materials. Businesses that take a hard look at their internal operations will notice opportunities for the development of effective environmental management systems. Those systems not only reduce liabilities and risks, because less pollution is produced, but they also increase profits because all resources are used more efficiently and effectively, making informed consumers more likely to buy the product or service even at higher per unit prices.

As the chief of Asda (the UK subsidiary of Wal-Mart), Andy Bond, says: ‘green is the new black’, as he states that he wants Asda to be Britain’s greenest grocer.

## Sustainable development

The well-known definition of sustainable development – coined by the Brundtland Commission in 1987 – has continued to command most widespread support (see also below). Sustainable development may also be defined as reducing pressure on natural resources and optimising the use of human resources. The term ‘double dividend’ has been coined to describe the dual benefit of sustained natural resources and higher employment.

The industry response of international environmental management has also been developing for over a decade. As was made clear at the 1992 Rio Conference or Earth Summit sustainable development is central to the issue of

international environmental management and has been embraced by many national policies in their reports on the state of the environment. Meanwhile the Business Charter for Sustainable Development had launched at the Second World Industry Conference on Environmental Management by the International Chamber of Commerce (ICC) in Rotterdam in 1991. The over-riding objective of the Charter was to encourage business to join the international effort to uphold the concept of sustainable development through sound environmental practice. Its aims were stated as:

- To provide guidance on environmental management to all types of business and enterprise around the world and to aid them in developing their own policies and programmes;
- To stimulate companies to commit to improved environmental performance; and
- To demonstrate to governments and electorates that business is taking its environmental responsibility seriously, thereby helping to reduce the pressure on governments to overlegislate and strengthening the business voice in debates on public policy.

Many members of the ICC and companies have seen the Charter as a major response to pressures for environmental codes of conduct. Meanwhile the ICC definition of environmental auditing has also played a key role in the spirit of ‘shared responsibility’ by the key players, government and industry.

## Corporate responsibility

It is imperative that every organisation, large or small, should focus on their individual role in the protection of the environment, irrespective of whether they are involved in a polluting industry or activity. In its 5th Environmental Action Programme ‘Towards Sustainability’, covering the period 1993–2000, the European Union (EU) targeted the role of industry in implementing the principle of ‘shared responsibility’ to achieve improved environmental protection and preservation. The European Commission has recognised that small and medium-sized enterprises (SMEs) must be equipped to participate fully in this initiative. Moreover, the EU’s Eco-Management and Audit Scheme (EMAS) exemplifies the need for a practical approach (see further below).

## Sustainability in business

In order to make business more profitable and benefit society as a whole, business organisations should aim to protect the environment by taking account of the highest standards in technology and good management practices. Management theories indicate that this is best achieved by a combination of formal and informal corporate measures including a comprehensive corporate policy on the environment and follow-up procedures such as environmental audits.

An enhanced awareness of the environmental aspects of running a business will entail reviewing procedures and processes not only to make them more environmentally sound but also to improve efficiency. Businesses across the spectrum have been surprised at the cost effectiveness of measures to reduce energy consumption and minimise waste generation. The use of low-energy technology, improved insulation, the plugging of leaks, recycling of materials and energy can all lead to significant savings.

## Transboundary issues

Transboundary issues play an important part in the context of the environment, risk and the corporation. Most of the global concerns have been laid at the responsibility of the industrialised world, thereby enhancing the importance of the debate over environment, risk and the corporation. While some have been more important regionally the global repercussions have raised awareness of the public and the need for pressure on business and government to take urgent steps.

The concept of ‘shared responsibility’ has been embraced by the EU since the 5th Environmental Action Programme of the EU Commission ‘Towards Sustainability’ which:

- Promoted the partnership of government and industry as a team working together; and
- Emphasised the way forward regionally and globally as the implementation of improved environmental standards through a mix of regulatory, voluntary and economic instruments.

This fact, along with the concern that there should be a level playing field in terms of international trade, has meant that there is an ongoing comparative exchange of information both by government and industry in relation to compulsory and voluntary standards. The principle of sustainable development as endorsed by the 5th Action Programme of the EU – and developed in the current 6th Programme – should be at the forefront of any corporate environmental policy. This principle recognises that world natural resources are either renewable or finite. Renewable resources should be managed in order to provide a continuous stream for ongoing productivity. Finite resources should be used only in the most productive and efficient ways in order to allow time for the development of alternative sources once existing resources have been depleted and/or for the development of comprehensive recycling schemes to renew these resources if practicable.

While the EU is working towards harmonisation within its borders, jurisdictional differences between member states do still exist and they maintain separate legal systems, some having imposed stricter standards than those enacted at EU level. The effectiveness of enforcement measures also varies widely. Looking further afield, there is an undoubted need to fulfil international environmental standards in order to compete globally in terms of trade, tenders and the market. Sustainable development requirements have pushed global business towards an enhanced proactive management approach.

Institutions in the WTO are also aware of the need for environmental understanding in the context of trade and competition. In addition the initiatives proposed in respect of emissions trading demonstrates the transboundary nature of this debate.

Finally the trends in favour of a common approach to environmental reporting also confirm the transboundary nature and interaction of the environment, trade and competition.

## Sustainability

The future growth and forward planning of any organisation requires crucial budgeting of available resources, the most important being financial and human resources. Management should consider projections in terms of a 'green budget' in their effort to support a credible environmental protection policy and to maintain a high marketing profile as well as to attract public support for ongoing activities. Management standards are an increasing feature of business life. ISO 14001 is now almost second nature and, beyond notions of quality, verifiable standards are being extended into new areas such as the environment under ISO 14001. In one sense the EU's Eco-Management and Audit Scheme has been another example of this trend, albeit with some novel aspects.

## Regulatory approaches

### UK background

The UK Environmental Protection Act 1990 (EPA) envisaged a comprehensive regulatory scheme of integrated pollution control, this principle having since been taken up as 'the way forward' by the EU. Historically, the EPA was influenced by the growing volume of EU legislation on the environment. Since the modifications to the original EEC Treaty (Treaty of Rome 1957) brought about by both the Single European Act (SEA) signed in 1986 and the Treaty on European Union 1991 (commonly known as the Maastricht Treaty), the institutions of the EU have an express mandate for the development of comprehensive environmental regulations with the support of all the member states, which has major ramifications for the operation of businesses. The Environment Act 1995 established a single Environment Agency in England and Wales and added a framework for dealing with contaminated land.

### The US connection

In developing its environmental legislation the EU has taken into account established environmental protection legislation and policy in the US. Liability for the clean-up costs of such sites may fall not only on the owner/operator, but also on companies who transported any waste to the site, previous owners of the site, companies whose waste was dumped on the site at any time and even lenders to those companies. The longstanding debate on environmental liability in Europe

(the Commission published a Green Paper on the subject in March 1993) also involves a stricter enforcement regime.

## Developing world perspective

Many third world countries have sophisticated environmental legislation on the books and when they commence effective implementation this will have a significant impact on any business operating within their territories. For instance, India has both environmental auditing and impact assessment regulations in place. In order to minimise any impact it is important to be aware not only of existing regulations but also of forthcoming regulatory developments and their enforcement.

Therefore from an international point of view the ideas behind an organisation's environmental policy are vital. At the very least the aim must be to comply with minimum standards. Ideally the standards maintained should be the strictest possible, bearing in mind the cost/benefit ratio. For international companies, a single policy encompassing all the varying requirements found in the jurisdictions in which they operate is an ambitious and potentially expensive endeavour, although the Bhopal incident in 1984 demonstrated that if high standards of management are not maintained, the consequences can be devastating. That particular incident led to American businesses being forced to maintain uniformly strict standards wherever they carry out their operations, irrespective of local regulations. Where financial constraints do not allow such an approach, a single minimum standard to be applied, with stricter standards for those jurisdictions which have enacted such standards, is a viable option for the effective management of an organisation's environmental pollution control efforts. This is true both of the developed and developing world. But by accepting higher standards before they become compulsory, it may be possible to gain market advantage.

## Current trends

The current trend is for increasing implementation of environmental legislation with stronger enforcement and tougher penalty provisions, including criminal fines imposed on those having control of the polluting operation. By way of example, the EPA 1990 strengthened the criminal penalty provisions within the UK and gave sweeping powers to the Secretary of State for the Environment to enact comprehensive regulations for the control of everything from air and water pollution through to litter. The recent re-enactments by the US Congress of the Clean Water Act, the Clean Air Act and the enactment of SARA in 1986 have tightened US federal laws, at the same time imposing stiffer criminal and civil penalties. Developments in Third World and Eastern European countries are being closely monitored by international organisations, including the UN. The imposition of penalties for environmental crimes moves by *inter alia* the EU to impose strict liability on companies causing environmental damage, and international monitoring of environmental protection efforts, should all be borne in mind when developing corporate environmental policy.

Further examples are provided in Chapter 3 of the trends and drivers affecting these sustainability issues.

## Being proactive: the advantages

One of the main reasons legislative developments need to be anticipated is the necessity to budget for capital items such as new plant and process equipment. It is particularly important to keep abreast of international initiatives, such as the famous example of the phasing out of the use of CFCs, which eventually have repercussions at regional and local level, in order for the business to remain competitive by anticipating new measures and acting upon them. Climate change is another vital issue that is engaging representatives of both the public and private sectors.

A well thought out public relations approach to increase awareness of a company's green credentials is invaluable. For some time we have witnessed the impact of organisations such as B&Q which have effectively dictated environmental management standards to would-be suppliers and, in some cases, have actually sought to assist smaller organisations in their supply chain to meet those standards.

## Value supply chain

Greenness often equals quality in the eyes of consumers, but consumer interest in the environmental performance of a business is no longer limited to those living in the immediate area of the company's activities. Moreover the debate has broadened to matters of corporate social responsibility, corporate governance and best practice. Many companies now publish details of their environmental policy in their annual report. The European Union believes that all sectors of society must be made to feel a sense of shared responsibility for the environment, and the drive to increase public access to environmental information is seen as fundamental in this context. The EU's 'eco-labelling' scheme had a similar thrust. In the UK the Department of Trade and Industry has recommended a 'cradle to grave approach' in relation to product stewardship, i.e. that the supplier of a product which has the potential for contaminating a site or causing pollution should take responsibility for it by developing environmentally sound practices covering the use of that product even when no longer within the supplier's control (e.g. when the product is being transported, used by the consumer or when it is sent for disposal). Recent examples of the implications of the WEEE and RHOS legislation demonstrate that these issues are of continuing importance for a corporation and relevance to their risk management policies.

## Stakeholder dialogue

Wherever a corporation operates and is implementing a risk management strategy communication is vital – workers, shareholders, the local community, green action groups and the press should be kept informed of how perceived

environmental problems are being managed and solved and, if possible, given a role in helping find solutions.

## Environmental risks and trends

Environmental risks can have significant impacts upon an organisation and the costs of production of goods and services. This has been assessed as 5.1% of the market value of the 350 largest EU and US companies (source: SERM). This risk to organisational value increases depending on the amount of legislation, volume of litigation and price of raw materials. There is also an increase in the level of stringency in environmental regulations at governmental and intergovernmental levels, as institutions like the EU make organisations (governments and companies) and their officers (ministers and directors) more accountable for their damage to the environment and people's health. These regulations will translate into increased levels of non-compliance fines and even personal liability for directors.

In brief, the risks include pollution incidents and emissions to air, water and land, as well as waste and hazardous substances like chemicals and asbestos. The level of environmental risk inherent within a company is dependent upon a range of issues, such as their sector of industrial activity and specific operational sites, or the countries they operate in. For example, exposure to litigation is much higher in the United States than in the EU, exposure to poor labour standards is generally higher in Asia and the water risk profile is higher if companies have operations in water-stressed countries.

The main types of risk reviewed here are liabilities, operational risks, financial penalties and enforcement costs, the increases in the cost of resources and the stakeholder perceptions of the company (see also Chapter 9).

## Financial risks

One method of accessing risk focuses on material or financial threats to an organisation's value. The risk assessment methodology measures a company's exposure to fines; penalties; increased expenditure on pollution abatement, compliance, clean-up and prevention measures; legal costs, increased resource costs and staff time. These factors can be combined with a weighting for their sector of activity, and their risk management activities. The resulting figure is the total potential financial loss the company could suffer if the environmental risk was to materialise. The average risk at stake is 5.1% of the market value of the 500 top EU and US companies, 2.2% of this is due to direct risk, whereas 2.9% is due to indirect risk.

Business managers may not be aware of the level of potential losses that could result from environmental risks, especially as many of these do not form a part of the standard risk management practice. The management responsibility for these issues is often delegated to operational managers and receives little strategic attention. There also has been a big rise in the number of directors fined for pollution incidents, according to Environment Agency (EA) figures.



In a recent survey by KPMG LLP results indicated a widespread lack of risk assessment and management. Forty-two per cent of Europe's largest companies (involved in mergers and acquisitions) said that unforeseen environmental, social and health and safety issues had led to higher operating costs; and that 21% of these companies had experienced direct financial liabilities.

Regulatory enforcement notices can mean a requirement to improve equipment and processes leading to production time being lost in the handover. For example, a large oil company received a £1 million health and safety fine, but lost the equivalent of £30 million due to having to stop production and replace the items stipulated in their enforcement notice. The 'Polluter Pays Principle' (see the box below) will come into greater prominence as companies are fined a percentage of their turnover.

Environmental costs are being incurred indirectly in the form of insurance costs due to general and specific environmental risks. A recent example has been the flood losses, which are estimated (by Screentrade) as having cost £700 million during the floods of 2001–02. The AA says that premiums across the entire home insurance industry have risen 1.5%. This situation will affect businesses as cover is being withdrawn in flood prone areas. New insurance products are being designed to cover environmental liabilities and insurance premiums are increasing. Large loss experience levels have increased sensitivity to these risk issues, for example recent estimates of a repeat of the *Exxon Valdez* spill have been placed at double the original loss of \$2.8 billion.

#### *Example 1: financial penalties*

In the UK the Environment Agency produces an annual review of business environmental performance called the 'Spotlight' report. This report looks at environmental performance on a sector-by-sector basis and highlights the key prosecutions that have occurred within those business sectors in the past year. The most recent Spotlight review (for 2004) provides statistical evidence showing that the courts are imposing more fines of a higher value on companies who are found to be in breach of environmental law. For example, in 2004, 233 limited or public limited companies and 13 directors were fined a total of £2.3 million for environmental offences. However, the average fine of £8524 was £546 less than it was in 2003.

Although the average level of fines in the UK is low the long-term trend is for a large increase to parity with the level of fines in the US. It is possible to get an idea of what the future may hold for organisations in the UK which fall foul of environmental law. A New York company that spilled thousands of gallons of oil off the Massachusetts coast will have to pay a \$10 million fine alone, and a large US retailer agreed to pay \$3.1 million in order to settle charges of excessive storm water runoff at its store construction sites, in violation of the US Clean Water Act (1972, with amendments in 1977 and 1987) (*Environmental News Service*, 14 May 2004). Both of these incidents are equal to or greater than the entire total for all UK fines.

It is arguable that the biggest impact is not directly financial but indirectly via negative publicity as the EA Spotlight series is also used to ‘name and shame’ those organisations that have breached environmental law. Given the growing public interest in environmental matters, incidents of poor environmental performance are also widely reported in the popular media often using this document as the original source.

## Operational environmental risks

Operational environmental risks are explored in depth in Chapters 19 *et seq* below.

## Legal risks

A company exposes itself to environmental risks on a regular basis. From water and energy use to disposal of waste, compliance with discharge consents to the management of its transport fleet, almost everything that any organisation does can have an impact. There is a growing body of international and domestic legislation, which means companies must properly consider and deal with the environmental consequences of business decisions. The range of reasons includes:

- Compliance failure can lead to the criminal prosecution of both the company and its officers;
- The organisation may be subject to civil claims by third parties;
- The costs of enforcement notices and remedial actions if clean-up costs have to be borne by the offending organisation. This may entail disruption to the business as well as costs; and
- There may also be damage to an organisation’s reputation if there is a failing to properly manage environmental risk.

Operational activities give rise to legal obligations set by civil society and stakeholders. These include civil damages, criminal penalties, enforcement and prohibition notices, as well as other methods of ensuring compliance with environmental and health and safety laws.

## Implementation risks

There are risks with the implementation of environmentally sustainable programmes. These may include:

- Public relations backlash if projects don’t provide the estimated savings, or improvements. This can lead to allegations of ‘greenwashing’ the public;
- Employees may think that improved environmental performance may lead to efficiencies which will cost them their jobs;

- The criteria for measuring improvements may not capture the real benefits of the programmes;
- Improved performance may lead to managers fearing further pressures (both internally and externally) for further improvement; and
- The measurement of environmental impacts and organisation's performance are based on moving concepts of what is 'right'. Our understanding of our impacts changes rapidly and the difficulty is having an EMS that responds to 'real' risks while still appearing to adhere to prescribed or historical targets for reductions.

## Human health risks

Environmental risks and human health cannot be easily separated, but these issues are dealt with in more depth in Chapters 16 and 17.

## Stakeholder and reputational risks

A company has stakeholder value which is a combination of the variables of a particular company's stakeholders and other interested parties. This also includes brand and reputational values, elements of goodwill and takeover premiums. It helps companies attract capable staff and retain existing talent. The following stakeholder framework can be used for assessing the stakeholder perceptions of a particular company (full review in Chapter 9).

### *The SERM stakeholder template*

- \* Academic and research organisations;
- \* Business partners, suppliers and trade bodies;
- \* Customers and their representatives;
- \* Direct action groups and NGOs;
- \* Employees and their representatives;
- \* Financial institutions (banking, investor and insurance criteria);
- \* Governmental organisations;
- \* Local and regional governmental organisations;
- \* International governmental organisations;
- \* Journalists and media organisations;
- \* Key competitors; and
- \* Local communities.

A selection of the main stakeholders driving environmental legislation and risk mitigation practices is analysed below. Your organisation could complete a full stakeholder analysis though to view all potential indirect risks.

**Customers and business partners:** the purchasing power of individuals and companies increases the pressure on suppliers of products and services to improve their environmental performance. There is a continuing growth of

consumer environmental awareness and awareness of the impact that environmental problems can have. This can lead to brand and reputation damage.

Several large companies are making their supply chain ‘green’ by developing Supplier Management Systems (SMSs). These can involve excluding suppliers, reducing the number of suppliers, or introducing extensive performance criteria and evaluation processes for suppliers. Requirements for supplier declarations on sustainability which outline minimum expectations of behaviour on environmental, health, safety and labour issues are becoming increasingly common. The range of information and ‘green’ consumer labels is also increasing.

**Direct action groups, including NGOs:** it is primarily large companies that attract the negative attention of non-governmental organisations (NGOs) and the media. However, the UK has always been at the forefront of developments in environmental activism and legislation (e.g. the Clean Air Act 1956). It is the birthplace and home to some of the most active NGOs, such as Greenpeace, Friends of the Earth, Oxfam and Christian Aid.

On the other hand, NGOs can be sources of good news and recognition for award-winning businesses. In 2003, five of Europe’s six best reporters were UK-based and the Co-operative Bank was voted the world’s best reporter and most sustainable organisation.

**International organisations:** these are developing agreements on limiting pollution (e.g. Montreal Protocol to Eliminate Ozone-depleting Chemicals) and are becoming the main drivers of environmental legislation. The influence of the EU has been responsible for raising the profile of the environmental agenda and for environmentally focused directives like the Integrated Pollution Prevention and Control (IPPC) Directive 96/61/EC which facilitates Europe-wide comparisons of environmental performance of business operations.

An example of recent international agreement is the ratification in May 2004 by 50 countries of the 2001 Stockholm Convention on Persistent Organic Pollutants. This makes illegal the use of a range of pesticides, dioxins and polychlorinated biphenyls. This trend of banning substances will increase as the ‘Precautionary Principle’ is adopted.

#### *The ‘Precautionary Principle’*

One of the main developments from international analysis of environmental risk is the ‘Precautionary Principle’. This principle has been a driving force in how the EU views environmental risk since 1993, allowing preventive action on issues if analysis of the best scientific evidence suggests preventive action. It perceives issues based upon a risk assessment approach. The primary idea is to avoid the use of known damaging agents, like heavy metals and endocrine disruptors (gender altering compounds). Key elements include the analysis of:

- \* Perceived risk level, and whether this is of a significant nature;
- \* Scientific assessment of this risk;

- \* Potential future impacts and mitigating factors;
- \* Potential measures for mitigating the risk; and
- \* Positive and negative implications of these countermeasures.

Dr Roberto Bertollini of the World Health Organisation (WHO) said: ‘I believe that what we do know now must guide us in our review and approval processes, and should become the basis of a bold new precautionary approach that puts the burden of evidence on safety first.’

This principle is beginning to be applied to environmental issues as the EU begins to restrict some of the 130 000 manmade chemicals on a human health basis. For example, recent research indicates that various pesticides increase the risk of Parkinson’s disease. More research indicates that the risk is even higher in patients with a certain gene variant. This trend will continue and bring substantial improvements in the ability of environmental and health enforcement agencies to prosecute on the basis of this new scientific evidence.

**Financial institutions:** the financial community is becoming more engaged in the environmental risk issues as discussed in more depth in Chapter 9. With regards to environmental issues there are particular developments.

Banks are tightening their lending criteria as larger loans and projects have to undergo environmental impact assessments. There are new voluntary codes of practice being developed which ensure that banks do not lend to environmentally damaging projects, the first of these, the ‘Equator Principles’, have been signed by the majority of the big UK banks.

Shareholder investor groups are becoming more active in their requests for action from companies on an increasing range of issues. In the US and the UK there are groups like the Carbon Disclosure Group who control over \$1 trillion in assets and are pushing for large companies to report on, and manage, their CO<sub>2</sub> emissions. In the US there are AIDS and race equality action groups. In the UK corporate governance activist investors are increasing their demands on larger companies, which are filtering down through their supply chains.

Insurers (who are also shareholder activists) are increasing premiums for policies which include health and environmental liabilities. They are also altering policies so that some items are not covered (flooding, asbestos and the like) as these issues surface as substantial material risks to their margins.

**Governmental organisations:** national and local institutions have an impact upon the development, and enforcement, of the regulatory framework. A variety of government departments and agencies are responsible for the establishment of standards seeking to reduce the level of harmful substances entering the environment and harming the public; imposing penalties; persecuting offenders; issuing enforcement notices; and taxing, subsidising and planning restrictions. The present government’s approach to many environmental issues

are to use market mechanisms as a corrective force. This has led to a range of environmental taxation and subsidies, which include:

- Aggregates tax;
- Climate change levies, and renewable energy grants;
- Company car and business vehicles taxation, especially used for private use;
- Landfill taxation; and
- Utility bill increases (sanctioned by government regulators) to pay for environmental remediation. For example, water companies will be allowed to raise customer charges to invest in improving their environmental performance.

As a result of numerous European directives, the UK government is increasing the level of regulation and enforcement. The Environment Agency has reiterated the importance of appropriate penalties to deter avoidable pollution and steer companies and businesses towards optimum environmental management. Spokesperson Kathryn Corcoran said:

Companies often look for the cheapest way out. To deter environmental damage it must be clear that the price of environment pollution is a lot higher than the price of environment protection. (April 2001)

In effect the government will move towards the ‘Polluter Pays Principle’ as they seek the dual benefits of increased government revenue and protection of the environment.

*The ‘Polluter Pays Principle’*

This has been incorporated in the UK’s Environment Act 1995 and initially in the Environmental Protection Act 1990. Within Europe the principle has been embedded within decision-making processes but was formalised with the Treaty of Amsterdam 1997. There is a growing tendency to incorporate the principle into legislation along with market mechanisms. This is evident from developments in the carbon taxation and waste disposal fields. The principle in its rawest form is that organisations that pollute will only be encouraged to desist by being charged a percentage of their profits/turnover as opposed to a minimum fine. Therefore, the larger the company the larger the fine, and this will become more apparent as regulatory enforcement agencies revert to fining organisations based on their ability to pay.

There will be increased environmental responsibility for the largest companies in the UK. The *Company Law Review* last stated that company directors:

must recognise, where relevant, the importance of relations with employees, suppliers, customers and others, the need to maintain a reputation for high standards of business conduct and impact of their actions on the community and environment.

**International governmental organisations:** there are numerous international laws governing legislation of the environment.

The UN Global Compact has also been launched at the World Economic Forum in Davos in 2000 and covers principles for corporate practices in three policy areas, one of which covers environmental measures. Organisations should:

- Principle 7: support the ‘precautionary principle’ to environmental issues as noted above;
- Principle 8: undertake initiatives and programmes to promote responsible environmental behaviour;
- Principle 9: encourage the development and distribution of environmentally friendly technologies.

There is a large body of legislation that covers the environment and a sample is indicated below:

*On air pollution*

- 1979 Convention on Long Range Transboundary Air Pollution;
- 1985 Helsinki Protocol on Reduction of Sulphur Emissions;
- 1985 Vienna Convention for the Protection of the Ozone Layer;
- 1987 Montreal Protocol and 1990 amendments;
- 1988 Sofia Protocol on Nitrogen Oxides;
- 1991 Geneva Protocol on Volatile Organic Compounds;
- 1992 Framework Convention Climate Change;
- 1994 Oslo Protocol on Further Reduction of Sulphur Emissions;
- 1997 Kyoto Protocol;
- 1998 Aarhus Protocol on Persistent Organic Pollutants (POPs) and 1998 Aarhus Protocol on Heavy Metals;
- 1999 Gothenburg Protocol to Abate Acidification, Eutrophication and Ground Level Ozone;
- Convention, Kyoto Protocol.

*Biodiversity and nature conservation*

- 1971 Ramsar Convention on Wetlands;
- 1973 Convention on International Trade in Endangered Species (CITES);
- 1979 Berne Convention on the Conservation of European Wildlife and Natural Habitats;
- 1979 Bonn Convention on Migratory Species of Wild Animals;
- 1992 Convention on Biological Diversity;
- 2000 Cartagena Biosafety Protocol.

*On water pollution*

- 1973 ‘MARPOL’ Convention on Pollution from Shipping;
- 1982 UN Convention on the Law of the Sea;
- 1989 Basle Transboundary Waste Convention on Waste Shipments;
- 1992 ‘OSPAR’ Marine Council Convention on Regional Seas.

Procedural conventions also exist that try to standardise general frameworks for national and international laws. There are conventions on: environmental assessments, the rights of civil society, environmental liabilities and environmental criminal liability.

*European Community (EC) law*

Framework Directive 1996/62 on ambient air quality assessment and management

Directive 1996/61/EC on IPPC

Directive 1999/13/EC on volatile organic compounds

Directive 2000/76/EC on the incineration of waste

Directive 2001/80/EC on large combustion plants

Directive 2001/81/EC on national emissions ceilings

## Indirect environmental risks

The consequences of our actions are vast and as yet the risks are largely unknown. There are also indirect risks (explored in Chapter 19) which are going to increase exponentially as a result of the following.

- Increased human use of resources through consumption per person and population growth;
- Other species decreasing in number or becoming extinct;
- Environmental changes and an increasingly chaotic climate;
- Land use degradation from deforestation, desertification;
- The unequal distribution of the remaining resources, especially water; and
- Organisations' direct and indirect impact upon:
  - Air (leading to climate change and damage to the ozone layer);
  - Land (habitat loss, waste disposal and pollution affecting all species' health and DNA); and
  - Water (marine life mutations have increased, breeding cycles have been effected and there are high levels of metal poisoning of fish being recorded).

For example, it is estimated that 5500 children die each day from diseases linked to polluted food, air and water (WHO quoted in *State of the World*, 2003).

## Risk management best practice

Internal compliance and management procedures have become the hot business topic of the early 21st century. However, some of the most embarrassing damage done to organisations on the public relations front is from suppliers and other stakeholders, and this is true of environmental risk.

## Rewards vs risk

Without taking risks there will be no progress in human society and especially commerce. The idea is to minimise the consequences of our actions and maximise the rewards. Examples of business opportunity maximisation, while potentially reducing risks, include the following:

- A US study of experts from the Toxics Use Reduction Institute (TURI) at the University of Massachusetts Lowell has found toxic chemicals are more



expensive than switching to safer alternatives. They identified safer, cheaper alternatives to five heavily used hazardous chemicals widely used in the drycleaning, wire and cable, metal finishing, healthcare, cosmetology and other industries. The ‘Five chemicals alternatives assessment study’, commissioned by the state authorities, investigated whether fewer toxic alternatives were available for lead, formaldehyde, perchloroethylene, hexavalent chromium, and di(2-ethylhexyl)phthalate (DEHP) and the results that the alternatives were cheaper came as a surprise (quoted from *Risks*, issue number 265, 15 July 2006);

- The use of solar energy and wind power which has grown by more than 30% annually over the past five years (compared to 1–2% annual growth for fossil fuels) in countries such as Germany, Japan and Spain thanks to policies which have encouraged their use; and
- The 100% brownfield housing development by McCarthy. But these in turn open up additional risks. When redeveloping a ‘brownfield’ site Persimmon Homes uncovered a toxic mound in Dilton Marsh. The site had been a landfill site for the disposal of surplus military explosive devices in the 1970s. Persimmon Homes planned to make this safe but there was an increased risk to the local community, who feared the work could put their health at risk.

## Environmental management systems

Due to the variety of its subject matter and the volume of environmental legislation, it is important that a company adopts a structured approach to the management of its environmental risk. Both the Environment Agency and the Scottish Environmental Protection Agency (SEPA) recommend that this structured approach should take the form of an Environmental Management System (EMS). An EMS will normally be a written document, and is generally described as the method by which a company identifies:

- All of its potential environmental liabilities;
- The effect that those liabilities will have upon the company’s business; and
- The means by which a company may effectively manage those liabilities.

A good EMS should therefore improve a company’s environmental, and thus potentially its social and financial performance by focusing on both best practice and regulatory compliance. It should also help a company anticipate and cope with any changes in existing legislation.

It should always be remembered that ultimately an EMS would only be of use if the company:

- Complies with it; and
- Ensures that it is kept up to date.

An EMS should therefore not be seen as an immobile policy document. Instead it is a living set of ideals and guidelines which will grow and develop as the

company itself evolves. Although the government have encouraged companies to adopt an EMS in one form or another, the debate over their true value continues.

## *The advantages*

The Environment Agency, Scottish Environment Protection Agency (SEPA), the Department for Environment, Food and Rural Affairs, the Department for Trade and Industry, the National Assembly of Wales and the Scottish Executive, together with the FTSE4Good and the Dow Jones Sustainability Group Index, have all at one point or another contended that establishing a well-developed and well-maintained EMS will bring the following benefits for an organisation:

- The company will have a greater awareness of its legal liabilities under environmental law. This will in turn allow the company to identify and manage their environmental risks, thus allowing it to be proactive and prevent future compliance failure;
- As part of the EMS, the company will be required to review the efficiency of its resource use. This information can be used to pinpoint possible cost saving opportunities;
- Producing an EMS will give the company a greater appreciation of its interaction with, and impact upon, the environment. This will allow the company to formulate a ‘best practice’ strategy to allow it to raise its environmental standards; and
- The cumulative effect of the points above is that the public reputation of the company will improve in a number of ways. Primarily, the company will be able to differentiate itself from competitors who are not as ‘environmentally friendly’. This will help the company build trust with various parties, such as consumers, suppliers, government bodies (i.e. local planning authorities), neighbouring proprietors and its employees. The FTSE4Good and Dow Jones Sustainability Group Index also suggest that a company with a good reputation in environmental matters will find it easier to attract inward investment from stakeholders.

## *The disadvantages*

Regardless of what type of EMS a company decides to establish, it will be required to invest a certain amount of time and money into the endeavour, e.g. in collating data, establishing the relevant management systems, training of employees and publishing environmental reports. Thus far there is no empirical evidence to suggest that this expenditure is cost efficient as the link between adopting an EMS and either improved environmental performance or cost savings has not yet been established.

The disparity in the quality of the various certification bodies has also been criticised. The Environment Agency has hit out at the lack of uniform standards between the various EMS certification bodies. They believe this undermines the

entire process as too few certification bodies are concerned with actual legislative compliance.

The European Commission, in conjunction with the LIFE Environment Fund, the Environment Agency, SEPA, IEMA (Institute of Environmental Management and Assessment) and IEPA (Irish Environmental Protection Agency), have commissioned and financed a study that is designed to investigate the validity of the criticisms levelled at the adoption of an EMS. Beginning in autumn 2002, the Remas Project is a UK-based three-year study linking environmental performance and management in up to 500 industrial sites across Europe. The aim of the Remas Project is to establish whether EMS actually delivers identifiable benefits to regulators, organisations and the environment.

The Remas Project also aims to prepare a European-wide approach to EMS, and to this end a collaborative workshop was held in July 2003 with the Netherlands Environment Ministry EMAP programme to promote a harmonised approach to EMS. It is believed that the project will, in time, provide the hard evidence required to prove that the adoption and use of an EMS is beneficial to business.

## Types of EMS

The content of an EMS will be company specific. The first question that a company should ask itself is whether it wants an informal or formal EMS. An informal EMS will essentially be an internal set of policies and procedures by which that company will manage its environmental risks. The other option is to develop an EMS that will be formally certified or accredited by an external organisation. The most common type of external accreditation of EMS is given by the International Standards Organisation (ISO) and Eco-Management and Audit Systems (EMAS) (see below). As of January 2006, there were approximately 3700 EMAS registered companies in Europe, of which 76 are in the UK. At that time there were also approximately 103 583 ISO 14001 certified companies in Europe, of which 6223 were in the UK. For national figures go to: <http://www.ecology.or.jp/isoworld/english/analy14k.htm>

## *ISO standards*

The ISO series is an internationally recognised set of business standards produced by the International Standards Organisation. Guidance for the establishment of an EMS framework is given in ISO 14001 and adherence to this standard is, of course, voluntary. ISO 14001 attempts to monitor not only the environmental impact of a company's actions but also those of its products and services, although the emphasis is upon process, not performance.

ISO 14001 focuses upon compliance with legislation and the maintenance of 'best practice' within the company. In order to achieve these goals ISO 14001 encourages organisations constantly to review and improve their EMS while

also providing all necessary and relevant training to their staff. The five core principles of ISO 14001 are said to be:

- Policy;
- Planning;
- Implementation and operation;
- Checking and corrective action; and
- Review of activities.

It should be noted that ISO 14001 is only one part of the ISO environmental series. It can be used as a starting point for companies who want to incorporate other environmental management tools provided by other standards in the ISO environmental series. It is an increasingly popular standard as the number of ISO 14001 certified facilities reached 46 836 certifications by the end of December 2002. This is a 27% increase compared to 12 months earlier.

## *EMAS*

While the ISO series is a set of voluntary international standards, EMAS is a voluntary European standard introduced by Council Regulation 761/01. EMAS is similar to ISO 14001, as it requires participating organisations to identify the environmental impacts of their business activities and to formulate procedures by which the company's environmental standards can be improved. The relevant EMS must be documented and continually renewed and improved. Staff must also receive all necessary training to ensure compliance with the relevant EMS.

While EMAS and ISO 14001 share the above noted common features, there are several differences between the systems that must be recognised. For example, while it is the company as a whole that registers and complies with ISO 14001, under EMAS an organisation must register its individual sites.

The primary difference between the two systems is that in order to comply with EMAS, an organisation must produce an annual environmental report and make it publicly available. This environmental report should summarise the activities and compliance performance of the company on a site-by-site basis. Each statement must be validated by an accredited environmental organisation that is independent of the site auditor. In the UK, the United Kingdom Accreditation Service provides this validation service. Due to this requirement to produce a periodic environmental report, EMAS is deemed to be more stringent than ISO 14001, which can be used as the first step towards obtaining EMAS accreditation.

The framework of an EMAS includes the following:

- Environmental policy: it must comply with relevant environmental legislation and show a commitment to continuous improvement;
- Environmental review: careful measurement and analysis;
- Environmental programme: with quantifiable targets;
- Environmental management system: operational procedures and controls are to be set out in detail;
- Environmental audit: measures progress against goals;

- Environmental statement: it should be published and tell the public about the environmental impact of the entity. It should enable reporting of environmental achievements to the entity's stakeholders; and
- Independent validation: i.e. external review.

(Source: *Tolley's Corporate Governance Handbook*, Andrew Chambers, 2nd Edition/2003.)

## Choosing the most appropriate form of EMS

The type of EMS which a company adopts depends on the specific nature of that organisation. The variety of EMS options available should provide the required flexibility for deciding upon the type of system that is most appropriate for the company in question. The government have indicated that they would prefer companies to obtain accreditation for their EMS under the EMAS system because EMAS systems emphasise pollution prevention and legal compliance, and have the additional requirement to produce and publish environmental reports.

It is nevertheless not always appropriate for a company to obtain accreditation under either EMAS or ISO 14001. The amount of time and money required to produce and obtain and retain accreditation may not be cost effective. It is suggested that while larger companies would be better served obtaining a formal EMS accreditation under either EMAS or ISO 14001, it might be best practice for smaller companies to have an informal, internal EMS. The Environment Agency suggests that smaller companies should consider signing up to the DTI/DETR Project Acorn, which is concerned with simpler EMS. The Environment Agency's website also contains a wealth of valuable information to help smaller companies both understand and manage their environmental risks on NetRegs.

## Supplier management

The requirements for supplier declarations on sustainability which outline minimum expectations for behaviour on environmental, health, safety and labour issues were rolled out to key suppliers last year. Case studies of supply chain improvements include the following:

- Crest Nicolson, the UK house builders, are seeking a reduction in number of suppliers and an increase percentage of suppliers with environmental policies and management systems. They also hold supplier of the year awards;
- Japanese companies are seeking a reduction in the complexity of their supply/value chains. They are setting targets for reducing the number of components by 20% per annum, which means fewer suppliers, and a greater opportunity for quality and environmental control; and
- Retailer Wal-Mart Stores Inc. has begun to send engineers into its chain of suppliers to find ways to reduce greenhouse gas emissions and profit by

doing so. Its suppliers generate about 200 million tonnes per year, or 10 times more than the retailer itself:

- At only the first factory they audited Wal-Mart helped cut electricity bills by 60% by installing readily available low emissions lighting and technologies.

## Eco-design

Innovation and eco-design includes industrial metabolism and increased efficiency from chemical reactions and materials flows in systems as most leaks of materials are as a result of poor design not by or from accidents. It should explore issues like those discussed in Chapter 3.

Risk management of these issues should involve procurement and product development systems, which ask vital questions like:

- Does the product produce less pollution than competing products?
- Are there alternatives to components that are more environmentally responsible?
- Are recycled materials in the product, or could their use be increased?
- Can the amount of packaging be reduced?

An assessment toolkit that takes organisations through this process is available from <http://www.iisd.org/pdf/eetoolkit.pdf> which was developed by the International Institute for Sustainable Development, the IISD.

## Reporting the benefits to stakeholders

This is covered in Chapter 9. Although in principle it is beneficial to communicate the risks to stakeholders, for larger companies there are also benefits from the verification of environmental data.

## Chapter summary

Set against this background, there is a potentially overwhelming array of issues for a company to address in the context of its operations and activities.

### *Useful web links*

- \* EMAS – Eco-Management and Audit Scheme Sites: regulatory texts and background information, guidance documents, and a list of verifiers: <http://europa.eu.int/comm/environment/emas/index.htm>
- \* The EMAS UK relevant site is at: <http://www.emas.org.uk/>  
European Environmental Law website: [www.eel.nl](http://www.eel.nl)
- \* GRI – Global Reporting Initiative: including a GRI content index and guidelines: <http://www.globalreporting.org/reportsdatabase/>
- \* International Institute for Sustainable Development: the IISD have produced an assessment toolkit that takes organisations through the sustainability product design process: <http://www.iisd.org/pdf/eetoolkit.pdf>

- \* INEM – International Network for Environmental Management: documents and hyperlinks to other websites of interest, including: EMAS Tool Kit for Small Organisations, Environmental Policy Checklist, and Environmental Statement and/or Environmental Report Checklists: <http://www.inem.org/>
- \* ISO – International Standards Organisation – ISO 14001 Global Overview: this site provides an up-to-date overview of sites certified against ISO 14.001 and sites registered under EMAS: <http://www.ecology.or.jp/isoworld/english/analy14k.htm>
- \* United Nations: reports on environmental trends: <http://www.un.org/esa/sustdev/publications/trends2006/index.htm>



19

Aspects of environmental risk



# 19

## Aspects of environmental risk

### CHAPTER OVERVIEW

The consequences of our actions are vast and as yet many of the risks – and the extent of their impact – remain uncertain. What has become absolutely evident over the last few months is a global acknowledgement that additional urgent action is required to engage everyone in the impact of human activity on climate change. Many are describing this as the ultimate challenge for all of us. Whereas there has been some understanding and action since the Rio Conference (see Chapter 18) the urgency of the need for action in terms of risk management – sustainable risk management – has been most dramatically evidenced only very recently in the Stern Report. It is therefore important to develop the discussion relating to environmental risks in more detail than other areas of risk. Their management goes to the heart of sustainable risk management. The SERM methodology measures that 5.4% of market value is at risk from these issues.

Overall it may be stated that the risks are going to increase exponentially as a result of the following inputs to businesses. These are taken into account in the SERM methodology.

### Risk analysis

SERM considers the following matters when reviewing the environmental risk management of an organisation:

- Environmental incident risk;
- The unequal distribution of the remaining resources, especially water;
- Organisations' direct and indirect impact upon:
  - Air (leading to climate change and damage to the ozone layer); environmental changes and an increasingly chaotic climate;
  - Resources use: increased human use of resources (i.e. land and water) through consumption per person and population growth;
  - Land (habitat loss, waste disposal and pollution affecting all species' health and DNA); and land use degradation from deforestation, desertification; and

- Water (marine life mutations have increased, breeding cycles have been affected and there are high levels of metal poisoning of fish being recorded).
- Other species decreasing in number or becoming extinct. Land use degradation from deforestation, desertification.

*The ultimate risk in sustainable risk management*

There is the ultimate risk – as a global society – of the end of human continuity, otherwise known as extinction. This is not as far fetched as it seems. Living in an interdependent world, survival is based upon the survival of other species. The biggest sustainable challenges/threats to life still include the depletion of the ozone layer, which is at its thinnest even with the successes accrued as a consequence of the Montreal Protocol. The UK Prime Minister, Tony Blair, seems to share this view. He said that damage to the environment is the greatest threat to humanity:

Climate change is probably, in the long term, the single most important issue we face as a global community – the issue is now, very, very critical indeed. (*The Guardian*, 27 May 2004)

The climate change and greenhouse gas issue is explored in more detail in Chapter 20. Clearly the whole debate is so vast that reference should be made in particular to the Stern Report but also to the many texts devoted to this challenge. Scientists have been warning of the various dangers for many years. However, the real risks are usually the ones which suddenly surface, have not been measured and, therefore, not been dealt with. For example, the ozone hole was discovered, by accident, by explorers in Antarctica. A certain phytoplankton is responsible for a chemical which in turn is responsible for producing the protective ozone layer, without which we would fry quicker than an egg! This species is vulnerable to the increasingly high levels of pollution in the sea and rapid changes in climate. There is some belief that the ozone hole is healing; nevertheless there is no doubt that in terms of environmental risk management the proactive and precautionary approach is the best strategy in the interests of all stakeholders.

The more localised impacts of the rising sea level and increased flooding could affect organisations. There is a possibility of new taxes being introduced on the causes of the environmental problems. The UK government is aiming for a 15.2% cut in harmful emissions levels from 1990 to 2010, but it is not clear how this will be achieved.

For example, it is estimated that 5500 children die each day from diseases linked to polluted food, air and water (WHO quoted in *State of the World*, 2003).

## An overview of scale of the risk

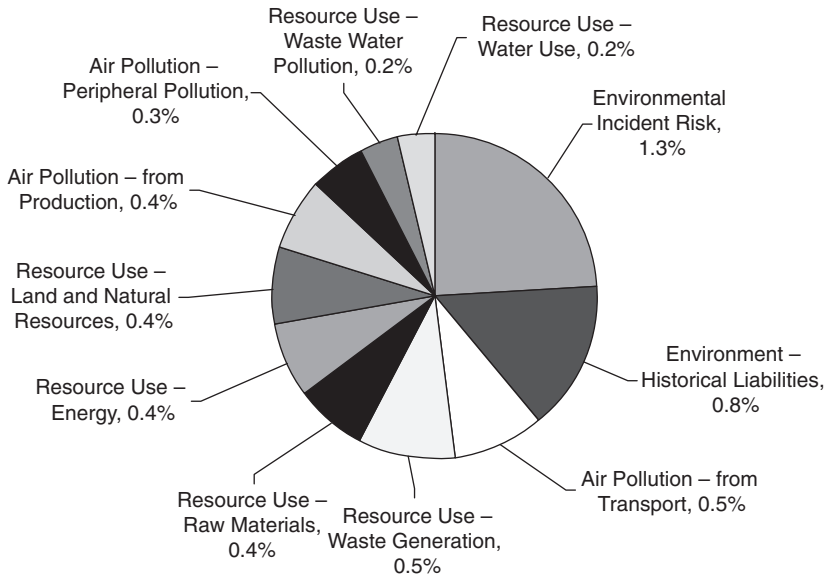
Research and analysis into environmental risk indicates that:

- 5.4% of market value of the top 500 EU and US companies are at risk as a result of environmental issues listed in the following subsections; and

- This risk exposure has been reduced from 8.2% of market value by good risk management techniques (the risk reduction/management factor). Thus risk management has saved 2.7% of the market value of these companies.

## Categories of environmental risks

The chart below shows the environmental risk categories by (net) risk to market value for the top 500 companies in the EU and US.



The table below shows the total environmental risk broken down by the risk categories in this chapter.

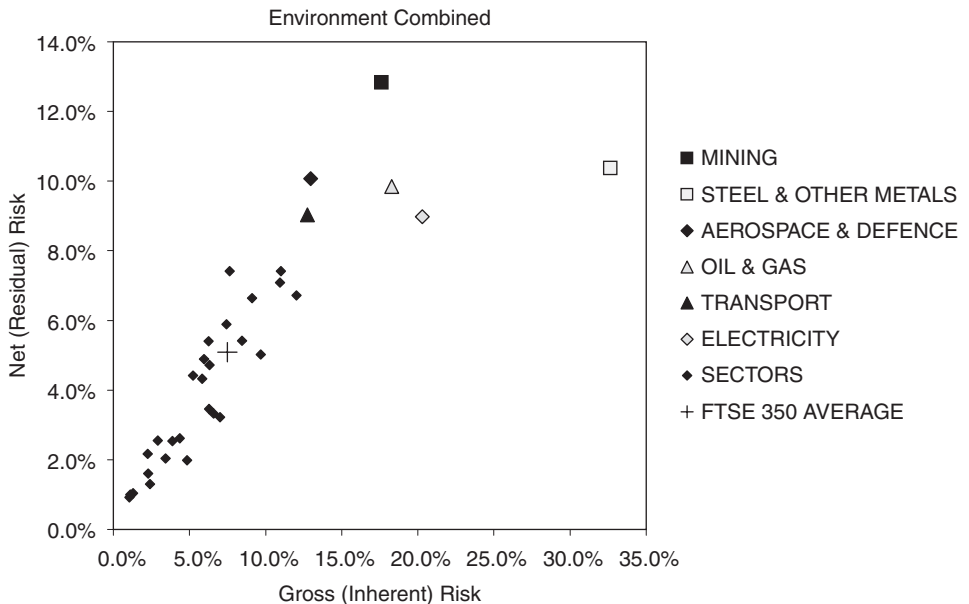
Risk issue	Net % risk to market value
Environmental incident risk	1.3%
Historical environmental liabilities	0.8%
Air pollution – from production	0.4%
Air pollution – from transport	0.5%
Air pollution – peripheral pollution	0.3%
Resource use – materials	0.4%
Resource use – energy	0.4%
Resource use – natural resources inc. land	0.4%
Resource use – waste generation	0.5%
Resource use – water use	0.2%
Resource use – waste water pollution	0.2%
<b>Total</b>	<b>5.4%</b>

A breakdown of the environmental risk by issue raises some interesting observations. The categories which contribute most risk to the capital are where harm to individuals is most likely and liability can therefore be attributed – environmental incidents and historical liabilities.

A recent report based on global scientific facts and projections from the UN's Ecosystem Assessment system and corporate interviews warns that companies must transform business models and operations if they are to avoid major economic losses caused by the current degradation of ecosystems and the vital services they provide. (There is a link to the report at the end of this chapter and on the attached CD-Rom entitled *Ecosystem Challenges and Business Implications*, 2006 by the Earthwatch Institute (Europe), the World Conservation Union (IUCN), the World Business Council for Sustainable Development (WBCSD) and the World Resources Institute (WRI))

## Environmental risk overview by sector

The following diagram maps out the sectors with the highest net risk from environmental issues.



The impact on sectors like mining and oil and gas are clearly visible as they are involved in large-scale extraction of natural resources on a very visible level and in environmentally sensitive areas of the world. Other higher than average risk sectors are those involved in high levels of energy use, the transport and electricity sectors. They also have a higher level of entrenched liability.

However, there are some surprises and the steel sector provides a good case study of how economic and environmental pressures are converging. The inclusion of this sector as high risk may be a surprise, and the results are not

indicative of an entire sector, as only a few were included in this research. However, even considering this factor the sector's primary inputs are environmental in nature, ore and energy, and are thus susceptible to environmental legislation, like carbon taxes. These resources are also susceptible to large fluctuations in price. The recent price increases forced many producers to develop innovative recycling programmes. Environmental efficiency is now part of the competitive landscape in the sector, an economic necessity, as those who are not signing agreements to take back their products will be at a disadvantage.

Another surprise is the aerospace and defence sector, which has below average management of these types of issues. Is this because of a higher than average level of secrecy in the organisations which inhibit transparency, or is it that they are under the protective wing of the government and do not feel the same commercial pressures that sellers of consumer goods do to raise standards on these issues?

What is noticeable is that the sector devotes more risk management time to the social and ethical dilemmas and public interrogation that they face. A trade-off of risk management resources would seem to have occurred, with the sector targeting their risk management priorities.

## General environmental risk management techniques

These are covered in more depth in this and the preceding chapter. Protection of the environment includes developing an environmental policy and processes to ensure performance towards the following aims are achieved:

- Setting an environmental policy and plan into place, indicating which staff are responsible for various activities;
- Setting standards for:
  - The controlling of dangerous pollutants and potential incidents;
  - Air emissions;
  - Holistic management of water resources, use and waste emissions;
  - Energy use, sources, security and efficient methods;
  - Promoting energy efficiency and combating climate change;
  - Raw material purchasing policies and efficient levels;
  - Noise, light, odour and other peripheral pollution levels;
  - Controlling the safe disposal, management and reduction of waste, including hazardous waste safety measures;
  - Product design and production efficiency;
  - The ability for the products and wastes to be recycled;
  - The promotion of waste reduction among business processes and suppliers;
  - The protection of land resources and wildlife habitats; and
  - The encouragement of wildlife diversity and sustainability of land resources.

## Analysis of environmental risk

Each environmental risk category will now be analysed in more detail, including more specific case studies of how companies are addressing these issues.

## Environmental incident risk

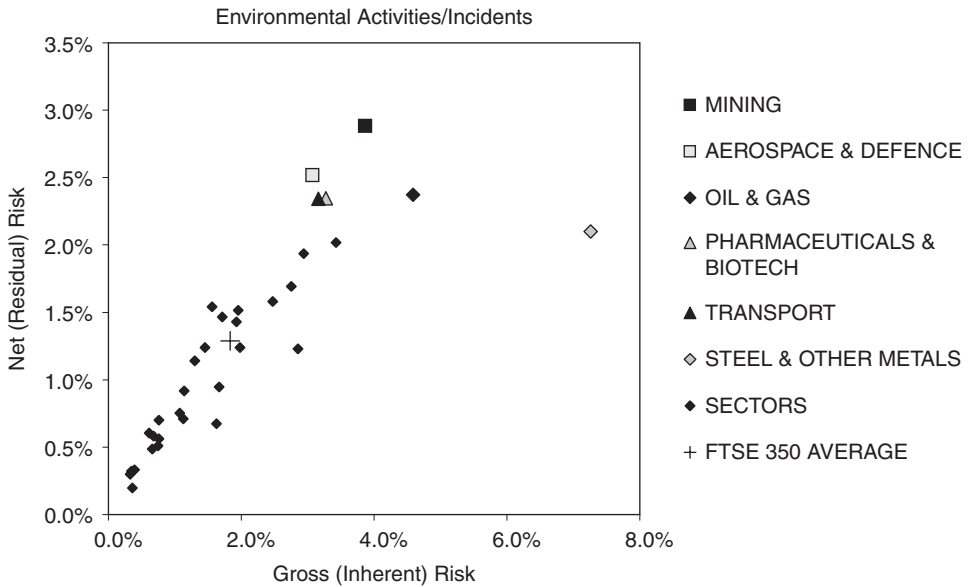
Analysis of environmental incident risk indicates that:

- Environmental incident risk is 1.3% of market value of the top 500 EU and US companies; and
- This risk exposure is reduced from 1.8% of market value by good risk management techniques (the risk reduction/management factor).

Environmental incidents are defined as one-off acts of corporate negligence or wrongdoing, where the negative impact on the environment is immediately perceived. For example:

- Significant spills of chemicals and oil, as well as incidents resulting in fines for non-compliance and legislative infringements;
- Chemical fires or vehicle crashes that result in chemicals being released into the environment; and
- Major impacts on biodiversity associated with activities and/or products and services on land, freshwater and marine environments.

The graph below shows the environmental risk (net) from environmental incidents by sector.



## Case studies

Such environmental incidents can have an impact on the following:

- Human beings: death, disease, serious injury, genetic mutation, birth defects or the impairment of reproductive functions. For example, according to the Food Standards Agency (FSA) the concentration of aluminium and mercury

in the UK's diet is increasing (Food Survey Information Sheet 48/04 as reported in the *ENDS Report*, April 2004, p. 12). An example is that officials in Tehran now say that toxic fumes killed 120 people a day in the city during October and November;

- Other living organisms or ecological systems: irreversible or other substantial adverse changes in the functioning of the ecological system; and
- Property (i.e. crops, domestically grown produce for consumption, livestock, game, other owned animals, etc.): substantial diminution in yield or loss of value due to death, disease or other physical damage, or property (i.e. buildings), structural failure, substantial damage.

## *Oil and gas sector*

The world's largest oil platform owned by Petrobras sank off the coast of Brazil in April 2001. The economic impact of this environmental disaster cost Lloyd's of London an estimated £600 million in claims. There was also substantial loss of life and significant oil pollution. This incident is a clear indication that environmental, economic, health and safety and social events are interlinked.

Shell Transport & Trading/Royal Dutch were fined over US\$50 million (£30 million) by a Texas jury for knowingly selling a leaking pipeline that polluted drinking water. Shell also had to pay more than US\$6 million in clean-up costs. It is also expected that they will have to pay the US\$5 million legal fees incurred by the company, which bought the leaking pipeline (*Environmental Law Bulletin*, August 2003).

BP plc has had its Georgian pipeline halted by the Soviet Republic of Georgia, whose Environment Minister said that the company had failed to provide contractually required environmental information (*The Observer*, 25 July 2004).

### *Company analysis of Exxon Mobil*

After the 1989 *Exxon Valdez* oil spill, company representatives made a promise to the affected communities of Prince William Sound that they would receive full compensation. Some observers note that the damage to the reputation of the world's largest oil company is still ongoing as the residents say they are still awaiting payment, after 15 years (see [www.ens-newswire.com/ens/mar2004/2004-03-25-11.asp](http://www.ens-newswire.com/ens/mar2004/2004-03-25-11.asp)). As a result of this type of management response and the objecting to the Kyoto protocol, there has been a UK consumer boycott, which is still in progress. This has been estimated to cost the company \$600 million in lost sales in the UK in 2003 (Co-operative Bank/CIS estimated figures based on the Ethical Price Index survey of customer behaviour patterns). The original cost of the *Exxon Valdez* disaster was a US\$2.8 billion clean-up bill, even though a double-hulled oil tanker only costs approximately US\$20 million in additional expenditure to help avoid these types of incidents. It is now estimated that the liability for such an incident has doubled in the last 15 years and that a repeat of this incident would cost at least US\$5.6 billion.

## UK-based examples of risk

There are very many examples of environmental incidents throughout the world: in this section some of the more vivid UK-based examples are cited:

- Abbey National plc were one of the underwriters for the funding of the Birmingham Northern Relief Road – a controversial project criticised for its expected adverse effects on the environment (i.e. traffic jams, house destruction, green belt land destruction) (*Ethical Consumer Research Supplement* ec84, September 2003, quoted in *Corporate Watch*, Autumn 2000);
- Bryant Homes have been involved in an incident of damage to biodiversity, as they are accused of having ruined the habitat of one of the UK's most endangered butterflies, the Dingy Skipper. They used the sensitive site as a dumping ground. In a rush to remedy the situation, the damage was magnified as they planted inappropriate grass on the site (*Birmingham Post*, 25 February 2002, p. 5);
- BT Group plc were found guilty of polluting the Thames with an oily, potentially toxic residue and fined £12 500 in 2002 (*ENDS Report*, issue number 335: *In Court*, December 2002);
- Diageo plc: according to the company's Corporate Citizenship Report 2003, four of the company's sites reported pollution incidents, all of which were oil spills. One resulted in a fine of £5000. The other three incidents resulted in actions to prevent reoccurrence;
- HSBC Holdings plc: Friends of the Earth reported that HSBC were one of the institutional UK investors in APP, an Indonesian paper firm, accused by Friends of the Earth of destroying 287 000 hectares of rainforest and clearing land belonging to indigenous peoples (*Earth Matters*, June 2001). HSBC have been noted as one of the main international banks in lending to the power sector. Power projects are criticised for their environmental impacts, forced displacement of people, and for a generally high level of bribery and corruption. It has also been noted that HSBC Markets was one of the financiers of the controversial Three Gorges dam project in China (*Probe International*, July 2000). HSBC and other banks are now addressing these risks issues as they have established a sector environmental behaviour code, 'the Equator Principles';
- Scottish and Southern Energy plc was found guilty of polluting groundwater in 2000. Over 1500 litres of power cable insulating fluid had seeped into a meadow rich in insect, plant and bird life, only metres away from a river in Berkshire (*ENDS Report*, 2001);
- Tesco plc: according to the Environment Agency's 'Spotlight on Business Environmental Performance 2002', Tesco Stores Ltd was listed as being one of 14 repeated offenders. In September 2001 Tesco was fined £30 000 for customers polluting a river with 197 abandoned trolleys between 1999 and 2001 (*ENDS Report*, issue number 320: *In Court*, September 2001). The company was reluctant to install coin-in-the-slot locks because it feared adverse customer reaction, yet did so after the prosecution. Tesco received a £10 000 fine in August 2002 for admitting to polluting groundwater in Dorset with 6000 litres of petrol (*ENDS Report 331: In Court*, August 2002);



- Thames Water has been called upon by the Environment Agency to find a solution to storm discharges that resulted in 600 000 tonnes of untreated sewage being released to the Thames on 3 August 2004. These discharges occur regularly, on average 50–60 times a year (*Financial Times*, 5 August 2004); and
- Unilever plc: according to Unilever's *Environmental Performance Summary Report 2002*, the company received nine fines in 2001 totalling €19 222 for infringement of environmental regulations. *The Ecologist* (March 2001) also reported that a Unilever site with 7.4 tonnes of toxic mercury (laced waste from a thermometer factory) had been discovered in India. The dumpsite was close to a school and a sensitive watershed forest. Company officials denied and downplayed the site.

### *Risk management case studies*

Governments are able to impose restrictions on a sector, e.g. the suspension of all single hull oil shipping movements as a result of a single hull oil tanker breaking up off the coast of Spain, with an eventual ban across EU waters. The following are examples of positive risk management programmes and projects:

- British American Tobacco has developed a positive environmental risk profile for their approach to biodiversity with their afforestation programmes. To ensure the use of renewable supplies of wood and the preservation of natural forests, British American Tobacco have sponsored and promoted the planting of over 250 000 hectares of managed renewable woodlands worldwide since 1970, the equivalent of 550 million surviving trees. The scale of the woodlands effectively means the group is responsible for one of the world's largest tree-planting operations outside the timber and paper industries (*BAT CSR 2003*, p. 90);
- Rio Tinto incorporates biodiversity damage assessments into their risk assessments for all primary and secondary projects impacts;
- Sainsbury's and Marks & Spencer have joined with other European food retailers in their drive to create a genetically modified ingredient-free consortium. Unilever and Nestlé also announce in 1999 that they will remove these ingredients from their food products;
- Shell publicly report on all their activities in IUCN category 1–4 protected areas and have even gone as far as to say that they will stop exploration in these sensitive areas;
- Bryant Homes have learnt from a previous incident and have taken extra caution. One example is that of slow worms being discovered on a building site in Solihull. Work stopped until specialists could be brought in to assess the environmental risks (*Birmingham Evening Mail*, 20 June 2003, pp. 1, 3);
- Unilever have won accolades for their approach to sustainable fisheries; and
- Wal-Mart has established two experimental stores, to test the environmental opportunities available. Their current goals are:
  - To be supplied by 100% renewable energy;

- To create zero waste; and
- To sell products that sustain our resources and environment.

Charles Zimmerman, vice president of prototype and new format development, said: ‘We see these stores as moving in the right direction for a more sustainable future for Wal-Mart. We will continue to lead the way in developing sustainable building and business practices.’

There are companies that can benefit from environmental incidents, like those that can win clean-up contracts after environmental disasters, like Hurricane Katrina, for example Aggreko makes temporary power generators that would be in higher demand, and this led to a 7.5% share increase shortly after the storm struck. At the same time these hazardous events can impact upon value as BP fell 2.3% when it was found that its Thunder Horse oil rig southeast of New Orleans had been affected by the storms (*Financial Times*, 13 July 2005).

## Historical environmental liability risk

Research and analysis into historical risk liability indicates that:

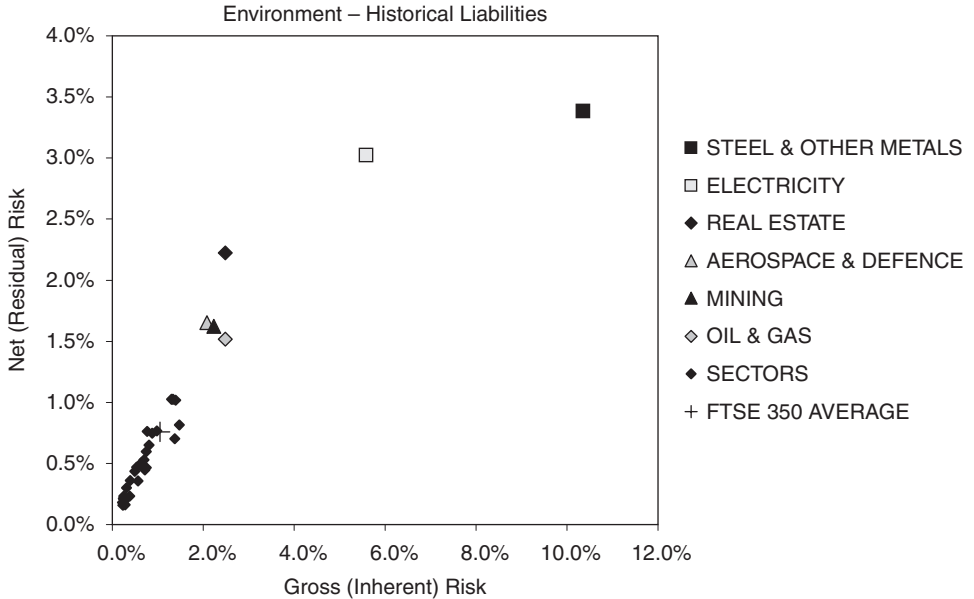
- Historical liability risk is 0.8% of market value of the top 500 EU and US companies; and
- This risk exposure has been reduced from 1.1% of market value by good risk management techniques (the risk reduction/management factor).

Historical liabilities are defined by SERM as an act of corporate negligence or wrongdoing where the negative environmental impact is discovered after a significant period of time. Examples of historical liability risk include:

- Contaminated land, water or air that has been caused by the operations of a company;
- Contamination leading to adverse health implications including, disabilities, long-term chronic illness, cancers and deaths; and
- Prolonged failure to clean/up grade contaminated land or waste disposal sites, and negligent sale of unclean or contaminated land to ‘high public contact’ industries, such as construction.

Although most US and EU organisations are becoming accustomed to environmental risk management in accordance with their own legislation, foreign countries are increasing their own standards of environmental regulation, requiring risk managers to familiarise themselves with environmental laws in countries in which their companies do business. Many countries are now passing laws similar to the American ‘past sins’ regulations; risk managers should investigate countries in which they are currently doing business, and countries in which they have done business in the past to avoid liability for clean-up of a previously polluted site.

The following graph shows the environmental risk from historical liabilities by sector.



For example, the EU passed legislation in 2004 mandating retrospective liability for corporate pollution damage, and environmental liabilities and environmental insurance is growing in Australia, New Zealand and Japan, as well as a number of Latin American countries.

## Case studies

The World Health Organisation (WHO) says that prevention is the way to reduce the historical liabilities of the future. For example, the long-term impacts of pollution upon the brains of children in many parts of Europe are now being discovered. The WHO claims that lead continues to be a menace, with up to 30% of urban children showing high blood levels in some regions.

ICI plc is facing a potentially huge historical liability suit in the US, where large class actions (300 000 litigants from Rhode Island) due to the sale of paint with lead in it are common.

Another big area of historical liability is contaminated land, which can have an impact whether owned, previously owned, rented or leased by the company. The UK has a high population density with high land resource prices, so the economic pressures on land resources are higher than in most other countries. This translates into higher risk levels and greater propensity to disturb polluted sites:

- Agrochemicals sites linked with the contamination of groundwater and surface water; and agricultural waste including animal residue, GM sites and old farm waste deposits;

- Asbestos contaminated sites: there are many risk exposures to asbestos for companies, as it has been such a widely used material;
- Chemical sites: drinking water boreholes can become contaminated. Chemical sites can have run-off polluting nearby rivers, like the former Mirvale Tarworks;
- Industrial sites: agrochemicals sites linked with the contamination of groundwater and surface water;
- Manufacturing: a brownfield site being redeveloped as a council depot was found to be heavily contaminated with solvents and metals linked to a former button manufacturing works;
- Military: a secret chemical weapons factory at the Royal Air Force Portreath base (Nancekuke), in Cornwall, closed in the 1960s leaving five dump sites, which are now causing pollution of groundwater, surface water and the sea;
- Oil: there are numerous incidents of leaking diesel and fuel storage tanks. Indeed, there is an increased requirement to assess liabilities in this field. BP Amoco/ARCO has received a record fine in the US for underground water pollution as a result of leaking storage facilities. There have been numerous incidents of groundwater and soil contamination and residents' complaints; and
- Secondary contamination can also occur as waste is removed from one site and dumped at another, e.g. the lead contamination of soil at an allotment site in Southampton occurred due to the importation of contamination from another site.

## *Risk management*

The cost of remediation of contaminated sites has outstripped the rise in inflation/interest rates and this situation is likely to continue as more individual liabilities are recognised as a result of environmental health incidents. This risk could be reduced such as in the following examples:

- National Grid Transco have over 700 sites, but have a phased plan for the disposal of them at a rate of several hundred a year. A best practice approach makes sense; and
- Wilson Bowden is mitigating their housing development work by building flood defences at the Gateway Glasgow site. It involves raising the level of the land and widening the Clyde, which borders the development. As part of the design exercise, engineers had to prove the flood prevention proposals would not result in problems being transferred further up or downstream (*Evening Times* (Glasgow), 11 April 2001, p. 7).

## *Air pollution risk – from production*

Research and analysis into the risk of air pollution from production indicates that:

- Air pollution emissions from production-related risk is an average of 0.4% of market value of the top 500 EU and US companies; and

- This risk exposure has been reduced from 0.6% of market value by good risk management techniques (the risk reduction/management factor).

It is estimated that the worst performer could lose 25% of its earnings due to regulatory compliance costs and the best could make a revenue addition of 11% to turnover. In the Carbon Disclosure Project analysis of 2000 companies [www.cdproject.net](http://www.cdproject.net)

Air emissions are a major cause of air pollution, and in particular greenhouse gases are the major cause of climate change. Historically this issue has periodically made the headlines, with a tax on coal helping Sir Christopher Wren completing St Paul's Cathedral, and the great London smog of the 1950s leading to some of the first pollution control legislation in the world.

The causes of air pollution:

- Carbon dioxide and other 'greenhouse gas' emissions like methane, which is emitted from many sources, including the decomposition of organic wastes, gases from living life forms like herds of cattle, the production of coal and natural gas and seepage from rotting vegetation from landfill sites;
- CFCs (chlorofluorocarbons), as used in solvents, aerosol sprays and refrigeration units are responsible for destroying atmospheric ozone which is essential to life as it absorbs harmful ultraviolet radiation;
- Combustion by products like carbon monoxide and PM10s from vehicles as well as dioxins, furans and PCBs (polychlorinated biphenyls); and
- Heavy metals like lead and mercury which placed into the air by engine combustion and industrial metal working and incineration processes.

The issue is promoting political debate as can be seen in the next chapter. Tony Blair's statement in May 2004 can only pave the way for future legislation to control emissions and subsidies to encourage good practice by individuals and organisations. At the moment many governments are not achieving all their targets. New reports show increasing emissions, though the UK Office of National Statistics redrafted a report and omitted to include that since 1990 there has been an 85% increase in air pollutants from the airline industry and 59% from freight transport ('Officials try to hide rise in transport pollution', *The Guardian*, 27 May 2004).

The financial community is expressing concerns about these emissions and the associated risks associated with air pollution, and in particular global warming. Clear reporting on emissions and pressure on larger companies to make their supply chain more efficient is necessary. The UK's Local Authority Pension Fund Forum is also attending the AGMs of several FTSE100 companies to press them to report on their carbon emissions. The Association of British Insurers (ABI) has announced that climate change claims have already doubled from 1998 to 2003 (to more than £6 billion), and that claims could treble in the future, pushing up premiums (*The Observer*, 6 June 2004).

The business community is also concerned as rising energy prices are 'set to hit company profits' (analyst's warning in the *Financial Times*, 4 August 2004).

## *Risks resulting from air pollution*

The effects of air pollutants:

- Acid rain and eutrophication: when sulphur dioxide and nitrogen oxides can cause sulphuric acid and nitric acid in rainfall. Acid rain has been linked to the killing of birds, fish, trees and entire water ecosystems, particularly lakes and ponds where concentrations of acidity build up;
- Climate change: the six greenhouse gases act so as to trap the infrared radiation emitted from the earth's surface. Some of the predicted changes are massive damage to economics, hundreds of millions of refugees, flooding of low lying land and greater strength of storms and increased desert spreading;
- Human health impacts: many air-borne pollutants affect human health, from cancer causing (dioxins and PM-10 particles), to nervous system damage (mercury and lead) and breathing problems. In the UK alone there are estimates of over 24 000 people dying prematurely as a result of poor air quality due to avoidable air pollution; and
- The hole in the ozone layer is still getting bigger and is now at its largest on record, according to US government scientists. 'From September 21 to 30, the average area of the ozone hole was the largest ever observed, at 10.6 million square miles (27.4 square kilometres)', said Paul Newman of NASA's Goddard Space Flight Center. Residents of Punta Arenas, the most southerly city in Chile, are warned to stay indoors on occasions now.

Localised air pollution is responsible for large numbers of deaths, mostly as a result of transport generated fumes. There is an increasing body of legislation and market mechanisms being applied to this problem and the trend will continue. More cities around the world will establish 'congestion charging zones' and subsidies for 'greener' transport.

There are major indirect impacts associated with air pollution, such as alteration of the weather and associated risks. These 'climate changes' are now a reality in many regions of the world, and risk managers need to begin preparing for the consequences and possible intense weather situations that will occur in the UK. This could involve increased incidence and durations of extreme weather events and other disastrous events that could interrupt daily operations. Companies should plan for more power interruptions and increased spending on energy supplies.

According to Swiss Re's 'Sigma' report, overall economic losses from natural disasters (aggravated by climate change) in 2003 amounted to an estimated \$70 billion. At the same time the global rate of ice melts has more than doubled since 1988 and could raise sea levels 27 centimetres (nearly 11 inches) by 2100 (*State of the World*, 2003):

The evidence for warming is now overwhelming. Over the past 100 years the global temperature has risen by around 0.6 degrees centigrade, according to the latest Intergovernmental Panel on Climate Change (IPCC) report about climate change, published in 2001. (*Reinsurance Magazine*, 'Energy and climate risk', Marc Jones, 1 February 2004)

The consequences could be severe, for example if all the ice sheets melted on earth then the sea levels would rise by 60 metres, the height of a 20-storey building.

### *Other air emissions*

There are other environmental and health damaging properties of air emissions. The following are examples of damage caused by air emissions:

- Carbon monoxide can damage the cardiovascular system and the lungs, and reduce brain function and cognitive abilities;
- Sulphur dioxide affects the lungs and can cause respiratory illness; it can prove problematic for asthmatics and could even help cause asthma. It also acts as a precursor to ‘acid rain’;
- Nitrogen dioxide can affect the lungs and weaken the immune system. It can also cause ‘acid rain’;
- Low-level ozone can cause premature ageing of the lungs, eye irritation and damage to plants. In London one of the main causes of low-level ozone is the London Underground system. Depletion of the ozone layer through use of chemicals (CFCs, HFCs) in a company’s refrigeration equipment, air conditioning systems, fire fighting equipment or in any industrial solvents can result in criminal prosecution and the imposition of a fine; and
- Other particulates, including metals such as lead, can accumulate in the body’s tissues, blood and bones, causing a range of side effects including damage to liver, kidneys and the nervous system as well as damage to unborn children. Smaller particles, like the PM-10 in diesel fuel, lodge in the lungs and cause particularly severe lung problems. The smaller the particles, the more serious are the risks to human health.

### *Legal risks of air pollution*

There is an increasing reliance on market mechanisms to regulate environmental damage, including environmental health impact issues, attempts to establish a carbon emissions market, and in the UK the Local Air Pollution Control (LAPC) which seeks to regulate air emissions from certain prescribed processes. The Integrated Pollution Control (IPC) seeks to regulate emissions to air, water and land from other prescribed processes.

The UK government seeks to control air pollution via permit regimes and workplace regulations as reviewed below:

- A UN report due in early 2007 will show stronger evidence that humans are causing global warming and this is likely to spur more lawsuits around the world;
- The Local Air Pollution Control (LAPC) to regulate air emissions and the Integrated Pollution Control (IPC) to regulate emissions to air, water and land were enacted under the Environmental Protection Act 1990 (EPA 1990), Part I;

- The Pollution Prevention and Control (PPC) regime is currently being phased in to replace LAPC/IPC under the Pollution Prevention and Control Act 1999; this is being brought in at an industry level, but all new installations require a PPC permit; and
- The Air Quality Standards Regulations 1989 (SI 1989 No. 317) and the Noise in the Workplace Directive 86/188.

If a company operates an installation that falls within either regime, such installation can only be operated under, and to the extent permitted by, the consent obtained.

International treaties exist for the protection of the ozone layer.

Under European law, the supply and use of certain specified ozone depleting chemicals is prohibited (although certain exemptions do apply). The Environmental Protection (Controls on Ozone Depleting Substances) Regulations 2002 (SI 2002 No. 528) mean an organisation must (a) identify whether or not it uses any of the prohibited chemicals, and (b) make all changes necessary to ensure compliance.

## *Health risks*

The significance of the problem should not be underestimated as over the last 10 years there has been a 500 000 increase in the incidences of asthma in the UK, and it is estimated that the death rate as a result of air pollution is increasing. Recent research from the US shows the scale of the problem with nearly one in five counties in the US having unhealthy air (according to the US Environment Protection Agency). It was also discovered that 159 million Americans live in counties that violate the Bush administration pollution rules.

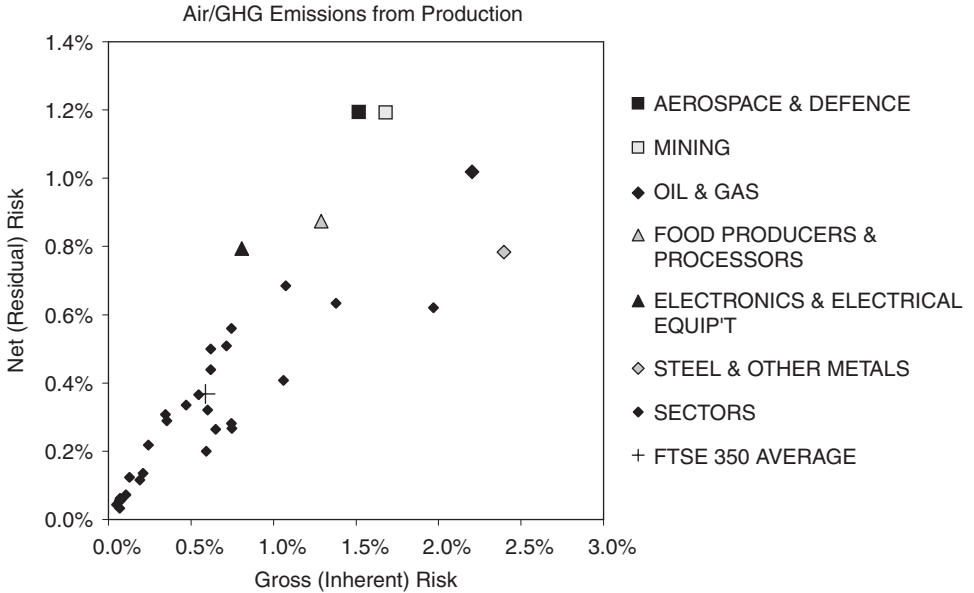
## *Stakeholder risks*

The scale of this risk to human health and the emerging economic sense of regulation to control the problem will lead to more stakeholder pressure. The savings are potentially vast, as between 1970 and 1990 the US Clean Air Act has been estimated to have had total benefits of US\$22 trillion. The costs of compliance for businesses were estimated at \$0.5 trillion (studies are available at [www.epa.gov/oar/sect812](http://www.epa.gov/oar/sect812)).

## *Sector overview*

The following graph shows the environmental risk from air pollution from production by sector.





The table below shows the environmental risk from air emissions in selected sectors.

Sector	Possible direct impacts/risk
Aerospace and defence	The sector has been a below average reporter on sustainability and risk issues, as well as being susceptible to a wide range of air emission liabilities.
Automobile	The car industry (the Society of Motor Manufacturers and Traders) is challenging the government to reduce their demands for cuts in energy use, which have been set at 18% over five years (100 000 tonnes of CO <sub>2</sub> ). They were looking for targets of 7%.
Chemicals	Energy efficiency is crucial as the industry's energy costs are a large proportion of their production costs. Climate change mitigation costs and taxation will directly affect the bottom line. Indirectly, competitive advantage may be lost as more energy efficient, lower CO <sub>2</sub> alternatives may be encouraged, such as sustainable wood usage instead of plastics.
Construction and materials	Building material, cement and glass manufacturers building are huge users of energy and the energy costs increases will affect them disproportionately. There are opportunities for improvement. House builders' raw materials will increase in price.
Electricity suppliers	This sector is responsible for a substantial proportion of the UK's CO <sub>2</sub> emissions and the climate change levy could force a switch to lower CO <sub>2</sub> emission stations. High CO <sub>2</sub> emitters will find themselves at a market disadvantage, as they will not be able to pass on costs easily due to market conditions (and subsidisation of renewable energy).

(Continued)

Sector	Possible direct impacts/risk
Electrical and electrical equipment	Significant energy use by products and at production stages. Many products do not have energy efficiency built in. Production cost will increase unless secure energy supplies are sought.
Food producers and processors	Increased exposure to transport dependency risk. There are the direct costs of air freighting food from around the world and the social fallout of not buying local produce. Reputational damage is reduced as most resellers of food produce import from great distances. These 'food miles' distances have large CO <sub>2</sub> usage implications.
Steel and other metals	Energy efficiency is crucial as the industry's energy costs are a large proportion of their production costs. Climate change mitigation costs and taxation will directly affect the bottom line.
Mining	High possibility of coal miners facing litigation for their products having been major contributors to any damage caused by climate change as a result of greenhouse gas emissions. This in turn will appeal to governments who will seek to impose extra CO <sub>2</sub> taxes on the mining of coal.
Oil and gas	The sector has a long-term strategic business model, which is dependent on the sale of fossil fuels (CO <sub>2</sub> emitters) and therefore there is a risk embedded within the business. However, repositioning as energy companies and focusing additional resources on the alternatives to CO <sub>2</sub> emitting fuels can mitigate this.

## Case studies

- Dongguan city in China's booming southern province of Guangdong has closed 43 cement factories for pollution, a move that was in line with a government campaign to cool the overheating economy;
- Scottish Power plc was reported to have had problems at their Dundee energy-recycling incinerator. Attempting to restart it after a fire, authorised limits were breached 19 times, 18 of those relating to hydrogen chloride, VOCs or nitrogen oxides. Twenty-four kilograms of ash were released into the air when a filter burst in June (*ENDS Report*, 4 June 2001);
- GlaxoSmithKline plc has attracted the attention of Friends of the Earth who note that the Glaxo Wellcome Ulverston plant (now GlaxoSmithKline plc) was third in their top 10 of sources of cancer-causing chemicals. According to an *Ecologist* report, the same plant emitted 773 tonnes of carcinogens in 2001, which translates into 10% of the total carcinogens released by large factories that year (*ENDS Report*, August 2000, and restated in November 2002 when they noted an increase in emissions from the plant); and
- Whitbread plc was ranked eighth in the *ENDS Report* on the 'Top ten polluters by number of court appearances' in July 2000. In 1999 they had appeared in court twice and been prosecuted for two offences. In total they were fined £11 000.

## *Risk management*

Even if one is sceptical of the causes of global warming and climate change, there are benefits in following precautionary principles and reducing air emissions and, therefore, a company's exposure to future litigation or volatility of fuel prices. If what can be measured can be managed, there ought to be more movement in the direction of energy efficiency and the reduction of an organisation's reliance on external energy supplies. Dependence on any supplier is a risk, especially for something as critical as vehicle fuel.

- The Co-operative Bank is one of the first organisations to move towards 100% renewable energy supplies for their operations. They are reducing the volatility of their energy costs and also the insecurity of energy supplies in a world overly reliant on the Middle East;
- BT plc have managed to reduce their reliance on global warming CO<sub>2</sub> emissions by a significant 42% since 1996 (*BT Social and Environmental Report 2004* [www.btplc.com](http://www.btplc.com));
- Centrica plc (owns British Gas in the UK) has joined a carbon reduction scheme and will invest in the reduction of emissions in developing countries (particularly at a Chinese chemical plant) and will use the credits to meet their European carbon reduction requirements. The project is estimated to be worth £445 million;
- French energy group Total said, on 16 December 2006, that it aims to cut gas flaring at its installations around the world by half by 2012;
- Dell says it is the first global technology company to offer customers the opportunity to offset the emissions associated with the electricity used to power their computers; and
- On an international level, there have been successes like the Montreal Protocol, which has helped reduce the emissions of ozone depleting chemicals. There are also an increasing number of organisations which are retiring equipment that contains ozone depleting materials.

The best risk management options for these issues are to use the same services more efficiently as follows:

- Increased efficiency in delivering services from a given energy input, elimination of waste, more efficient products and more efficient power generation and transmission;
- Redesigning products, services and premises, as well as substitution and lifestyle changes, from high energy to low energy services (assuming they have the same or better utility). For example, video-conferencing as a substitute for tiring and expensive business travels;
- Re-engineering the systems by substituting high carbon forms of energy with low carbon sources, such as natural gas instead of coal, and from gas to zero carbon sources, such as renewable energy and possibly nuclear energy;
- Reclaiming CO<sub>2</sub> through the creation of sinks to absorb the organisation's greenhouse gases; and

- There should be strict measures to control the release of ozone depleting materials which can be found in old refrigeration equipment and the following items:
  - Solvents (CFC 113 can last up to 90 years in the atmosphere; also carbon tetrachloride solvents);
  - Fire extinguishers (these can contain Halon 1301 which has an ozone depleting life of 110 years); and
  - Aerosols, foam air conditioning and refrigeration units (CFC 11 and 12, which can last up to 73 years).

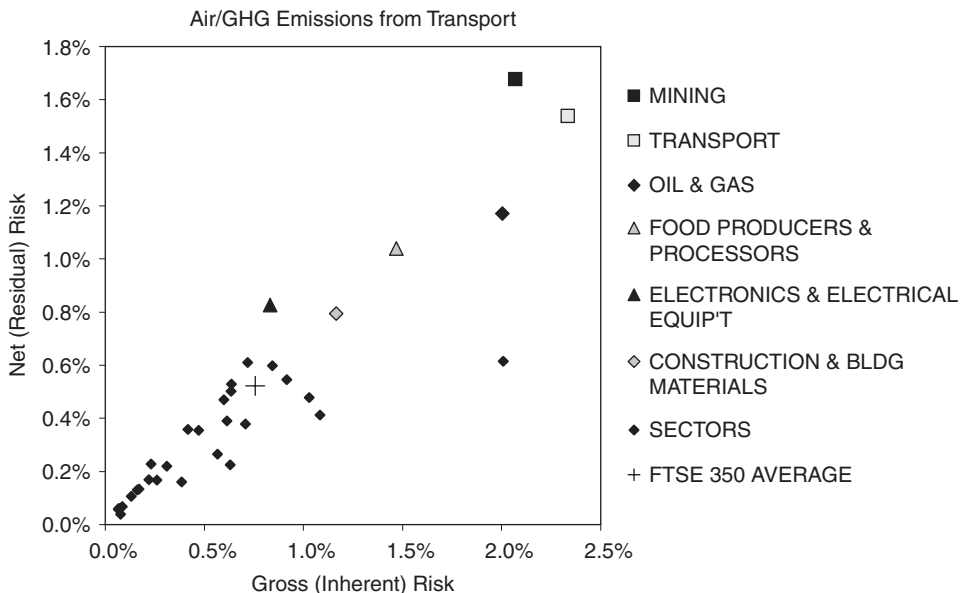
## Air pollution risk – from transportation

Research and analysis into the risk of air pollution from transport indicate the following results:

- Air pollution emissions from transport-related risk are 0.5% of market value of the top 500 EU and US companies; and
- This risk exposure has been reduced from 0.8% of market value by good risk management techniques (the risk reduction/management factor).

This section covers emissions to the atmosphere resulting from an organisation's use of transport (such as low-level ozone, SO<sub>x</sub> and NO<sub>x</sub>, PM-10s from diesel fuel, etc). It specifically covers greenhouse gases emitted from any vehicles which are used by the company.

The following graph shows the environmental risk from air pollution from transport by sector.



## Case studies

The greatest risk and liability arises among the companies that have to transport people and materials as part of their core business. Transport contributes significantly to the greenhouse gas effect and climate change. Although there have been some improvements to air quality, such as the dramatic reduction in the lead levels present in the air, the general trend is increased emissions from transport. The UK may even miss its Kyoto reduction targets because of increases in transport traffic. EU working papers note that the benefits of reducing these emissions are vast:

At the community level, the policy of internalising all external costs of transport would reduce carbon dioxide emissions on average by 11.5%. In addition to carbon dioxide reductions, the net benefit to European citizens from reduced time spent suffering congestion, and from decreased accidents, noise and other emissions, would range from 28–78 billion ECU per year. (EU working paper (CEC, 1998, p. 17) quoted from *Earth Summit 2002: A New Deal*)

There are new transport taxes coming into effect, there are others which affect company cars and personal use of company vans, as well as the London congestion charge which is to be copied in cities around the UK and the world. Such regulations will increase the base operating cost of organisations with a high-risk profile in this area. A recent report for the UK government by former British Airways chief Rod Eddington, said properly targeted and priced road tolls could save 28 billion pounds a year by 2025 and all but torpedo the case for major new road building. Thus the marketplace will be used to price users off the road, so businesses need to be prepared for this extra type of expense.

The likely methods of dealing with these issues impact businesses. The London congestion charge is a prime example of this impact. There will be a continued extension of market principles to transport pricing with:

- Increased research into and subsidisation of alternative fuels and vehicle types;
- Increased inner-city charges for entering and parking in these zones;
- Increased prices for and taxation of private cars, vans and fuel, with the stated objective of encouraging more resource efficient vehicles;
- Greater land management to minimise travel distances (e.g. use of urban brownfield sites); and
- More developments where good transport infrastructure already exists.

Further developments in legislation and product labelling are likely:

- The European Directive 99/94/EC sets standards for consumer information on passenger cars in respect of their official fuel consumption and official emissions of CO<sub>2</sub>. The Directive was implemented in the UK by the Passenger Car (Fuel Consumption Carbon Dioxide Emissions Information) Regulations 2001 (SI 2001 No. 3523). These require all car dealerships to attach labels to all models of passenger cars in the showroom, and list the CO<sub>2</sub> emission and fuel consumption figures of all models available from that dealership on a poster. Fuel consumption and CO<sub>2</sub> information must also be included in all promotional literature of passenger cars (*ENDS Report*, issue number 350, March 2004, pp. 35–36);

- The Canadian E3 Fleet system was the first green rating system for vehicle fleets in North America. It provides an environmental Rating Guide, a points system for determining just how green a fleet is, a third party audit of fleets and a rating of Bronze, Silver, Gold, or Platinum level; and
- At the 2007 North American International Auto Show Sunday, General Motors' head Rick Wagoner unveiled the Chevrolet Volt concept sedan and a new generation of electric vehicles could eliminate gas stations for Americans who live close to their workplaces.

Key findings of the US Opinion Research Corporation survey suggest most Americans think: 'President Bush and Congress could help U.S. automakers be more competitive by increasing the federal fuel-efficiency standard to 40 miles per gallon.' Such a move is supported by 78% of Americans, including 45% who back it strongly. Support for a 40 mpg fuel-efficiency standard cuts across party lines: Republicans (70%); Independents (78%); and Democrats (84%).

In response to the survey Civil Society Institute President Pam Solo said:

What Americans are saying to American carmakers is that they are ready for change. We know the technology exists for higher fuel efficiency that will save money, reduce this nation's dependence on foreign oil and diminish the pollution linked to global warming. (GreenBiz.com, 24 November 2006)

Whereas it would seem Toyota has hit the jackpot with its electric hybrid, the Prius.

## *Risk management case studies*

- BT plc is an example of a company pre-empting the impact of resource cost increases as they reduced their fleet of vans by 832 vehicles in the 2004 financial year. This has reduced their fuel consumption by 4% as they are also using smaller vehicles for the rest of their fleet (*BT Social and Environmental Report 2004*, www.btplc.com);
- Japan's largest refiner, Nippon Oil Corp., and auto giant Toyota Motor Corp. are planning to develop bio diesel from palm oil with Malaysian state oil firm Petronas;
- UK retailer, Tesco has saved £720 000 annually on diesel fuel costs; cut the number of miles travelled by three million; and reduced their CO<sub>2</sub> emissions with a new groceries distribution system;
- Transport initiatives: 'Taxi Zero Pollution' vehicles are to combat air pollution in Mexico. The Mexican government has commissioned an unnamed French company to build 40 000 'Taxi Zero Pollution' vehicles to try to combat air pollution in Mexico City;
- Richard Branson's Virgin Atlantic started trialling a new plan aimed at cutting aviation emissions by towing aircraft to take-off areas at London airports from December 2006; and
- US healthcare giant Abbott was the first company to sign up to PHH GreenFleet (developed jointly by PHH Arval and Environmental Defense to reduce pollution), designed to improve vehicle efficiency and reduce fuel consumption among commercial fleets. Abbott says that this will help it meet

its corporate goal of reducing operational greenhouse gas emissions to 10% below its 2004 levels by 2010.

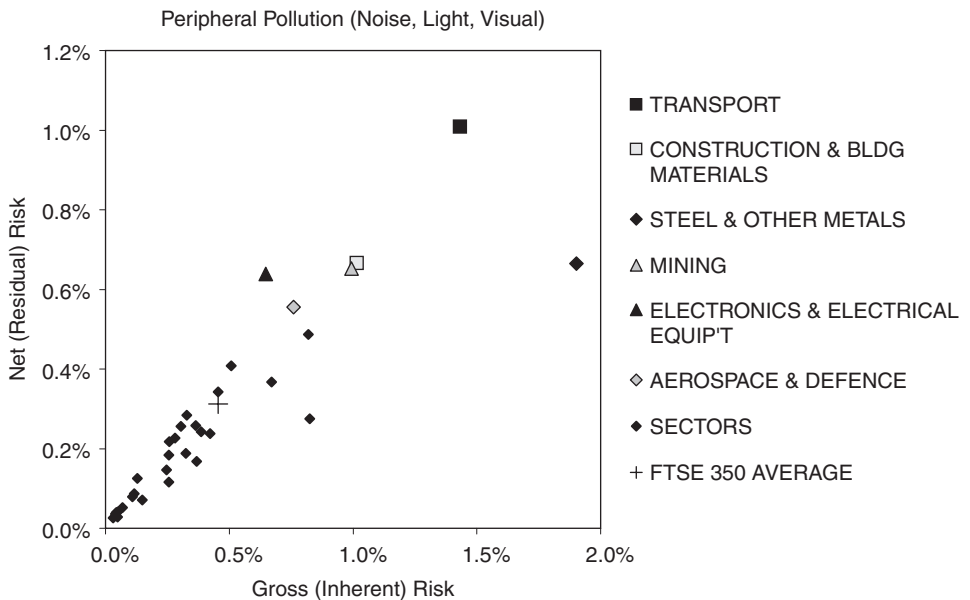
## Air pollution risk – peripheral pollutions

Research and analysis into the risk of peripheral air pollution (odours, noise, visual pollution and dust) shows that:

- Peripheral pollution risk is 0.3% of market value of the top 500 EU and US companies; and
- This risk exposure has been reduced from 0.5% of market value by good risk management techniques (the risk reduction/management factor).

This section concerns the effort a company makes to mitigate the impact of transportation of products and staff, noise, odour, dust, light and delivery times on the public, especially in the immediate vicinity of company operations.

The following graph shows the environmental risk (net) from air pollution – peripheral pollutions by sector.



Most of the impact of noise pollution is measured upon the impacts on humans and their quality of life. There is now a growing view that noise pollution is a serious concern and in the UK there has been a sixfold increase in complaints over the last 20 years, primarily domestic noise issues. There are growing views that noise disturbances cause an effect upon wildlife, whether it is noise scaring breeding birds, industrial seismic activity in oil exploration harming whales and dolphins, or air craft causing disruption to noise sensitive species. Our increasing moves as a species towards a 24 hour society is undoubtedly having adverse impacts upon each other and the species we share this planet with.

A feature of noise pollution is that it is not persistent in the same way as other pollutants; this means that it is more difficult to enforce standards. There is little defined legislation on noise pollution and it tends to be covered by aviation and road traffic regulations.

## *Case studies*

Companies need to show evidence that they have listened to the concerns of the public and changed their actions accordingly. The adverse consequences of a company failing to address these types of concerns could be that they receive fines and may find it difficult to obtain planning permission in other areas. This may directly affect their licence to operate and expand.

The severity of these types of pollution incidents has been underestimated to date. For example, exposure to excessive noise can cause hearing problems, stress and poor concentration, productivity losses in the workplace, communication difficulties, fatigue from lack of sleep and a loss of psychological well-being. It can also cause accelerated heartbeat, high blood pressure and gastro-intestinal problems.

These health aspects of peripheral pollution are explored in more depth in Chapter 18, but as an example the Health and Safety Executive have carried out an impact assessment study in connection with Directive 2003/10/EC which aims at determining the benefits and costs involved for UK industry to comply with the new requirements of the Directive. The study put the total quantifiable health benefits to UK society over 10 years at between £265.1 million and £582.3 million. With these sorts of financial benefits from reducing noise pollution there will be an increased level of government movement to internalise organisations' external impacts.

There are legal controls which include notices, stop provisions, and product and specification standards on products and machinery. Industrial noise is not often regulated as a specific control; however, there are elements of industrial activity that attract more attention than others. Examples include:

- Aircraft and airport usage noise levels. Standards have been set under the 1944 Chicago Convention and the issue of noise levels on neighbouring communities that live near airports have been one of the main drivers for quieter aircraft. Levels have become so high in total at many airports that night flights have been banned and human rights challenges have been instigated. The noise levels of Concorde have been mentioned as one of the possible reasons it was retired from service;
  - Eco-design can help reduce these risks – a new example is the design of a silent, environmentally friendly passenger aircraft which researchers from Cambridge University and the Massachusetts Institute of Technology (MIT) began working on three years ago. The overall shape incorporates the wings and engines into the body of the plane with air intake for the engines mounted above the aircraft in long ducts, muffled with acoustic liners to reduce the noise. It also has the potential to be more fuel efficient (Environmental News Service, 9 November 2006).



- The construction sector is particularly vulnerable to these types of risks as their activities take place outside and quite often in public areas. Their operations can cause noise, dust and traffic disturbances and attract a lot of attention as they usually occur in already inhabited areas. The following are some examples:
  - Construction noise and restrictions often imposed by local government stakeholders on the behalf of nearby communities, businesses and residents. These can include controls on hours of operation, types of plant and times of use and the levels at which noise is permitted. There are case studies where work has begun too early on building sites and this has warranted fines for breach of agreements;
  - Odour pollution: local residents in Bransholme, UK, have concerns over Persimmons Housing Development and the additional strain this would put on their sewage system. The residents said that their gardens were regularly flooded with raw sewage and felt that the developers and Yorkshire Water had ignored their concerns. Councillors were told that ‘in theory’ the existing sewerage system could cope with new demands (*The Hull Daily Mail*, 6 June 2003); and
  - Noise pollution: a building firm was fined £8000 for causing noise and nuisance to residents on a new housing estate, after workers arrived too early to avoid traffic problems. Redrow Homes (Midlands) Limited of Flintshire admitted eight charges under the Control of Pollution (Amendment) Act 1989 and fined £1000 on each count (*Birmingham Evening Mail*, 3 March 2003).

## *Risk management*

Examples of positive risk management programmes and projects include the following:

- Traffic calming by Wilson Bowden in Ravenstone, UK: David Wilson Homes has provided £70 000 so that traffic calming can be introduced on roads in the village (*Leicester Mercury*, 14 February 2002); and
- Noise pollution: Redrow Homes (Midlands) Limited of Flintshire have taken appropriate risk action to ensure there is no reoccurrence of the fines outlined above. The company have now warned subcontractors they will lose their jobs if there are any further early starts (*Birmingham Evening Mail*, 3 March 2003).

## Resource usage risk – materials

### *Risks resulting from resource usage*

Research and analysis into resource usage risk shows that:

- Raw material risk is 0.4% of market value of the top 500 EU and US companies; and
- This risk exposure has been reduced from 0.6% of market value by good risk management techniques (the risk reduction/management factor).

This concerns the extent to which a company is attempting to reduce its consumption of natural resources by replacing raw materials with either industrial

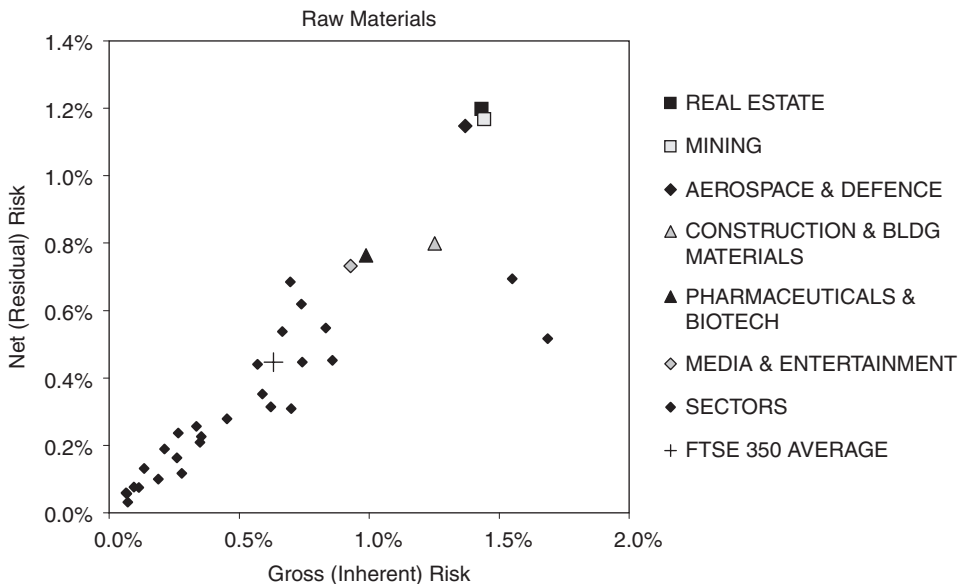
or consumer waste products (or recycled materials). The measurement is the percentage of waste products used as raw materials. It refers to both post-consumer recycled material and waste from industrial sources.

Raw material is defined to exclude fuel and water, which are measured elsewhere.

Recycling is defined by SERM as ‘processed or unprocessed wastes from sources external to the reporting organisation (tonnes or kilograms)’.

Excessive consumption by the world’s richest nations is making life even more difficult for the world’s least fortunate. The US research group Redefining Progress says that the wealthiest nations are depleting global resources at an unprecedented rate (with the US leading the way) and are mortgaging the future at the expense of today’s children, the poor and the long-term health of the planet ([www.ens-newswire.com/ens/mar2004/2004-03-30-10.asp](http://www.ens-newswire.com/ens/mar2004/2004-03-30-10.asp)).

Resource costs are increasing and will continue to do so – there are rising costs of fuel (oil has hit \$40 a barrel and gas prices have doubled), water, waste disposal (landfill costs have tripled in one year), and insurance premiums are also on the rise in order to cover increased flood and ‘natural’ disaster incidence. Environmental resource use has an impact on our economic stability as interest rates are set to rise to counteract the inflationary pressures of energy ‘supply’ problems. Surely more attention should be paid to ‘demand’ management. Most financial analysts did not predict these circumstances, or the rapidly spiralling resource demand from China where car sales hit a 60% increase over the previous year. This raises important questions as to how this situation is to be made sustainable and what the impacts on companies are.



The graph above shows the environmental risk (net) from material resource usage by sector.

## *Case studies*

The metal processing and mining sectors are becoming more involved with recycling and take-back programmes, but are not fully addressing the primary industries' reliance on taking the majority of their raw materials from the earth, quite often in turbulent parts of the world.

## *Food sector*

The food sector has had a large number of difficulties with its supply chain and environmental health issues: BSE in cattle and humans; foot and mouth affecting the UK pig herds; Salmonella; SARS and Asian flu in poultry; toxicity from above safety limits of pesticides in fruit, vegetables and farmed fish; contamination of tuna and other fish with high levels of mercury and other heavy metals; and general issues like the large-scale nitrate pollution of water, or the over-application of antibiotics, which is reducing human resistance to infectious diseases.

Arguably, these happened because of several key factors:

- **People:** there were no individuals ultimately responsible (the government blamed the farmers, the farmers blamed the government). This has been partially addressed by the establishment of the Food Standards Agency (FSA);
- **Policies:** the only policy was a short-term economic one (encouraged by the EU and state subsidies) to maximise output at the detriment of all other considerations (society and customer feedback with the option of quality produce as well as a segment wanting low priced food – this can be seen in the growth of organic produce demand);
- **Processes:** there are few brands in farming. The lack of brand building processes means the farming sector is less concerned about an individual organisation's loss of reputation, thus risk management processes are also less developed; and
- **Performance:** overall performance has led to thousands of farmers going out of business; incomes being slashed, diversifying of the remaining businesses and farmers investing in creating stakeholder value by going to meet the customers directly. There has also been a change of direction in governments with the introduction of grant schemes to support farmers who wish to have a lower impact on the environment.

## *Company specific case studies*

- Both Coca-Cola and PepsiCo have shown some leadership in material use by having a 10% recycled content in plastic bottles and promising to work with competitors toward setting beverage container recovery goals;

- GUS plc: Argos sold snooker cues made from illegally logged Ramin timber (a species listed under the Convention on International Trade in Endangered Species). It was allegedly taken from dwindling Indonesian rainforests, even though the Indonesian government banned all cutting and export in 2001. Illegal logging destroys over 2 million hectares of Indonesian rainforest each year and it is also linked to corruption and human rights abuses (Red Pepper Report, September 2003 quoted in the *Ethical Consumer Research Supplement*);
- According to the spring 2001 edition of the *Corporate Watch* newsletter, NatWest Bank and other banks were among the companies financing Boise Cascade, the American forestry giant responsible for deforesting an area the size of Luxemburg each year in regions such as the Amazon, South East Asia and Canada (*Ethical Consumer Research Supplement* EC89 July/August 2004 referring to the *Corporate Watch* newsletter: 2 (1 April 2001)). Friends of the Earth claim that NatWest had provided finance to APP (the Indonesian paper company) which has been accused of clearing vast areas of Indonesian rainforest. The allegations were also made against: Barclays Bank plc (who had helped to arrange loans of over US\$500 million to APP companies); Scottish Widows Investment Partnership (now part of Lloyds TSB); and Framlington Investment Management (FOE UK: 26 June 2001); and
- Brambles have lost a custody battle in the US after a wood recycling firm caught hoarding 30 000 of the company's pallets refused to give them back. This verdict could add £6.8 million a year to Brambles' costs. It has been estimated that in 2002 there were 2.5 million missing pallets in their US business, leading to an unexpected charge to interim profits of £11 million.

## Risk management

Developing a vision of eco-efficiency in which wealth is doubled and resource use is halved, resulting in a fourfold increase in 'resource productivity', is seen as one of the keys to sustainability. This concept, called 'Factor 4', refers to a hypothetical fourfold increase in 'resource productivity', brought about by simultaneously doubling wealth and halving resource consumption. The concept was introduced in 1998, in a book of the same name written by L. Hunter Lovins and Amory Lovins of the Rocky Mountain Institute, and Ernst von Weizsäcker, founder of the Wuppertal Institute for Climate, Environment and Energy.

There seems to be a lack of focus upon resource efficiency along the lines of Factor 4, despite plenty of examples of positive programmes and projects being introduced. BASF have even launched their own product eco-efficiency labelling scheme. As a supplier of 8000 products to other businesses this could have a profound effect for environmental engagement between businesses. Other examples include the following:

- The American Society of Heating, Refrigerating and Air-Conditioning Engineers (ASHRAE) has published a report focusing on the design, construction and operation of sustainable buildings;

- Green buildings can improve the bottom line, says a report in the Building Design and Construction (BD+C) entitled *Green Buildings and the Bottom Line*. This contains an examination of progress in the building of green homes in the US. The details of the financial implications of sustainable building are covered in this comprehensive report, which shows that the predictions of high costs of sustainable design did not come true;
- A number of studies have confirmed that the premium for sustainable designs is actually quite low, and that this investment can be paid back in a few years through lower energy costs and other savings. Another report indicated that, in late 2003, the Massachusetts Technology Collaborative (Kats, Gregory 2003) surveyed 33 LEED buildings across the US and the findings showed an average premium of just 1.84% for a sustainability designed building (GLOBE-Net, 17 December 2006);
- Intel has said they will begin eliminating 95% of the lead it uses in processors and chipsets;
- The Japanese economy is famous for its prudent use of raw materials through processes like miniaturisation, and philosophies like Kaizen which sees any waste as an indication of inefficient management;
- A coated board mill in Alabama, Mead Westvaco's Mahrt, has worked to reduce:
  - Nitrogen oxide emissions by 95% through a Predictive Emission Monitoring System;
  - Opacity emissions by 35%;
  - Solid wastes by better landfill management, which has increased landfill life by 30% while reducing the budget by 50%;
  - Fibre loss by 20 tons per day, which has resulted in substantial financial and fibre supply benefits for the division;
  - Landfilling sludge by finding alternative uses for it, including transformation into roofing felt;
  - Wastewater below permit limits and increased compliance margins;
  - Pulping chemical losses to wastewater through efficient recovery for other uses; and
  - Annual water use while increasing tons of paper produced.
- Office Depot has customised its 'Green Book' catalogue of environmentally preferable products in six country specific versions;
- Wal-Mart Stores says it plans to begin implementing its 'Preferred Chemical Principles' to establish a clear set of preferred chemical characteristics for product ingredients; and
- Xerox Research Centre of Canada and Palo Alto Research Center Inc. (PARC) scientists have invented an 'erasable paper' whose images last only a day, so that the paper can be used again and again. The technology could ultimately lead to a significant reduction in paper use as two out of every five pages printed in the office are for 'daily' use, like emails, web pages and reference materials that have been printed for a single viewing.

These seem to be win/win situations and must be highly motivational for the staff involved in the processes. The continued improvements to the Mahrt

operation have had a great influence on increasing production while reducing the mill's environmental impact (World Business Council for Sustainable Development (WBCSD) 'MeadWestvaco: environmental opportunities add business value', 2 April 2004: [www.wbcds.ch](http://www.wbcds.ch)).

## Resource usage risk – energy

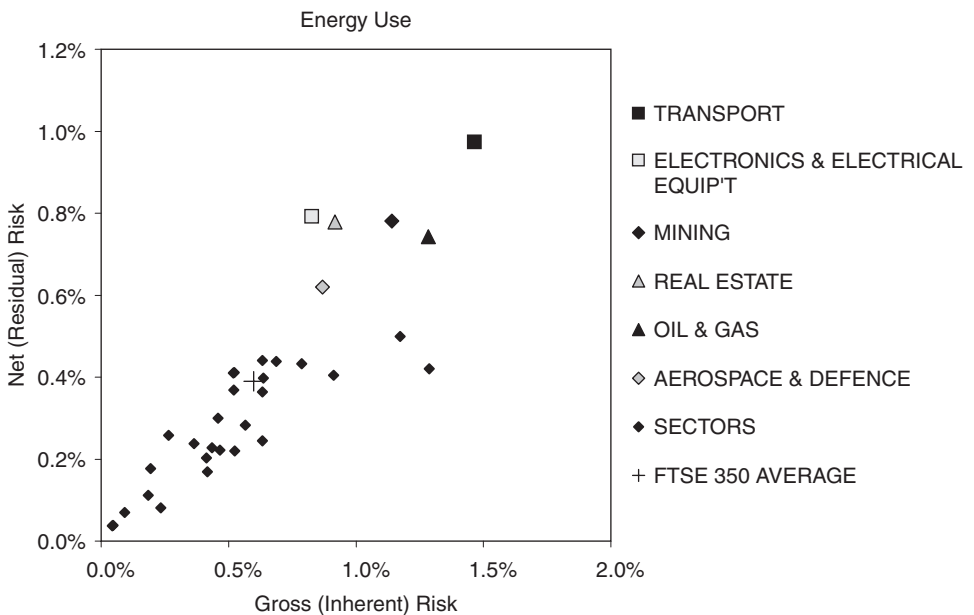
Research and analysis into energy use risk indicates that:

- Energy use risk is 0.4% of market value of the top 500 EU and US companies; and
- This risk exposure has been reduced from 0.6% of market value by good risk management techniques (the risk reduction/management factor).

Energy use is divided into the following three categories:

- Direct consumption: the volume of energy used by the company in its own production process;
- Indirect consumption: the volume of energy used by the supplier of energy in its production process; and
- Aggregate consumption: the above two categories combined – a measure of the overall energy consumption of the production process. Aggregate consumption measures energy efficiency per unit of sales.

The graph below shows the environmental risk (net) from energy resource usage by sector.



## *Case studies*

These risks include the spiralling cost of energy fuels as consumption growth in Asia increases rapidly and the Middle Eastern security situation deteriorates. World energy demand is expected to increase by 50% by 2030. For example, in 2004 China will install generating equipment equivalent to the entire UK capacity of 42 gigawatts. China is also set to become a net importer of coal in 2004 and double its percentage of total world oil consumption from 5 to 10% by 2010.

There is an increased trend in labelling the efficiency of products in order to compare the indirect energy use of companies. This is becoming a source of comparison between competitors, and some companies are using this to their advantage.

There are the Energy Star, the Energy Efficiency Awards and the European Energy Label, as well as a range of European country labels for consumers to make informed choices about the environmental damage some products can do. This level of measurement has been extended to cars and is now making progress in the energy efficiency standards for dwellings and service sector buildings. Other countries (e.g. Singapore, the Philippines, etc.) establish mandatory or voluntary standards for service buildings. It is also expected that there will be an integration of renewable and micro-power systems into the building codes making small buildings subject to more complex performance-based building codes.

## *Risk management*

Examples of positive risk management programmes and projects include the following.

Improved management performance systems alone can have large benefits like:

- A UK-based consultancy, Cogitare, who have helped reduce future tube energy consumption by 5.2 billion kWh by working with London Underground and Metronet to optimise existing systems and planned upgrades which will deliver new, faster and more frequent trains. The winners are the UK tax payer, London Underground passengers and the planet;
- BT plc consumes approximately 1.8% of non-domestic electricity, making the company one of the largest consumers of electricity in the UK. BT started to address their energy risk issues in 1986 and claim to have saved £100 million in the last decade, also reducing CO<sub>2</sub> emissions by 40%. They have an adventurous target of an additional cut of 25% of energy consumption by 2010. To date they have managed their risk by implementing the following schemes:
  - Commitment to sourcing 10% of their energy needs from renewable sources by 2010;
  - Use of fresh air-cooling systems as replacements for chemical-based refrigerant systems; and
  - Supporting innovative renewable energy initiatives, with plans to scale up any successful trials.

- Their progress in the 2004 financial year has been good with a reduction of 1.5% in total electricity consumption to 2074 GWh (*BT Society and Environmental Report 2004*: [www.btplc.com](http://www.btplc.com)).

Rethinking existing processes:

- Going carbon neutral: the UK-based insurer Aviva has cut building and travel-related carbon dioxide emissions by 54% since 2002. It currently has 64% of electricity obtained from zero emission sources and Aviva will offset the remaining emissions by purchasing carbon credits that support tree planting and carbon-free power sources such as solar and wind, thus becoming carbon neutral;
- The largest US meat producer, Tyson Foods Inc., produces 2.3 billion pounds of animal fat a year and now thinks this could be turned into fuel, 'We believe it's a win for our energy independence, it's a win for our environment, and we believe it will be a big win for our shareholders as well', said Jeff Webster, an official with the company's Corporate Strategy and Development team;
- Some construction companies have begun to realise the competitive advantage environmental health and energy efficiency can bring and the otherwise similar products of bricks and mortar. John Laing Homes in the US has designed their houses to make more use of natural ventilation and central vacuum systems that lower allergen levels;
- Royal Dutch Shell is investing US\$6 billion in a technology which converts natural gas into clean fuels. The company announced an agreement with the Egyptian Oil Ministry to build a large-scale gas-to-liquids plant. The 75 000 barrel-per-day facilities, along with a similar plant in Trinidad and Tobago, will help increase Shell's lead in new fuels development (*The Times*, 6 October 2000); and
- Local authorities can often set the pace on environmental issues and a good example of this is that Woking Borough Council operates the largest fuel cell in the UK at 250 kW.

Renewable energy continues to gain in popularity:

- The wind power capacity of the US surged 27% in 2006;
- Cleantech Venture Network LLC says investment by North American venture capitalists in renewable fuels and other so-called clean technologies had their ninth consecutive quarter of growth, a 10.8% rise over the previous quarter, and a 120% increase over the same quarter last year and reached a year-to-date total of \$2.29 billion;
- The Worldwatch Institute and the Center for American Progress say that many of the new technologies that harness renewable power are, or soon will be, economically competitive with fossil fuels. In 'American Energy: The Renewable Path to Energy Security.' (Worldwatch Institute and Center for American Progress. September 2006 [www.worldwatch.org/node/4405](http://www.worldwatch.org/node/4405));
- Google will house the largest corporate solar installation in the US;
- Texas built more renewable energy capacity in 2001 than in the previous century. This amounts to more than 1000 MW;



- Even the oil state has been trumped by Los Angeles City Council, which has plans to source 50 000 MW/year from renewable energy;
- Australia will build the world's biggest solar power plant amid warnings of blackouts within five years unless it can increase electricity generation to meet growing demand for air conditioners;
- In Spain solar panels are now compulsory on all new and renovated buildings as part of the country's efforts to bring its building rules up to date and curb growing demand for energy;
- All but four of the US states now have incentives in place to promote renewable energy; and
- Ted Turner plans to partner with Dome-Tech Solar (a leading solar energy developer), based in New Jersey, to create DT Solar, a Turner renewable energy company.

#### Energy efficiency:

- The carbon trust ([www.carbontrust.co.uk/energy](http://www.carbontrust.co.uk/energy)) say they can save UK companies between 10 and 30% of energy bills annually;
- General Motors has reduced its energy use by 25% and added solar and landfill gas as energy sources over the past five years;
- Philips Semiconductors estimate they can save around 8% of their electricity bill simply by adjusting the time schedule settings on their air conditioning; and
- A football team in the UK saved 12% of their annual costs after repairing plant equipment, insulating valves and pipes, installing draught proofing, energy efficient lighting and reducing the base electrical load.

## Resource usage risk – natural resources and land use

### *Risks resulting from damage of land resources*

Results of research and analysis indicate that:

- Natural resources usage risk is 0.4% of market value of the top 500 EU and US companies; and
- This risk exposure has been reduced from 0.7% of market value by good risk management techniques (the risk reduction/management factor).

This is concerned with the ethical issues surrounding natural resources, such as animal testing and genetic manipulation of life forms. It covers the major impacts on biodiversity associated with the organisation's activities and/or products and services, including:

- Land ownership and usage;
- Degradation of natural habitats resulting from the organisation's activities;
- The number of IUCN Red List species with habitats in areas used or managed by the organisation; and
- Land stewardship through ownership, renting or business partners.

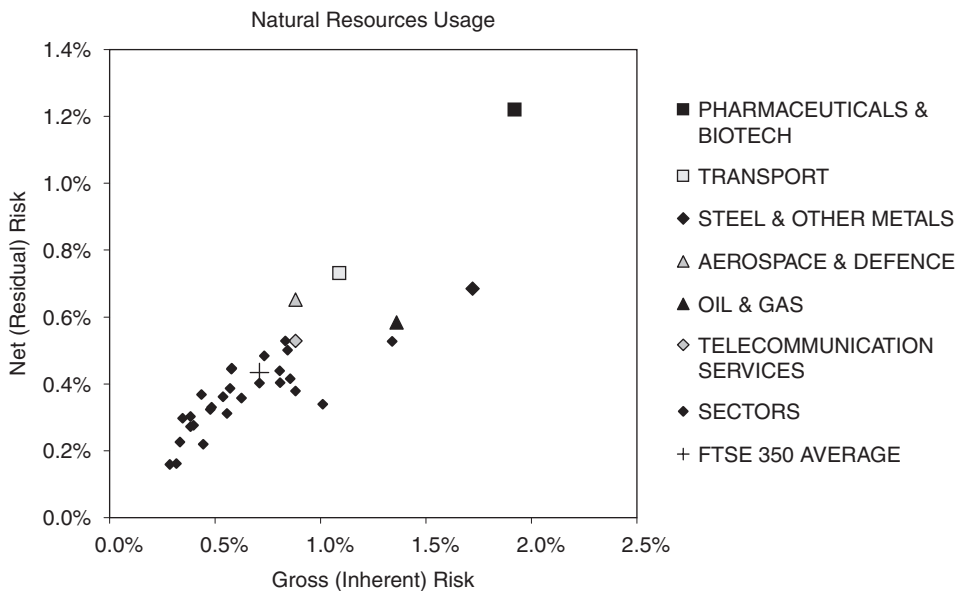
### Biodiversity

The variety of organisms found within a specified geographic region and in totality the variety of life forms on the earth.

### Biocapacity

An example of the excess of societies in terms of their capacity to be sustainable is defined by the European Union's 'ecological footprint' methodology. This estimates the EU is using more than twice its own biocapacity. The term 'ecological footprint' refers to a measurement of human resources that compares the rate the planet is using its resources with its ability to renew them. Europe is consuming 4.8 hectares per capita a year (its footprint) but its capacity to regenerate is only 2.2 hectares per capita, leaving it running at a 'deficit' of 2.6 (WWF *Living Planet Report 2006*, October 2006: [http://assets.panda.org/downloads/living\\_planet\\_report.pdf](http://assets.panda.org/downloads/living_planet_report.pdf)).

The following graph shows the natural resources usage risk by sector.



It is no great surprise that the pharmaceutical industry has a high risk exposure to elements of this risk category through risk linked to animal testing. But there are other instances of risk from product liability such as:

- The anti-inflammatory drug (Diclofenac) is given to cattle and is alleged to be responsible for the death of 10–14 million vultures in India, Nepal and Pakistan. This rate of destruction at 30–50% of the species population per year has been described as 'the most significant conservation disaster ever in terms of the number of birds lost,' according to Jemima Parry-Jones of the US National Aviary.

The food industry is also facing particular shortages as it is estimated that:

- Fish stocks worldwide are in serious decline: 48% are fully exploited, 16% overfished, and 9% depleted, according to the United Nations Food and Agriculture Organisation (FAO);
- Overfishing threatens 20% of the world's 547 shark and ray species with extinction (World Conservation Union – IUCN); and
- All species of wild seafood that are currently fished are projected to collapse by the year 2050, according to Dalhousie University. The scientists warn that the loss of biodiversity is reducing the ocean's ability to produce seafood, resist diseases, filter pollutants, and rebound from stresses such as overfishing and climate change (Environmental News Service, 6 November 2006).

Habitat loss from deforestation, desertification and salinisation already has a significant impact on the rate of extinctions of species, some of which are vital for our survival. Bird extinctions are running at 50 times the natural rate due to habitat loss and other consequences of human activity (*State of the World*, 2003). Desertification is a particularly serious problem in some regions of the world. About 17.5% of China is desert. This figure has been increasing by 2640 square kilometres every year. The pressure upon this limited resource is mounting and the indirect impacts upon business costs will also increase exponentially.

Land resources are protected by law from the impact of environmental incidents in several ways: for example, internationally with treaties and conventions extend to the protection of various sites (including waterfowl habitats), while in the UK there are Sites of Special Scientific Interest (SSSI) which have been designated to protect over 6000 sites which have a higher value than their market land valuation.

In the US there is the potential for increased environmental liabilities from Natural Resource Damages (NRD) as defined in CERCLA of 1980 (the superfund law) and the Oil Pollution Act of 1990 to include land, fish, wildlife, biota, air, water, ground water and drinking water. Compensation for NRD is separate from the costs of clean-up and recovery and costs associated with the protection of human health or compensation for the lost use of that resource. Most settlements related to pollution cases have not addressed NRD issues, and cases could be reopened to obtain further compensation (Donnellon and Rusk 2005).

The challenge is that in economics rarity = increase in value/price which does not bode well for endangered species. An example is that the once common Scottish river muscles were almost taken to the edge of extinction as their natural river pearls became highly prized. They have now had to become a protected species as market forces made their pearls' rarity even more prized and therefore spelt their doom unless legislated against.

There are the beginnings of moves to properly quantify the value of the 'natural' world to human society and economic systems. An example of this is recent research that boreal forests provide US\$250 billion a year in equivalent ecosystem services, like reducing atmospheric carbon and water filtration, but these values are not largely acknowledged by governments and business.

## *Biodiversity and extinctions*

Human-caused extinctions have been estimated to range from 600 a week to as many as 120 000 species being lost a year in *The Sixth Extinction*, according to Richard Leaky and Roger Lewin 1995, p. 241. Many species have already been lost from the ‘developed world’ including the eastern mountain lions (as late as 1890 there was a bounty on them in New York state), the southern states warbler (Bachman’s warbler) and the Carolina parakeet. Where humans go large-scale extinctions occur; in North and South America at least three-quarters of large species died when humans arrived. North America lost over 30 genera of large animals. Globally there are only four land animals weighing over a tonne now, elephants, hippos, rhinos and giraffes.

Organisations can assist with the reduction of their contributions, directly and indirectly, to the damage caused to flora and fauna and their habitats. The rate of species loss is estimated to be as high as 120 000 lost forever each year; our personal and organisations’ activities help this rate of species loss.

## *Resource and nature conservation*

These risk issues are not just about reducing and protecting against species loss but of efficient and responsible, even respectful use of the natural world around us. There are short and long term benefits to be obtained, other than just compliance with laws. These might be the: avoidance of public relations disasters, staff morale benefits and even the more creative and considerate of land stock can have unforeseen benefits. Potential projects to change organisations’ views of their relationship with the natural environment might range from businesses and schools establishing their own kitchen gardens (and finding this has cost, health and social benefits) to the purchase of large areas of land for setting aside as preserved areas.

EC laws include the 1979 Conservation of Wild Birds and 1992 Conservation of Natural Habitats Directives. The signature countries to the 1992 Convention on Biological Diversity should have developed national biodiversity action plans, which should outline which species and habitats are protected within nations and therefore within the areas relevant to your organisations’ countries of operation. Examples of organisational risk include:

- There has been refusal to allow renewable energy barriers (like the Cardiff Bay barrage project) to be built as although there would be numerous benefits these were weighed up to have been exceeded by the damage to natural resources once these had had a value attached to them;
- Several deep water ports have been denied as these were seen to cause direct and indirect damage to nearby conservation and protected areas;
- Australia and New Zealand went to court and brought a claim against Japan for breaching of a fishing treaty protecting the southern bluefish tuna;
- The US imposed import restrictions on tuna over concerns about the incidental effect on dolphin populations of tuna fishing methods. The US also required any country exporting shrimps to the US to prove that their harvesting methods did not endanger sea turtles;

- Elephants are protected under Nepali law, which provides for jail sentences of up to 15 years for killing one, since Nepal's elephant population has dwindled to about 100; and
- The Indian Wildlife (Protection) Amendment Act 2006 came into force in September and aims to save the big cats, whose numbers have fallen alarmingly because of poaching and encroachment of communities and businesses into their territory.

## *Landscape management*

This is the preservation of a particular distinctive landscape or landscape type and can even involve the preservation by law of individual trees that contribute to visual benefits within an area. There are a range of national designations ranging from National Parks to UNESCO protected heritage sites, through to environmentally sensitive sites, or areas which have particularly beautiful, aesthetic, or scientific value:

- Wind farms are having planning consent denied as they will have impacts in visually important areas.

## *Contaminated land*

Contaminated land has been recognised as an important area of risk in most jurisdictions. The UK's Environmental Protection Act 1990 (EPA 1990) has led to contaminated land becoming a prominent legal risk for organisations. There is now retrospective liability for the pollution, and use, of (ownership or occupation of) contaminated land. Section 78A(2) of the EPA 1990 defines contaminated land as land which appears to be in such a condition, by reason of substances in, on or under the land, that:

- Significant harm is being caused or there is a significant possibility of such harm being caused; or
- Pollution of controlled waters is being, or is likely to be, caused; and
- The guidance in support of EPA 1990 Part IIA defines what 'significant harm' is as follows:
  - Human beings: death, disease, serious injury, genetic mutation, birth defects or the impairment of reproductive functions;
  - Living organisms or ecological systems: an irreversible or other substantial adverse change in the functioning of the ecological system or harm which affects any species of special interest within that location and which endangers the long-term maintenance of the population of that species, at that location;
  - Property (i.e. crops, domestically grown produce for consumption, livestock, game, other owned animals, etc.): substantial diminution in yield or loss of value due to death, disease or other physical damage; and
  - Property (i.e. buildings): structural failure, substantial damage or substantial interference with any right of occupation.

If land is deemed to be contaminated in accordance with EPA 1990 Part IIA, the ‘appropriate person’ is required to bear the cost of remediation for the land. The appropriate person is in the first instance the person who caused or knowingly permitted the contamination to occur. If that person cannot be identified, the current owner of the property may be required to accept responsibility for the contamination.

Following identification of ‘contaminated land’ and the ‘appropriate person’, the local authority within whose area the contaminated land has been discovered must serve an identification notice and, if voluntary remediation is not forthcoming, a remediation notice upon that appropriate person.

The impact that new and historic land contamination will have upon the value of the property is increasing. The UK contaminated land regime although important is dwarfed by the scale of the US\$274 billion superfund clean-up agreement. The overall effect is that organisations must increasingly consider the costs involved in remediation of land in respect of which they are deemed to be the appropriate person. These costs can have a significant impact upon cash flow and budgetary plans for those organisations that intensively utilise land resources, i.e. house-building. If required to remediate land, there is also the risk that the premises will be temporarily shut down or restricted until the necessary remedial works are completed.

## Case studies

- GlaxoSmithKline plc: the head of GSK, Jean-Pierre Garnier, has warned that attacks by animal rights extremists are damaging the sector by driving away research (*Financial Times*, 28 July 2004). This follows on from protests forcing RMC plc (the world’s largest concrete company) to withdraw their involvement from a controversial laboratory project. A firebomb has already caused £150 000 worth of damage and was ‘putting lives at risk’. The Oxford University scheme has become the focus of attacks by the Animal Liberation Front (*Financial Times*, 21 July 2004);
- Reckitt Benckiser: there have been several pollution incidents and there are concerns over the level of animal testing the company conducts. There is a product boycott call on the company’s products from PETA;
- John Lewis Partnership plc: Greenpeace unveiled that Waitrose was stocking illegally fished toothfish. Illegal fishing in the area of the Southern Ocean was said to have drowned 15% of some albatross species and the extinction of the toothfish was to be expected soon, should the fishing continue;
- Earth Matters reported that Friends of the Earth was targeting Homebase for selling peat-based garden products, which threaten previous wildlife habitats in the UK and Ireland;
- Unilever have won accolades for their approach to sustainable fisheries; however, they are alleged to use large volumes of phthalates, which is of concern due to the toxicological potential of DEHP and DBPs. There are also concerns over animal testing, and that they are members of the pro-GM lobby group Europabio; and

- Two college researchers recently presented evidence that the tobacco industry, particularly Philip Morris, experimented with genetically engineered tobacco as early as the 1980s in an effort to control nicotine levels in cigarettes (*Monterey County Herald*, 21 November 2002).

## *Risk management*

Companies should also consider the effect that being identified as an appropriate person (for remediation liabilities) could have upon both their reputation and the future marketability of both the business and the land in question. It is vitally important that a company considers contaminated land issues every time it buys or sells property to ensure that the attendant risks are adequately dealt with at the pre-contractual stage and in any resultant documentation.

There is the potential for large-scale, high profile projects that benefit the environment and the reputation of the organisations involved. An example is that Goldman Sachs have purchased large tracks of land where species have become endangered and the United Nations and Africa's Nobel laureate, environmentalist Wangari Maathai, have launched a project to plant a billion trees worldwide to help fight climate change and poverty.

To ensure the use of renewable supplies of wood and the preservation of natural forests, British American Tobacco has since the 1970s sponsored and promoted the planting of over 250 000 hectares of managed renewable woodlands worldwide, the equivalent of 550 million surviving trees. The scale of the woodlands effectively means the group is responsible for one of the world's largest tree-planting operations outside the timber and paper industries (*CSR 2003*, p. 90).

Royal Dutch Shell publicly reports on all its activities in IUCN category 1–4 protected areas, and Rio Tinto incorporating biodiversity into its risk assessments for all primary and secondary impacts of projects.

Bryant Homes downed tools after the discovery of slow worms on a development (*Birmingham Evening Mail*, 20 June 2003, pp. 1, 3).

## Resource usage risk – waste generation

Research and analysis into waste generation indicates that:

- Waste generation risk is 0.5% of market value of the top 500 EU and US companies;
- This risk exposure has been reduced from 0.9% of market value by good risk management techniques (the risk reduction/management factor); and
- There is generally better than average management of these issues in the FTSE350. This could be as a consequence of regulation of the waste disposal regime and increasing costs of disposal.

This risk covers the total amount of waste produced, and the destination of such waste. The raw material section above covers the inputs to the organisation

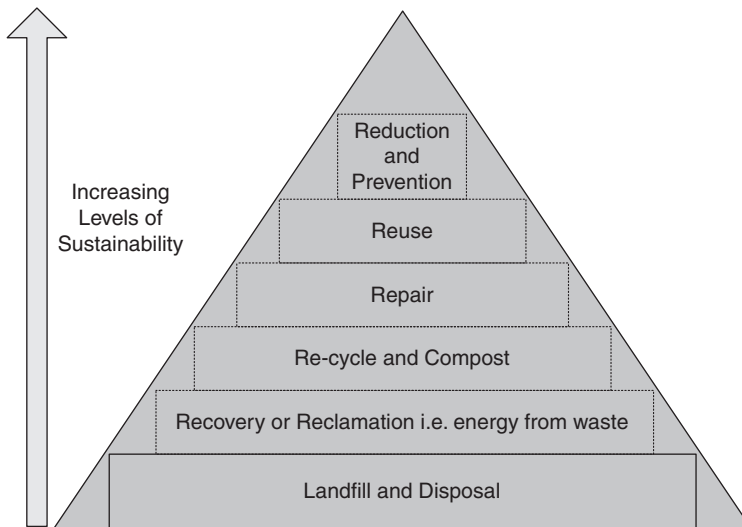
and this section covers the outputs. 'Destination' refers to the method by which waste is treated, including:

- Composting;
- Reduction; reuse; repair; recycling; recovery (the five Rs of the waste hierarchy explained below);
- Incineration; and
- Landfilling.

Managing the production and disposal of waste is one of the most significant environmental challenges facing organisations. In the UK alone there are almost 450 million tonnes per annum produced. Largely waste volumes are produced by a few sectors (the primary sectors), including the agricultural, construction and mining sectors which utilise natural resources to the fullest extent.

The method of disposal varies in each country but some are very dependent on landfill disposal of waste and have not managed to develop more stringent waste management and reuse systems. For example, the UK recycling rates are still only about half those on the rest of the EU members.

## *The waste hierarchy*



- Reduction and prevention: the aim is to prevent the creation of waste by reducing the purchase of materials, through proper resource reduction design of products, services and buildings, etc.;
- Reuse: return materials to the process and don't allow inputs to the production system to become waste as they are then both a lost resource and expense as waste disposal is a cost base;
- Repair: reconditioning, rebuilding and repairing of materials so they are again fit for purpose;

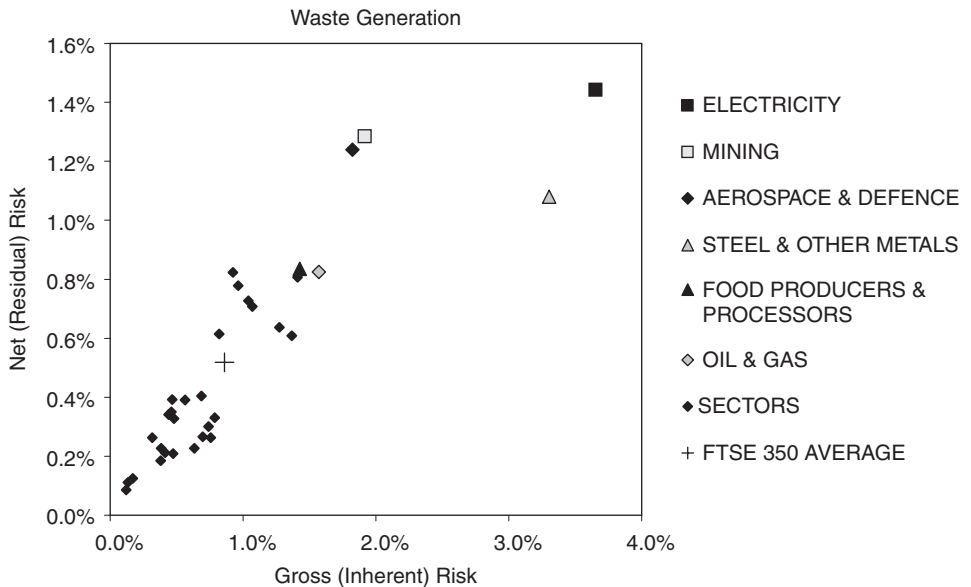


- Recycling and composting: recycling is the reprocessing of materials into new products and it prevents useful material resources being wasted, reduces the consumption of raw materials and reduces energy usage; composting is the controlled decomposition of organic matter for further use;
- Recovery or reclamation: reclaiming energy from resources by incineration; and
- Landfill and disposal: the least sustainable, although in some instances energy can be recovered from landfill sites.

There are specific risks as well like the treatment of hazardous substances defined as toxic, harmful, corrosive or irritant substances (e.g. chemicals, fuels, pesticides, radioactive or explosive substances) and as micro-organisms. Particular interest should be directed to the production, transportation method and movement of hazardous wastes. Stewardship initiatives include efforts to improve product design to minimise negative impacts associated with manufacturing, use and final disposal. Materials of particular interest are those that qualify as ‘hazardous’, ‘explosive’, ‘oxidising’, ‘highly flammable’, ‘flammable’, ‘irritant’, ‘harmful’, ‘carcinogenic’, ‘corrosive’, ‘infectious’, ‘teratogenic’, ‘mutagenic’, ‘toxic’ or ‘ecotoxic’.

The best method of dealing with waste is of course reduction. This involves the clever use of purchasing techniques to reduce the level of inputs into an organisation, thus reducing waste by default. In the Japanese business philosophy of Kaizen, any waste is, in effect, a paid-for resource which was surplus to requirement; i.e. an inefficiency which has to then be avoided.

The graph below shows the environmental risk (net) from waste generation by sector.



## Case studies

In the EU, two-thirds of waste is landfilled, whereas waste recycling rates have shown a rather limited increase over the recent years. The EU is now pursuing a

policy of landfilling waste only as a last resort. Waste that cannot be recycled is planned to be incinerated and this will cause its own repercussions. Land contamination is reviewed in depth under the historical liability section. Raw material reductions (the minimisation of waste) are considered in a previous section of this chapter. Examples of how waste disposal can go drastically wrong are:

- Airlines in the US ‘throw away enough aluminum cans every year to build 58 new 747s. It’s the same story with paper and plastic’, said Dr Allen Hershkowitz, a senior scientist at the Natural Resources Defense Council (NRDC) (Green Biz.com, 15 December 2006);
- Australians are creating a small mountain of e-waste as they discard their old computers, prompting industry calls for nationwide regulations on recycling and disposal as discarded computers and electronic goods are growing three times faster than regular waste. Official figures estimated Australia, a country of 20 million people, discarded or stockpiled a total of 8.7 million computers by the end of 2006;
- Globally the situation is severe enough as each year up to 50 million metric tons of e-waste is generated worldwide. To meet this risk the representatives of 120 governments are pledging to fight the rising tide of electronic waste, or e-waste, with projects to take back obsolete electronics and with ‘urgent action’ to fight illegal e-waste traffickers (Nairobi, Kenya, 4 December 2006, from Environmental News Service);
- A London-based multinational commodities company is facing a £100 million claim for compensation over allegations that it arranged to dump 400 tons of toxic waste in Ivory Coast, causing the deaths of 10 people and injuring up to 100 000 (*The Independent*, 10 November 2006);
- Britain’s government has told supermarkets and food producers to do more to cut the volume of food waste and packaging or they could face regulation that would force them to do so;
- New technology will increasingly be used to find non-compliance and to detect leaks and illegal waste sites. An example is that the Japanese Ministry of Environment is developing a radar-based search technology deployed in helicopters to detect waste like metal, wood or sludge by using radar; and
- Shell’s Brent Spar oil platform in the North Sea had its disposal at deep sea approved by the UK government and only considered other waste management options (recycling in Norway) after a highly public campaign by an NGO.

## *Legal risks*

European laws on waste management are based around principles for licensing and inspection regimes to ensure there is no harm, primarily to human health, and generally to the environment. In the EU there are frameworks on general waste (75/442) and hazardous waste (91/689). There are more detailed directives on a range of other waste streams including: electrical equipment, hazardous wastes (like batteries, titanium dioxide and PCBs), incineration, landfill, packaging, vehicles, waste oils and integrated pollution prevention.

Under waste disposal rules covering waste transport, treatment and disposal, a company faces a set fine. However, the trend is towards changing a percentage of profits or turnover. At present, EPA 1990, Section 34 places a statutory duty of care upon anyone who produces, keeps, treats, carries or disposes of ‘controlled waste’:

- Household waste: means waste from domestic property (including caravans and residential homes); premises forming part of an educational establishment; or hospital or nursing home;
- Industrial waste: means waste from any premises used as a factory; for the provision of public transport services, the supply gas, water, electricity, postal, telecommunications services or sewerage services;
- Commercial waste: means waste from premises used wholly or mainly for trade, or for the purposes of sport, recreation or entertainment; and
- ‘Special waste’: mean waste under the following headings – ‘explosive’, ‘oxidising’, ‘highly flammable’, ‘flammable’, ‘irritant’, ‘harmful’, ‘toxic’, ‘carcinogenic’, ‘corrosive’, ‘infectious’, ‘teratogenic’, ‘mutagenic’, ‘toxic’ or ‘ecotoxic’. These types of waste have specific and more stringent provisions applying to their storage, handling and transportation.

Under UK law a company should identify the types of waste it generates and the specific hazards associated with each type. Individual waste streams should then be properly labelled so that they, and the dangers they pose, are clearly ascertainable. When a company transfers its waste to a waste management company, it must provide the person to whom the waste is being transferred with a written description of the waste. The company must keep a copy of this written description, together with a written note recording the transfer, for a period of two years after the transfer.

## *Waste packaging*

Packaging and packaging waste: the Producer Responsibility Obligations (Packaging Waste) Regulations 1997. This involves the obligations of those who manufacture packaging, manufacture the materials for packaging or sell the packaging onto customers. They now have to:

- Register and supply data on volumes handled annually;
- Recover and recycle a percentage of the previous year’s production; and
- State and complete a certificate of their compliance with the previous year’s target.

If a company falls within the criteria stipulated within the UK’s Producer Responsibility Obligations (Packaging Waste) Regulations 1997 (SI 1997 No. 648) (as amended), it is obliged to recover and recycle a specific amount of its annual packaging waste and to demonstrate compliance by submitting certain information to the EA or SEPA. It will be up to each company to decide which option will allow it to manage its risk most efficiently and cost effectively. Failure to comply with these obligations can lead to criminal prosecution and the imposition of a fine.

## *Future developments: more producer responsibility for waste*

The Packaging Waste Regulations (SI 1997 No. 648) (see Chapter 18) were the first in what is likely to become a series of measures emanating from the EU based on the principle that those who produce a product should be responsible for dealing with that product at the end of its life when it becomes waste. This principle is known as ‘producer responsibility for waste’.

For example, the End of Life Vehicles (ELV) Directive (2000/53/EC), adopted in September 2000, introduces responsibility for cars and other vehicles. This directive aims to raise the recycling rate for vehicles from a current rate of approximately 75% at the start of the Directive to 85% last year (2006) to 95% by 2015. The principle is that of producer responsibility and there are restrictions on the types of materials used in construction and a ban on the use of hazardous materials to facilitate the ease of recycling.

Waste electrical and electronic equipment Directive 2002/96/EC (WEEE) and its sister directive ban the use of certain hazardous materials in electrical equipment (including heavy metals cadmium, lead and mercury, and brominated flame retardants) from 1 July 2006. These set out the criteria for: the recovery, treatment and recycling of all forms of electrical equipment. Retailers must now take back WEEE at no expense and producers have to: cover any costs of recovery and recycling; ensure products are easier to reuse and recycle; ensure products are well labelled so as to make it clear that they can be recycled and are not to be placed with general waste; and provide data of their activities with these issues with regards to volumes and types and amount recycled. The Directive (2002/96/EC) on waste electronic equipment (with an amendment 2003/108/EC) is designed to manage the rapidly increasing volume of this type of waste being sent to landfill and incineration.

Recognising that many hazardous substances are used in electrical and electronic equipment (e.g. lead, cadmium, mercury, bromine compounds, etc.), both Directives aim to minimise the impact of electrical and electronic equipment on the environment during both their working life and when they enter the waste stream. The WEEE Directive sets collection, treatment, recycling and recovery targets for a wide variety of waste electrical and electronic equipment. Producers of the relevant electrical and electronic equipment will become responsible for financing most of these activities although, in the case of commercial electrical and electronic equipment, they will be able to pass on these costs to the business user.

Accompanying the WEEE Directive, the Restriction of Hazardous Substances Directive 2002/95/EC (RoHS Directive) seeks to restrict the use of various hazardous substances in new electrical and electronic equipment. From 1 July 2006, the sale of new products in the EU which contain more than agreed levels of certain prescribed substances have been banned unless their use falls within one of the small number of exempted processes where the use of these substances is permitted until alternatives are found.

The UK government transposed both Directives into UK law by 13 August 2004. The DTI have thus far carried out two consultations (which ended 30 May 2003 and 1 March 2004) in respect of the government’s approach to

implementing both Directives. A third and final consultation ‘took place’ in May 2004 with the proposed draft regulations soon to be published.

There has been quite a strong legislative response from both the UK government and the EU on the issue of waste management due primarily to the toxicity and harmful nature of much of the waste. Radioactive materials and flammable or harmful substances even have their own legislation managing their use and disposal. For example, the Control of Asbestos at Work Regulations 2002 (SI 2002 No. 2675) introduced a new duty on (a) employers and (b) the owners or occupiers of non-domestic premises who have a duty to maintain and repair those premises.

Enforcement actions seem to be slightly lacking in force, and finding those who are responsible can prove difficult. This situation is set to worsen without stronger sanctions. At the moment many hazardous waste treatment sites are said to be failing to meet management and operational standards, as the Environment Agency and the Health and Safety Executive noted that the industry does not give ‘high enough priority to health and safety and environmental considerations’ (*ENDS Report*, issue number 351, April 2004 quoting *Hazardous Waste Storage and Treatment Facilities 2002/3: Report on a Joint Enforcement Programme*).

There will be increased liability for control of chemicals due to the European Commission concluding that reform of the chemical regulation legislation was necessary as the number of chemical substances was reported as 100 106 in 1981. It is estimated that over 30 000 of these are currently marketed in volumes starting at 1 tonne per year. Approximately 140 of these substances have been identified as priority substances and are subject to comprehensive risk assessment carried out by member state authorities under Regulation (EC793/93). The EU White Paper intends to bring new and existing chemical substances under a unified regime called REACH (Registration, Evaluation and Authorisation of Chemicals). The new regulatory approach will not only impact the chemicals industry, but also anyone who imports anything considered as chemicals (such as printer ink cartridges). In the coming 10 years this is expected to cost the industry more than €3000 million.

The regulation replaces 40 legislative texts that now govern chemicals in the EU and is a new regulation for 30 000 chemicals which will oblige producers to register all chemical substances produced or imported above a total quantity of 1 metric ton per year. European Parliament President Josep Borrell said that REACH was,

one of the most complex texts in the history of the EU, sets up an essential piece of legislation to protect public health and the environment from the risks of chemical substances, without threatening European competitiveness. It offers EU citizens true protection against the multitude of toxic substances in everyday life in Europe.

The government also see REACH as a vital element in the EU’s attempt to meet the target set at the World Summit on Sustainable Development in Johannesburg in September 2002:

To achieve by 2020 that chemicals are used and produced in ways that lead to the minimisation of significant adverse effects on human health and the environment, using

transparent science-based risk assessment procedures and science-based risk management procedures, taking into account the precautionary approach. (See [www.defra.gov.uk/corporate/consult/reach/consultation.pdf](http://www.defra.gov.uk/corporate/consult/reach/consultation.pdf) – UK Consultation Paper on the New EU Chemicals Strategy – REACH)

## *Risk management*

An organisation should ensure that all waste generated in the course of its activities is stored, handled and transported safely. All waste should be securely stored to prevent leakage and pollution, and to ensure that it neither causes litter nor is susceptible to fire or vandalism.

You should identify the types of waste you generate and the hazards associated with each type and then the individual waste streams should be properly labelled. When you transfer waste to a third party, you must provide the person/organisation with a written description of the waste. Your organisation should keep a copy of this written description, together with a written note recording the transfer, for a period of two years after the transfer. Ensuring that third party waste brokers also have the appropriate registrations with licensing bodies is important, as it is now an offence in an increasing number of countries to arrange for disposal of waste with unlicensed third parties.

One example of a positive risk management programme is Philips forging ahead with their eco-design programme. The Dutch electronics giant are steadily increasing the number of their ‘green flagship’ products which are designed to have significantly better environmental performance than their predecessors or those of competitors. For example, the company plan to phase out the use of the brominated flame retardant TBBA in printed wiring boards by 2006 and looks set to cut packaging by 10% over four years. Other examples of their eco-design philosophy include the following:

- Their flat-screen liquid crystal display televisions have an ‘active control’ feature, which detects how much light is in the room, and controls light output accordingly. Some models have at least 40% lower energy consumption per year than their major competitors;
- By substituting plastic components with metal parts, one of their DVD players, for example, is ‘20% more recyclable’ than its closest commercial competitor; and
- The company has phased out its use of lead, mercury, hexavalent chromium, cadmium and two classes of brominated flame retardants – polybrominated biphenyls (PBBs) and polybrominated diphenyl ethers (PBDEs), in line with the requirements of the EU Directive on the restriction of hazardous substances in electronics.

Other examples of what can be achieved are that:

- BT plc have managed to reduce their level of waste to landfill down by 10 201 tonnes while increasing the percentage of total waste which is recycled up to 26% (*BT Social and Environmental Report 2004*); and
- Both Coca-Cola and PepsiCo have promised to work with competitors toward setting beverage container recovery goals.

## Resource usage risk – water use

### *Risks resulting from water resources and contamination of water*

Research and analysis into water use risk shows that:

- Water use risk is 0.2% of market value of the top 500 EU and US companies; and
- This risk exposure has been reduced from 0.3% of market value by good risk management techniques (the risk reduction/management factor).

At present, around 40% of the world's population is experiencing regular shortages of drinking water. A recent study predicted that over the next quarter century, two out of three people would be faced with regular depletion of drinking water supplies. By 2025, about 60% of the world's people will be living in water stressed countries. Industrial development is one of the major factors driving increasing water demand. While agricultural water use currently tops the list, this will change as developing economies increasingly choose industry over agriculture in pursuit of economic growth ('No water, no business', WBCSD, 19 October 2006).

At the same time as restricted supply and increasing demands there will be further demand pressure as global warming is expected to raise the global average temperature by 1.4–5.8 degrees by 2100, thus further increasing demand upon a scarce resource.

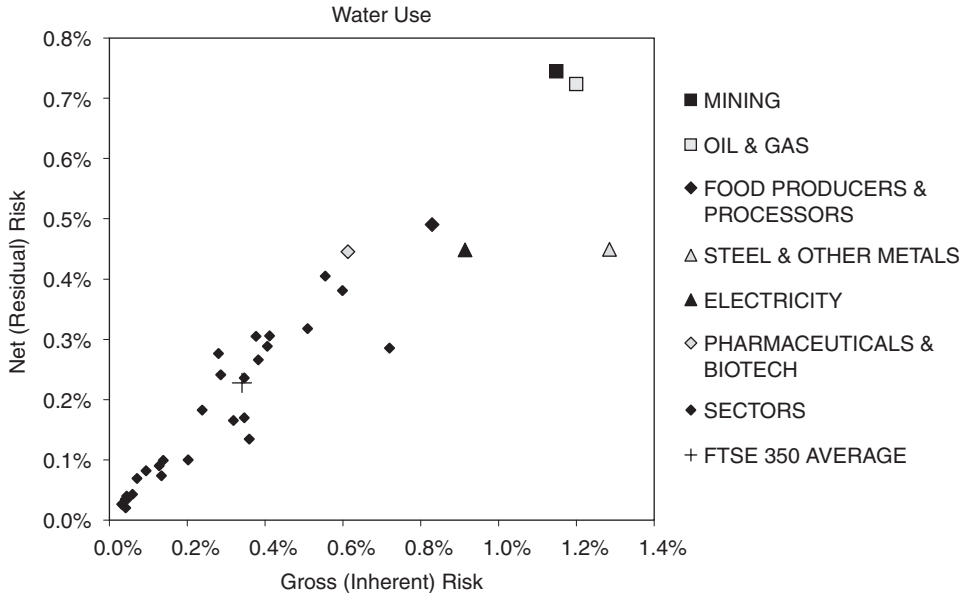
The nature of changes now occurring simultaneously in the global environment, their magnitudes and rates are unprecedented in human history. The Canadian Environment Minister David Anderson said that global warming posed a greater long-term threat to humanity than terrorism because it could force hundreds of millions from their homes and trigger an economic catastrophe.

Natural disasters caused by extreme weather, including heatwaves and tornadoes, claimed more victims in 2003 than the previous year and the trend is set to continue. Disruptive environmental changes include surging urban populations, wild weather patterns, depleting fish stocks, diseases and water scarcity. Environmental changes are also seen as a trigger for conflict ('Environment looms as major security threat', *World Environmental News*, 1 March 2004).

The WBCSD report entitled *Business in the World of Water* ([www.wbcsd.org](http://www.wbcsd.org)) highlights that water crisis can hit all businesses not just those in the water supply business. Additional findings include:

- Water issue and sourcing complexity will drive up business operating costs;
- Businesses cannot survive in societies that thirst; and
- Businesses can be part of the solution and depend on their ability to engage.

The graph below shows the environmental risk (net) from water usage by sector.



The sector-ranking graph highlights some heavy water users.

- The food producers and processors in this sector include drink makers;
- Natural resource extraction industries can use large amounts of water in their processes. Oil and gas and affiliated activities can use large amounts of water but the risk is similar to the mining sector in that these activities often occur in water stressed areas, or where extraction can adversely affect the local environment;
- Mining operations can use vast amounts of water for cutting softer gravels away from faces and in separation processes, the sector's aggregated usage figures can also mask hit usage in countries where water is a very limited commodity; and
- The water sector has always been directly linked to the use of water as one of its primary roles is to deal with others' water emissions, much of which is polluted. However, there are extensive fines from the Environment Agency against water companies and they can often run into conflict of interest with competing risks on each side. An example of this is ScottishPower who own PacifiCorp in the US, where an Indian tribe are complaining that the company's dams are destroying their sacred river and fish populations. They have even taken their struggle to ScottishPower's annual general meeting (AGM) (*The Guardian*, 'US tribes dance to shame ScottishPower', 24 July 2004).

## Case studies

Approximately 20% of the world's population lack access to safe water and about 50% lack access to adequate forms of sanitation. This causes severe stress in societies with nearly a billion people in 50 countries experiencing severe water shortages every day (in *Preparations of Guidelines in the Water Resources Sector*, EU DG VIII, October 1997). The UK view is best represented



by the Ministry of Defence, which believes water security will become the 21st century's major source of interstate conflict. This is as a result of 40% of the world's population living along shared water resources (*Everybody Lives Downstream*, World Day for Water, UNEP, March 1999).

It is also estimated that there are 250 million cases of water-related disease each year. This results in a preventable minimum death toll of 10 million people per year. This is a risk issue which is going to increase in severity and is not only relevant to the developing world. In fact, there are almost a million cases of water-borne disease in the US each year. With growing populations there will be increasing pressure on water availability and costs.

In the UK these issues translate into responsible use of a resource which is in increasing demand. Even though the UK is blessed with large reserves of fresh water, its location is often away from populations and there have been incidents of shortages and contamination. The quality of groundwater and river networks in the UK is being damaged by inappropriate use of resources, while the price of water is increasing.

## *Risk management*

Examples of positive risk management programmes and projects include the following.

- The Global Environmental Management Initiative's Water Sustainability tool includes five modules to help industry to achieve sustainable management of water:
  - Module 1 explains how to analyse water use, impact and source assessment;
  - Module 2 is about business risk assessment and ensures that water risks are prioritised;
  - Module 3 addresses business opportunity assessment;
  - Module 4 is about strategic direction and goal setting to identify the business case for action; and
  - Module 5 covers the strategy development and implementation. It helps defining key organisational roles and water strategy and action plan development.
- The tool is available on the Global Environmental Management Initiative (GEMI) water strategy website: <http://www.gemi.org/water/>
- Folkestone and Dover Water are pre-empting their future levels of risk from water use. Their risk management plan has highlighted the likely impact of climate change and demand growth as putting heavy pressure on their supply network. Their response was the mandatory introduction of water meters for 200 000 customers. This is the cheapest option and avoids the need for the construction of a new reservoir;
- Nestlé, the food and drink giant, emphasised the importance of eco-efficiency and sustainability, particularly the responsible use of water. Nestlé created the Sustainable Agricultural Initiative, which aims to combine the influence of food producers to protect and improve the natural environment.

Between 1997 and 2001 Nestlé increased production by 32% at the same time reducing water use in one South African plant by almost half; and

- Ford's largest plant in the US have a plan to collect and recycle all rainwater on their premises, this includes making their entire vast car parking areas pervious, thus allowing rainwater to penetrate into the ground and minimise localised flooding.

## Resource usage risk – waste water pollution

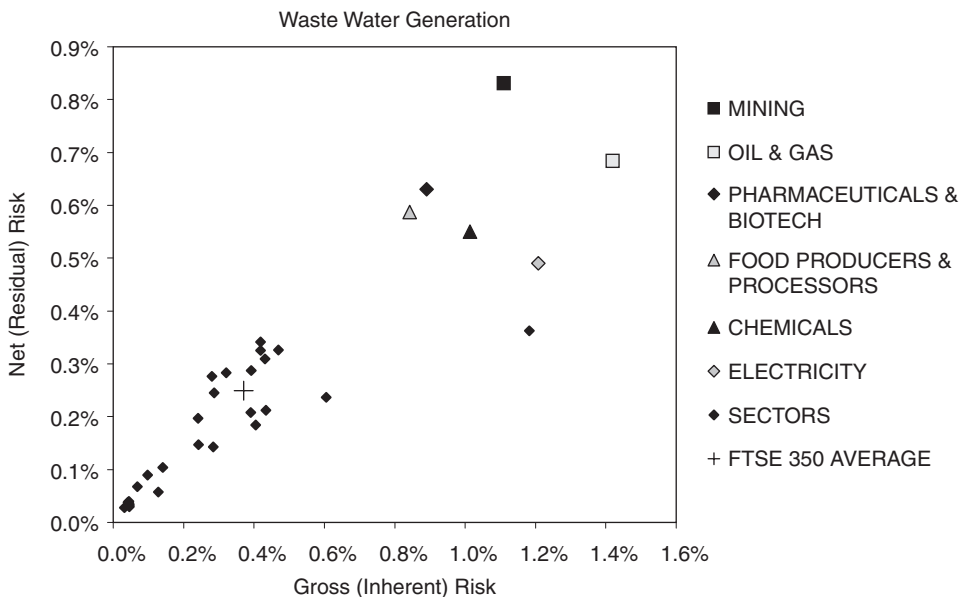
Research and analysis into waste water generation risk indicates that:

- Waste water generation risk is 0.2% of market value of the top 500 EU and US companies; and
- This risk exposure has been reduced from 0.4% of market value by good risk management techniques (the risk reduction/management factor).

There is a trend towards increased levels of litigation and fines in order to ensure the security of this resource. Water companies already have to spend up to £450 million to meet EU Water Directive regulations, which will require the removal of nitrates and pollution from drinking water between 2005 and 2010. At some stage the UK legal system will allow water companies to seek redress from the creators of water pollution.

The US Environmental Protection Agency (EPA) is facing increased pressure from lawsuits and environmental groups to begin enforcing the Clean Water Act more vigorously, and separate US states and counties are even encouraging developers to adopt new techniques to reduce pollution runoff.

The following graph shows the environmental risk (net) from waste water generation by sector.



### Water pollutants and their sources:

- Atmospheric chemicals that can cause acidity levels to rise in water courses like sulphuric acid from sulphur dioxide;
  - Biological contaminants such as bacteria, viruses and GMO material;
  - Chemicals, chemical fertilisers and biological altering chemicals that can affect the DNA and gender of species;
  - Heat can directly kill water life forms and also help deoxygenate water;
  - Heavy metals and other toxic compounds;
  - Leachates from waste sites, often of a highly mixed and contaminated nature;
  - Oil and fuel spills;
  - Organic wastes such as sewage, animal waste (silage), organic fertilisers and industrial processes like food processing, which acts to deoxygenate and therefore reduce life sustaining capacity of the water; and
  - Physical materials such as sediment, silt, and human refuse and waste materials, plastic bags, shopping carts.
- (<http://ec.europa.eu/environment/ipcc/index.htm>)

## Case studies

- Cadbury Schweppes plc – Environment Agency officials found three skips left uncovered for several days in heavy rain. Two contained solid waste with pesticide residues from raw cocoa beans, while the third leaked liquid sludge onto the concrete (*ENDS Report*, November 2000);
- Reckitt Beckiser plc was found guilty of exceeding wastewater limits in two incidents:
  - According to Reckitt's Environmental Report 2002 they were fined \$1000 for altering wastewater off-site, while a more permanent solution was investigated; and
  - They were also fined €2100 in Spain in 2002 for exceeding the limit due to a power cut. The company said a fail safe system was being installed.
- Thames Water was fined £50 000 for polluting a five mile stretch of the River Thames in July 2002 killing 15 000 fish (*Financial Times*, 3 July 2004).

Even in the developed world this issue can pose a large indirect risk. It is estimated that as much as a quarter of Ireland's ground water supplies were contaminated with sewage in 2002; it is alleged that this is largely as a result of high levels of illegal dumping in the country.

For the rest of Europe the scale of the problem is also large as: 'More than half of the freshwater bodies in the EU are polluted and can never be cleaned up again,' said Christa Klass MEP (EPP-ED, Germany). 'This is why we must protect them better' (EurActiv.com, 13 December 2006).

There are large risks associated with the long-term contamination of water by chemicals and pharmaceutical products, as many of the 130 000 manmade chemicals released into the environment have not been tested for impact on human health, and pharmaceuticals such as estrogens are altering the biology

of sea life forms by turning male fish into females. Microscopic plastic pollution is occurring all over the globe as plastic bags break down. One concern is that toxic chemicals could attach themselves to the particles, which would then help to spread them up the food chain.

The pollution of waterways and underground water supplies emphasises the importance of protecting this resource. Companies may be fined or their directors given custodial sentences for the contamination of water. In the EU there are new rules coming into effect under numerous directives on drinking water, dangerous substances in water, bathing water, groundwater, freshwater fish, and nitrates. The level of legislation is set to rise and, at the moment, most of the cost is being borne by water consumers as their industrial and domestic bills are increased to recover the additional £400 million a year that water companies need to invest in order to reduce the level of contaminants in water sources.

For example, there are measures to come into effect in 2009 that will require EU countries to prevent hazardous substances from entering underground water used for human consumption. The European Parliament gave its formal green light to an agreement on 12 December 2006 on the groundwater-protection directive.

Decision 2455/2001/EC of 20 November 2001 establishes a list of 33 priority substances in the field of water policy (ID 3484). The list contains substances that have been identified as highly dangerous to the aquatic environment and to human health via the aquatic environment. The following substances have been included: alachlor, anthracene, atrazine, benzene, brominated diphenylethers, cadmium and its compounds, C10-13-chloroalkanes, chlorpyrifos, 1,2-dichloroethane, dichloromethane, di(2-ethylhexyl)phthalate (DEHP), diuron, endosulfan, fluoranthene, hexachlorobenzene, hexachlorobutadiene, hexachlorocyclohexane, isoproturon, lead and its compounds, mercury and its compounds, naphthalene, nickel and its compounds, nonylphenols, octylphenols, pentachlorobenzene, pentachlorophenol, polyaromatic hydrocarbons, simazine, tributyltin compounds, trichlorobenzenes, trichloromethane (chloroform), and trifluralin.

Penalties for non-compliance are also set to increase in the US with new legislation like the Coast Guard and Maritime Transportation Act of 2006, recently passed by Congress. This increases the penalties for oil spill damages in waterways and rivers, requires anyone to report river obstructions to the Coast Guard and Army Corps of Engineers, and increases liability limits for single-hulled vehicles ('Congress raises penalties for oil spills on waterways', *Insurance Journal*, 30 June 2006).

## *Risk management*

- Measures to tackle the discharge and emissions of the substances listed above must be adopted and organisations should aim at the cessation or phasing out of discharges, emissions and losses within 20 years after their adoption at community level;

- Review the use and facilitate the replacement of particularly toxic or hazardous substances that could cause a pollution incident, or could become involved in a disaster or terrorist incident (see Chapter 8);
- Encourage organisations' developments and redevelopments to adopt new techniques to reduce pollution runoff into streams, rivers, lakes and bays. The adoption of mini-wetlands to reduce runoff and rain gardens to ease the flow of rain waters in suburban neighbourhoods;
- Working with stakeholders (non-governmental organisations and governments) can help develop increased water supplies and benefit firms that have high consumption levels. Procter & Gamble is a good case study for these types of activities as they are working in developing countries to provide safe drinking water at its point of use;
- New online monitoring systems integrate various common analytical instrumentation, like pH and chlorine monitors, with advanced interpretive algorithms to enhance detection and identification and real time accident management; and
- There will be the potential for waste treatment to become a resource rather than just a cost as developments will lead to being able to clean water and derive energy from the process. An example is that Cornell University's College of Engineering plans to recoup energy from wastewater treatment within the next three years through the use of bacteria.

## Chapter summary

It is important for all organisations to keep abreast of this practical area of risk management:

- Whatever their size;
- Wherever they operate; and
- Regardless of their sector.

As is also clear from Chapter 18 and this chapter, this is a complex aspect of risk management that can also impact on the sustainability of the organisation in terms of its viability and its reputation. Those days in which environmental issues were regarded as a peripheral area of risk management are well and truly over.

### *Useful web links*

- \* European Union Environment Resource Homepage: <http://ec.europa.eu/environment/>
- \* GRI – Global Reporting Initiative: including a GRI content index and guidelines: <http://www.globalreporting.org/reportsdatabase/>
- \* INEM – International Network for Environmental Management. Documents and hyperlinks to other websites of interest, including: EMAS Tool Kit for Small Organisations, Environmental Policy Checklist, and

Environmental Statement and/or Environmental Report Checklists.  
<http://www.inem.org/>

- \* The carbon trust ([www.carbontrust.co.uk/energy](http://www.carbontrust.co.uk/energy)) says they can save between 10 and 30% of UK companies' energy bills annually.
- \* United Nations – reports on global trends are available from: <http://www.un.org/esa/sustdev/publications/trends2006/index.htm>
- \* US Environmental Protection Agency: <http://www.epa.gov/>
- \* WBCSD – The World Business Council on Sustainable Development has been voted the best global resource for case studies on sustainable development: [www.wbcsd.org](http://www.wbcsd.org)

#### *Publications*

- \* *Ecosystem Challenges and Business Implications*. The publication by Earthwatch Institute (Europe), the World Conservation Union (IUCN), the World Business Council for Sustainable Development (WBCSD) and the World Resources Institute (WRI) is based on global scientific facts and projections from the UN's multi-year Millennium Ecosystem Assessment. Available at: [http://www.wbcsd.org/DocRoot/TG54Y61bSf5w1ATAR0jj/Business%20and%20Ecosystems\\_211106\\_final.pdf](http://www.wbcsd.org/DocRoot/TG54Y61bSf5w1ATAR0jj/Business%20and%20Ecosystems_211106_final.pdf)
- \* ASHRAE – The American Society of Heating, Refrigerating and Air-Conditioning Engineers has published a 'GreenGuide' focusing on the 'design, construction, and operation of sustainable buildings'. Available for purchase at: <http://www.engineeringforsustainability.org/>

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# PART E

## Case Studies of Business Risks

We cover the key environmental aspects of risk which include:

- A review of the climate change debate and risks (Chapter 20);
- An overview of relevant governance and risk issues (Chapter 21);
- Legal risk management in the US (Chapter 22);
- Selected international dimensions of risk management and corporate governance (Chapter 23); and
- Conclusions and future trends (Chapter 24).

Although the book includes case studies throughout, here there is some emphasis on key global risks facing the world today, such as climate change and food safety. There is no doubt that the Enron catastrophe that embraced economic crime and mismanagement has been the moment in corporate history which defined the need for urgent change and ushered in a new era to corporate governance and



strategic risk management. It highlighted the need for a review and reappraisal of corporate behaviour and accountability. In turn this had major implications for sustainable risk management.

Therefore this handbook concludes with some analysis and comment on the comparative responses to the Enron case study, with some recommendations based on the need to consider emerging risks in emerging economies that are so rapidly taking place at the forefront of globalisation.



20

Climate change – air pollution risk

# 20

## Climate change – air pollution risk

### CHAPTER OVERVIEW

SERM research indicates that the combined total for greenhouse gas-related risk from production and transportation amounts to 1.4% of all the market value of the companies analysed. This figure is an average although there are wide variances within anticipated loss scenarios.

The Carbon Disclosure Project analysis of 2000 companies estimates that the worst performer could lose 25% of their earnings due to regulatory compliance costs, but the best could make a revenue addition of 11% to turnover.

### The issue

Climate change is one of the most serious issues facing the planet. Scientific evidence shows that temperature changes are likely to have profoundly negative consequences for human society, the global economy and the world's natural systems. This poses risks and opportunities to which investors and companies must respond.

The current situation is that it is generally accepted within the scientific community that the planet is warming. The role that human activity plays in this warming remains more controversial. An address by Kofi Annan, Secretary General of the United Nations, mentions:

Climate change is not just an environmental issue, as too many people still believe. It is an all-encompassing threat.

It is a threat to health, since a warmer world is one in which infectious diseases such as malaria and yellow fever will spread further and faster.

It could imperil the world's food supply, as rising temperatures and prolonged drought render fertile areas unfit for grazing or crops.

It could endanger the very ground on which nearly half the world's population live – coastal cities such as Lagos or Cape Town, which face inundation from sea levels rising as a result of melting icecaps and glaciers.

All this and more lie ahead. Billion-dollar weather-related calamities. The destruction of vital ecosystems such as forests and coral reefs. Water supplies disappearing or tainted by salt-water intrusion. (At the UN Climate Change Conference in Nairobi, Kenya, on the 15 November 2006)

Human emitted greenhouses gases are viewed as being responsible for contributing to an effect called global warming, which in turn is seen as causing climate change and increased turbulence and unpredictability in weather patterns. Recent reports highlighting these issues as a critical one for society and therefore directly and indirectly for businesses are as follows:

- In the Lehman Brothers report entitled *The Business of Climate Change: Challenges and Opportunities*, they state that the pace of a company's adaptation to climate change will influence whether, over the next several years, it survives and prospers or withers and quite possibly dies;
- The UK 'Stern' report on the *Review of the Economics of Climate Change* published at the end of October 2006 estimates that the costs of doing nothing about climate change are:
  - £3 680 000 000 000 (£3.68 trillion) in damages; the do nothing scenario means 5–20% of the global economy will be at risk;
  - Up to 200 million extra refugees;
  - Up to 40% of species lost; and
  - Water shortages for 1 in 6.
- There will be sea level rises, melting glaciers, increased storm severity and droughts. This means increased market forces of taxation, more green power, etc. It was also announced there will be a climate change bill. Some commentators say the signs are visible across the United States, according to some experts, who point to an increase in tornadoes, brushfires, hailstorms, hurricanes and droughts. The author Sir Nicholas Stern, head of the UK government's Economic Service and former chief economist at the World Bank, said, 'We can grow and be green.' A 1% average increase in prices is needed in order to save 5–20%. The burden of CO<sub>2</sub> cuts should be in the developed world. The President of the Maldives, His Excellency Maumoon Abdul Gayoom, is so alarmed that his country is soon to be overwhelmed by the ocean that he will be sending this book to all 193 heads of state in the world. Stern also said:

This is a doubly inequitable process as it's the rich countries who are responsible for 75 percent of the greenhouse gases that are up there and it's the poor countries that will be hit earliest and hardest. ('India will suffer most due to climate change' – Stern, Planetark, Reuters, India: 7 December 2006)

- A survey of more than 33 000 people from 30 countries across the world finds that in each country polled, a large majority of the survey respondents believe that climate change is a serious problem. The poll was conducted by GlobeScan and WorldPublicOpinion.org from October 2005 to January 2006: 'Trend – 30-country poll finds rising concern over global warming', *Insurance Journal* (04/25/2006);

- A resolution that acknowledges the harmful effects of greenhouse gases on the climate has cleared the US Senate. The resolution states that greenhouse gases are directly responsible for the inordinate increase in the earth's temperature and thereby will likely bring about rising sea levels (Senate Resolution Addresses Global Warming Claims (08/05), volume 53, number 8, p. 10);
- EU Environment Commissioner Stavros Dimas told a group of British MPs in London on 11 January:

It is clear that the fight against climate change is much more than a battle. It is a world war that will last for many years ... It is like a war because to reduce emissions something very like a war economy is needed. (<http://www.wbcsd.org/includes/getTarget.asp?type=DocDet&id=MjIzNzg>)

- The US Climate Change Science Program (CCSP) has released a new study that examines how human activity may have influenced global warming. Titled *Temperature Trends in the Lower Atmosphere: Steps for Understanding and Reconciling Differences*, the report addresses some of the obstacles that have stood in the way of understanding the root causes in atmospheric changes ('US report on climate change finds "substantial human impact"', *Insurance Journal* (05/04/2006));
- A study, *Climate Change and Insurance: An Agenda for Action in the United States*, was issued by Allianz Group, one of the largest insurance providers in the world with operations throughout the US, and World Wildlife Fund (WWF). The report notes that, climate change has the potential to significantly alter and intensify destructive weather patterns in the US, leading to increased flooding, forest fires and storm damage; and
- The UN's Intergovernmental Panel on Climate Change (IPCC) 4th Assessment Report entitled *Climate Change 2007: The Physical Science Basis* has been compiled by 130 leading climate change scientists based on the work of thousands of scientists. The report states that it is 90–99% certain that human activities are causing warming in the climate and that further emissions of greenhouse gases will accelerate global warming. It notes that:
  - 'Warming of the climate system is unequivocal, as is now evident from observations of increases in global average air and ocean temperatures, widespread melting of snow and ice, and rising global mean sea level';
  - It also claims that positive feedback effects caused by the oceans and forests becoming less adept at absorbing carbon as temperatures rise could drive temperatures still higher; and
  - The report concludes that temperatures will probably increase by between 1.8 and 4°C by 2100, though they could climb by as little as 1.1°C and as much as 6.4°C, which would result in catastrophic effects such as major droughts and sea level rises.

## A review of the main trends

- Political pressure is growing:
  - In his address to the World Economic Forum US President George Bush described climate change as a 'serious issue' and promised to cut US gasoline

consumption by 2017 in favour of alternative fuels like corn-based ethanol. Dan Esty, director of the Yale Centre for Environmental Law and Policy, said Bush had taken ‘an important first step’ (‘Davos leaders challenge Bush to be bolder on climate’, reported in the Agence France-Presse (AFP), 24 January 2007);

- Stakeholder pressure is growing:
  - Increase stakeholder activism on the risks – an example is the Carbon Disclosure Project (CDP) which has 225 signatory investors controlling trillions of dollars in assets, with the aim to increase greenhouse gas emission reporting. See the stakeholder analysis below for more details;
  - The Institutional Investors Group on Climate Change (IIGCC) has launched an ‘Investor Statement on Climate Change’ which was signed by institutions managing assets worth more than £850 billion. The signatories have pledged to use their collective financial size to encourage companies and governments to act to reduce global greenhouse gas emissions; and
  - The financial community is expressing concerns about these emissions and the risks associated with air pollution, and in particular global warming. Clear reporting on emissions and pressure on larger companies to make their supply chain more efficient is necessary. The UK’s Local Authority Pension Fund Forum is also attending the AGMs of several FTSE100 companies to press them to report on their carbon emissions. The Association of British Insurers (ABI) has announced that climate change claims have already doubled from 1998 to 2003 (to more than £6 billion), and that claims could treble in the future, pushing up premiums (*The Observer*, 6 June 2004).
- Weather extremes will increase according to the Intergovernmental Panel on Climate Change (IPCC), drawing on scientific advice from around the world, both drought and floods could be more common due to global warming (see below for further details);
- Global warming is threatening the planet’s biodiversity, particularly migratory species like birds and marine animals, and species loss is expected to increase;
- Greenhouse gas (GHG) emissions trading will take on greater importance;
- The planetary climate will warm over the next several decades, resulting in sea-level increases of some unknown magnitude;
- Increased taxation of GHGs. An example is that France is to push coal and carbon taxes in support of the Kyoto Protocol;
- Legal actions:
  - The US Supreme Court considered its first global warming case in November 2006, known as *Massachusetts vs EPA*. This case was brought by a dozen US states and 13 environmental organisations against the US Environmental Protection Agency. The plaintiffs argue that the greenhouse gas emissions from cars, trucks and factories should be regulated by the US government. The Supreme Court is expected to rule on this case by the middle of next year (‘Supreme Court hears first global warming case’, Planetark, Reuters USA: 30 November 2006);

- Business pressure is growing:
  - The chairman of the Lloyd's insurance market said governments and businesses must act now against climate change, and the United States needs a bigger public debate about its risks ('Lloyd's boss demands action on climate change', AFP, 12 January 2007);
  - The business community is also concerned as rising energy prices are 'set to hit company profits' (analyst's warning in the *Financial Times*, 4 August 2004); and
  - Ten major US businesses have joined with four US environmental organisations to form an unprecedented alliance – the United States Climate Action Partnership (US-CAP) – and issue a joint report, *A Call to Action* (available at [http://action.environmentaldefense.org/ct/J1\\_p\\_741hmua/](http://action.environmentaldefense.org/ct/J1_p_741hmua/)). They are calling for the federal government to pass strong national legislation to cut global warming pollution. The companies involved include: Alcoa, BP America, Caterpillar, Duke Energy, DuPont, Florida Power and Light, General Electric, Lehman Brothers, Pacific Gas & Electric and PNM Resources. The NGOs involved are: Environmental Defense, the World Resources Institute, Pew Center on Global Climate Change and Natural Resources Defense Council.

The trends for the climate are that the UN's Intergovernmental Panel on Climate Change (IPCC) 4th Assessment Report highlights the following impacts from global warming and climate change:

- \* The main result is that there is evidence to suggest a total net anthropogenic effect by humans on the heating of the planet;
- \* Eleven of the last 12 years (1995–2006) rank among the warmest years in the instrumental record of global surface temperature (since 1850);
- \* Widespread decreases in glaciers and ice caps have contributed to sea level rise;
- \* Global average sea level rose at a rate of 1.8 mm per year from 1961 to 2003. The rate was faster from 1993 to 2003, about 3.1 mm per year. The total 20th century rise is estimated to be 0.17 m;
- \* Average Arctic temperatures increased at almost twice the global average rate in the past 100 years;
- \* More intense and longer droughts have been observed over wider areas since the 1970s, particularly in the tropics and subtropics;
- \* Significantly increased rain/precipitation has been observed in eastern parts of North and South America, northern Europe and northern and central Asia; and
- \* There is observational evidence for an increase of intense tropical cyclone activity in the North Atlantic since about 1970.

The likelihood that trends have occurred due to human pollution is as follows:

<b>Phenomenon and direction of trend</b>	<b>Likelihood that trend occurred in late 20th century (typically post-1960)</b>
Warmer and fewer cold days and nights over most land areas	<i>Very likely</i>
Warmer and more frequent hot days and nights over most land areas	<i>Very likely</i>
Warm spells/heat waves. Frequency increases over most land areas	<i>Likely</i>
Heavy precipitation events. Frequency (or proportion of total rainfall from heavy falls) increases over most areas	<i>Likely</i>
Area affected by droughts increases	<i>Likely in many regions since 1970s</i>
Intense tropical cyclone activity increases	<i>Likely in some regions since 1970</i>
Increased incidence of extreme high sea level	<i>Likely</i>

(Extract from the IPCC 4th Assessment Report)

## The scale of the problem

These results have been compiled from the merging of the two separate categories addressed in Chapter 19, which are Air Pollution from production and transportation.

Research and analysis into the risk of air pollution from production indicates that:

- Air pollution emissions from production and transportation-related risk is an average of 0.9% of market value of the top 500 EU and US companies. The majority of this risk exposure is from greenhouse gas-related emissions; and
- This risk exposure has been reduced from 1.4% of market value by good risk management techniques (the risk reduction/management factor).

Sectors particularly likely to be affected include: utilities; integrated oil and gas; mining and metals; insurance; pharmaceuticals; building and construction; and real estate.

It is estimated that the worst performer could lose 25% of its earnings due to regulatory compliance costs and the best could make a revenue addition of 11% to turnover, according to the Carbon Disclosure Project analysis of 2000 companies: [www.cdproject.net](http://www.cdproject.net)

Air emissions are a major cause of air pollution, and in particular greenhouse gases are the major cause of climate change. Historically this issue has periodically made the headlines, with a tax on coal helping Sir Christopher Wren complete St Paul's Cathedral and the great London smog of the 1950s leading to some of the first pollution control legislation in the world.



## The causes of greenhouse gas air pollution

Greenhouse gases are produced from carbon dioxide and other emissions like methane, which is emitted from many sources, including the decomposition of organic wastes, gases from living life forms like herds of cattle, the production of coal and natural gas and seepage from rotting vegetation from landfill sites. Emissions to the atmosphere resulting from an organisation's use of transport (such as low-level ozone, SO<sub>x</sub> and NO<sub>x</sub>, PM-10s from diesel fuel, etc.) also contribute to the problem. This includes greenhouse gases emitted from any vehicles that are used by the organisation.

The scale of the problem is also being masked by the poor provision of information, and an example is that a report from the UK Office of National Statistics omitted to include that since 1990 there has been an 85% increase in air pollutants from the airline industry and 59% from freight transport ('Officials try to hide rise in transport pollution', *The Guardian*, 27 May 2004).

## Risks resulting from air pollution

Climate change may cause the economic environment to alter more suddenly, particularly when government policy responds to the perceived threat. A change in greenhouse gas regulations on utilities, fuel economy standards for vehicles, airline taxes or building regulations can immediately affect companies' profitability and prospects.

The effects of air pollutants:

- Climate change: the six greenhouse gases act so as to trap the infrared radiation emitted from the earth's surface. Some of the predicted changes are massive damage to economics, hundreds of millions of refugees, flooding of low lying land and greater strength of storms and increased desert spreading;
- Increased costs and taxation of carbon emission are likely. An example is that the Australian government in November 2006 said that it would consider taxing industry's carbon emissions if other countries agree to do so;
- Localised air pollution caused by the burning of fossil fuels like coal and diesel has contributed to a worrisome slowdown in rice harvest growth in India in the past two decades, scientists said. The so-called atmospheric brown clouds, formed from soot and other tiny air-borne particles belched into the air when fossil fuels are burned, can cut rainfall and lower temperatures ('Air pollution hurts India's rice crop – study', PlanetArk, Reuters USA: 5 December 2006);
- The legal environment will become increasingly open to the idea that businesses may be held legally responsible for damage caused by the greenhouse gases they produce. A group of state attorneys general has already filed a public nuisance suit against utility companies for the companies' release of greenhouse gases. While lawsuits against individual companies for climate issues remain difficult due to problems with demonstrating causation, more plaintiffs are now able to show that they are suffering demonstrable, measurable harm

(Burr, Michael T. 'Corporate America feels the heat', *Corporate Legal Times* (08/05) volume 15, number 165, p. 44);

- Global warming, which causes flooding and droughts, has many consequences including the spread of tropical climate diseases to otherwise cooler regions, and the spread of disease has already begun with victims dying of West Nile virus in Canada, for example;
- Peter Levene warned that vast storms bigger than Hurricane Katrina are likely to batter the United States in coming years; Levene runs the world's biggest insurance market at London-based Lloyd's and was formerly a sceptic on climate change;
- The developing world's struggle for food security will increase unless new crop varieties are deployed to help poor farmers adapt to climate change, agricultural experts and climate scientists have warned ('Climate change increases food security concerns', ENS, 5 December 2006);
- A senior Chinese government official admitted in August 2006 that Hong Kong's chronic air pollution was having a negative effect on its economy, affecting companies' decisions to invest in the region; and
- The UK's National Trust says 60% of the 700 miles of UK coastline it manages faces the threat of coastal erosion due to rising sea levels ('UK environmental group cites threat of rising sea levels', Robert O'Connor BestWire, 29 April 2005).

## Risk management

The pace of a firm's development of a sustainable risk management framework and adaptation to climate change and related policies and taxation is thus likely to prove to be another force that will influence whether any given organisation survives and prospers, or withers.

Companies that prosper in an environment of changing climate and policies will tend to be those that are early to recognise its importance and inexorability, foresee at least some of the implications for their industry and take appropriate steps well in advance. These practical steps could include:

## Developing a strategic analysis of climate risk and emissions management

- Organisations' management should consider a strategic analysis of climate risk, including a clear and straightforward statement about implications for competitiveness, for example how the access to resources like fuel will be affected;
- The following issues should also be addressed where they are relevant to the organisation:
  - Climate change statement: a statement of the company's current position on climate change, its responsibility to address climate change, and its engagement with governments and advocacy organisations to affect climate change policy;
  - The development of an emissions management plan providing an explanation of all significant actions the company is taking to minimise its climate

risk and to identify opportunities: specifically, this should include the actions the company is taking to reduce, offset, or limit greenhouse gas emissions. Actions could include establishment of emissions reduction targets, participation in emissions trading schemes, investment in clean energy technologies, and development and design of new products. Descriptions of greenhouse gas reduction activities and mitigation projects should include estimated emission reductions and timelines;

- Inculcating in management a constructive culture of adaptation to a changing economic landscape;
- Encouraging employees to embrace change, and equipping them to do so; and
- Undertaking the research and development on the risk issues and how to manage them and translating this research into appropriate investments.

## Undertaking an assessment of physical risks of climate change

Climate change is beginning to cause an array of physical effects, many of which can have significant implications for companies. Organisations should begin to investigate how climate and weather generally affect their operations and supply chain. These effects may include the increased number and intensity of storms; sea-level rise; water availability; changes in temperature; and impacts of health effects, such as heat-related illness or disease, on their workforce. After identifying these risk exposures, companies should describe how they could adapt to the physical risks of climate change and estimate the potential costs of adaptation.

## Reporting on the steps organisations are taking to manage these risks

Organisations should disclose their total greenhouse gas emissions. Investors can use this emissions data to help approximate the risk companies may face from future climate change regulations.

Specifically, investors strongly encourage companies to disclose:

- Current and historical direct and indirect emissions; and
- Estimated future direct and indirect emissions of greenhouse gases from their operations.

## Develop a framework for the analysis of regulatory risks

As governments begin to address climate change by adopting new regulations that limit greenhouse gas emissions, organisations will face regulatory risks that could have significant implications. Companies should research:

- Any known trends, events, demands, commitments and uncertainties stemming from climate change such as increased energy and transportation costs. The analysis should incorporate the possibility that consumer demand may shift sharply due to changes in domestic and international markets;

- A review of all greenhouse gas regulations that have been imposed in the countries in which the organisation operates and an assessment of the potential financial impact of those rules; and
- The future cost of carbon resulting from emissions reductions.

## Develop a proactive programme for tackling the issue

The best risk management options for reducing your impacts are to operate more efficiently by:

- Increased efficiency in delivering services from a given energy input, elimination of waste, more efficient products and more efficient power generation and transmission;
- Redesigning products, services and premises, as well as substitution and lifestyle changes, from high energy to low energy services (assuming they have the same or better utility). For example, video-conferencing as a substitute for tiring and expensive business travel;
- Re-engineering the systems by substituting high carbon forms of energy with low carbon sources, such as natural gas instead of coal, and from gas to zero carbon sources, such as renewable energy and possibly nuclear energy; and
- Reclaiming CO<sub>2</sub> through the creation of sinks to absorb the organisation's greenhouse gases.

## Risk management case studies

- Enel has also been developing renewable energy projects in Latin America and two of them have already been approved by the CDM board and generated credits for Enel worth several hundred thousands tonnes of CO<sub>2</sub> equivalent, said Fabrizio Barderi, head of Enel's Strategies and Sales Analysis Department. In China, Enel also participates in renewable energy projects in wind and hydro generation. Enel has also been working on pilot projects to capture CO<sub>2</sub>, but they were still far away from industrial realisation;
- Dell says it is the first global technology company to offer customers the opportunity to offset the emissions associated with the electricity used to power their computers;
- The makers of the independent film *Sweet Land* seem pleased with another accolade, being carbon neutral. This means that all of the carbon dioxide emitted by the filmmaking process – lights, cameras and transportation – was totalled up and offset by comparable investments in renewable energy;
- Rock band Coldplay bought 10 000 mango trees for villagers to plant to offset the carbon emissions of greenhouse gases the creation of its CDs would create;
- The US is choosing a site for its US\$1 billion FutureGen project for what President George W. Bush calls the 'world's first coal-based, zero-emissions electricity and hydrogen power plant'. Increasing numbers of companies, including American Electric Power, BP, E.ON, Statoil and Vattenfall, are in a race to develop technologies that store carbon and reduce carbon emissions; and

- In the Netherlands, for example, one oil refinery began pumping its carbon dioxide emissions into 500 greenhouses to reduce its emissions and to cut down on the energy needed in the summer to create the gas for the growing season. Energy consumption has become one of the biggest obstacles recently as gas and oil prices continue to soar and economies are forced to seek out alternatives.

## A business opportunity?

European Commission President José Manuel Barroso met with a group of 15 business leaders telling them it was ‘to their advantage to lead and not to be led’ on the way to a low-carbon economy. Several agreed saying:

- ‘Climate change is business and will lead to new jobs’, said Lars Goeran Joesfsson, chief executive of Swedish power company Vattenfall; and
- ‘Combating climate change ... is a business opportunity’, said Fulvo Conti from Enel, saying the Italian utility and other energy groups were already investing billions in energy research and energy efficiency.

Other noted research comes up with savings and benefits to the economy at large, furthering other business opportunities:

- Research by Shell Springboard shows that the challenge of tackling climate change could create a market of up to £30 billion for British business over the next 10 years (Climate change to be 30 billion pound opportunity for UK business: [http://www.greenbiz.com/news\\_third.cfm?NewsID=34128](http://www.greenbiz.com/news_third.cfm?NewsID=34128)). The research identifies major opportunities for small and medium-sized enterprises in a wide range of markets, by responding both to consumer demand for environmentally friendly goods and to demands created by government action. The biggest identified markets for SMEs in 2010 will be:
  - Building regulations for commercial and industrial use – £950 million;
  - Renewable electricity – £800 million;
  - Renewable road transport fuels – £500 million;
  - Domestic energy efficiency – £400 million; and
  - Building regulations for domestic use – £275 million.
- The European Environment Agency (EEA) argues that ‘stringent EU climate change policies’ offer general health and cost-savings benefits to Europe. The report notes that reducing the air pollution that fuels global warming will reduce premature deaths in Europe related to air pollution and estimates Europe could save \$15.4 billion a year in air pollution-control costs by 2030 through ‘burning smaller amounts of fossil fuels’ (‘EEA report says “tackling climate change” will save lives’, *Insurance Journal*, 15 May 2006).

## Emerging technological opportunities

### *Renewable energy*

Using and investing in renewable energy will increase – combustible renewables and waste and hydro power account for nearly all the world’s renewable energy

production. 'New' renewable energy sources like geothermal, solar, tidal, wave, wind and others will rapidly increase from their small proportion of production:

- China is the world's leading producer of energy from renewable sources, using it for 7.7% of its total energy supply, and this will increase to 19% of the nation's needs by 2020. China is also the world's leader in passive solar energy (for water and space heating) and it is also the largest source of emissions credits under the Kyoto Protocol's Clean Development Mechanism, and is expected to remain so (source: <http://www.newenergyfinance.com/>);
- China will build the world's largest solar power station (100 megawatt (MW)) in the northwestern province of Gansu, at an approximate cost of 6.03 billion yuan (US\$766 million);
- 'BP Solar to invest \$70 million to expand U.S. facility at Frederick, MD', World-Wire, 16 November 2006: BP Solar today unveiled its plans for a \$70 million expansion project at its North American headquarters in Frederick, MD;
- Google took steps in a greener direction, announcing it is to make its Silicon Valley headquarters the largest solar-powered office complex in the world. The 1.6 MW of solar power generated will meet about a third of the offices' electricity needs; and
- Technology rival Microsoft has installed 2288 solar panels at its research site in Mountain View, which will produce 480 kW of energy.

## *Carbon capture*

- 'Clean' coal-fired power plants that bury greenhouse gases will be up and running in 5–10 years but will be money-losers unless governments impose tougher policies for fighting global warming, experts said in December 2006; and
- 'Carbon capture could be demonstrated technically viable within 5–10 years but there's still no commercial incentives', said Harry Audus, general manager of the International Energy Agency (IEA) Greenhouse Gas Research and Development Programme ('Clean' coal seen in 5–10 years, but costs high', Reuters Norway: 8 December 2006).

## **Carbon finance**

A case study of a market-based solution to carbon emission is that of carbon finance and trading of permits. With political positions evolving, the likelihood is that a form of a global emissions trading system will be in place within the next few years. There are two categories of countries involved in carbon credit trading and finance:

- Developing countries, which do not have to meet any targets for GHG reductions. However, they may develop such projects because they can sell the ensuing credits to countries that do have Kyoto targets; and
- Industrialised countries, which include the richest nations of the world and countries in transition from centrally planned to open market economies. They are part of the Protocol's Joint Implementation (JI) mechanism.

## Trading carbon credits

To implement the Kyoto Protocol, a ‘cap and trade’ system is being established. Under these systems, companies are obliged to match their greenhouse gas emissions with equal volumes of emission allowances.

Governments initially allocate a number of allowances to each company. Any company that exceeds its emissions beyond its allocated allowances will either have to buy allowances or pay penalties. A company that emits less than expected can sell its surplus allowances to those with shortfalls.

Companies or countries will buy these allowances as long as the price is lower than the cost of achieving emission reductions by themselves.

## Demand for carbon credits will grow

The demand for carbon credits is expected to grow for the following reasons:

- Because of projected shortfalls and higher relative carbon abatement costs, it is anticipated that OECD countries will fail to meet their Kyoto target by 2012. The higher relative emissions abatement costs in these countries mean that they will find it attractive to buy carbon credits generated elsewhere;
- Private companies in industrialised countries will increasingly be subject to ‘cap and trade’ mechanisms, such as the EU Emission Trading Scheme which started on 1 January 2005 (although this will initially cover only 50% of emissions). The EU scheme is separate from the Kyoto Protocol but the ‘Linking Directive’ of 2004 allows a European company to buy Kyoto Protocol carbon credits to comply with their obligations under the EU Emission Trading Scheme; and
- Governments will also have to buy carbon credits because the ‘cap and trade’ mechanisms will initially only apply to a fraction of each state’s economy and governments are responsible under the Kyoto Protocol for meeting their countries’ targets. OECD governments and European companies subject to the EU Emission Trading Scheme will therefore be the main buyers of carbon credits.

## Low-cost carbon credits available

The idea behind carbon trading is that firms that can reduce their emissions at a low cost will do so and then sell their credits on to firms that are unable to easily reduce emissions. A shortage of credits will drive up the price of credits and make it more profitable for firms to engage in carbon reduction. In this way the desired carbon reductions are met at the lowest cost possible to society.

## The business opportunity from carbon trading

With the creation of a market for trading carbon dioxide emissions within the Kyoto Protocol, it is likely that London financial markets will be the centre

for this potentially highly lucrative business; the New York and Chicago stock markets would like a share (which is unlikely as long as the US rejects Kyoto). The European Union's European Union Greenhouse Gas Emission Trading Scheme (EU ETS) began operations on 1 January 2005.

Twenty-three multinational corporations have come together in the G8 Climate Change Roundtable, a business group formed at the January 2005 World Economic Forum. The group includes Toyota, Ford, British Airways and BP. On 9 June 2005 the Group published a statement stating that there was a need to act on climate change and stressing the importance of market-based solutions. It called on governments to establish 'clear, transparent, and consistent price signals' through the 'creation of a long-term policy framework' that would include all major producers of greenhouse gases.

Examples of the growth of this sector are:

- Climate Change Capital, the boutique investment bank, has raised \$1 billion for a fund designed to profit from the growth of the carbon market, the largest amount raised by a private institution to date. The investors include Dutch pension funds ABP and PGM and Centrica, the energy company; and
- Italy's biggest utility Enel aims to earn millions of greenhouse gas reduction credits in 2007 through investments in China and India under the Kyoto Protocol's Clean Development Mechanism (CDM), a senior Enel manager said recently ('Enel earns emissions credits in China', Reuters India: 8 June 2006). 'We are talking about credits worth several million tonnes of CO<sub>2</sub> emissions (per year)', said Fabrizio Barderi, head of Enel's Strategies and Sales Analysis Department.

#### *The Clean Development Mechanism (CDM)*

The CDM lets rich countries earn credits by investing in green projects in poor countries, where it is often cheaper to achieve reductions. Although Chinese projects are awaiting authorisations from the United Nations CDM board.

The credits will be valid for use in Europe's emissions trading scheme, which caps industry's CO<sub>2</sub> output and is the centrepiece of the bloc's effort to meet its Kyoto Protocol commitments.

## Carbon issues

Most of these gases are emitted from the energy sector, where capital investments last for decades. Private firms are unlikely to invest adequately in advanced technologies to cut their emissions unless they believe that limits will become sufficiently strict as governments get serious about slowing global warming.

There is no clear plan for Kyoto's successor. The Kyoto Protocol itself does not offer an effective framework. The US has pulled out and has yet to offer an



alternative strategy for slowing global warming. Canada and Japan have formally joined the Kyoto treaty, but neither nation has yet offered a workable plan for meeting its Kyoto commitments. Only the European Union is implementing a scheme that will yield compliance with its Kyoto obligations. But a system that attracts only Europe is unlikely to exert much leverage on global emissions, as the EU accounts for only 15% of the world's total emissions. Moreover, the limits on emissions enshrined in the Kyoto agreement exclude developing countries, which account for nearly half of the world's GHG emissions. (China alone is responsible for 12%.) Because they are more populous, these countries' per capita emissions remain much lower than that of the industrialised world.

Since the baseline for all carbon trading calculations is the level of 1990 emissions, polluting countries such as Russia and the US automatically own vast amounts of carbon credits, and therefore own the 'right' to spew out most of the world's pollution. In contrast, developing nations own almost none of the rights to the atmosphere, as their carbon emissions were negligible in 1990. This means that in order to develop its economy, these countries must buy carbon credits from rich, heavily polluting countries. Any system which allows those countries to cause the climate change problem to continue to pollute, and at the same time bars desperately poor countries from providing basic services, must be considered inequitable and fundamentally unjust.

### *The Kyoto Protocol*

Kyoto obliges 35 industrialised nations to cut emissions to 5% below 1990 levels by 2008–12. Although the US is not a signatory to the agreement more than 330 US cities have endorsed the Kyoto Protocol, in a grassroots support for its aims. The Kyoto Protocol has the following characteristics:

- \* There is a divide between the interests and obligations of developed and developing countries;
- \* Developed countries currently account for more than half of the greenhouse gas (GHG) emissions;
- \* The Kyoto Protocol in force as of 16 February 2005 seeks to reduce GHG emissions blamed for global warming;
- \* The Protocol provides the means to monetise the environmental benefits of reducing GHGs;
- \* The Protocol has created a market in which companies and governments that reduce GHG gas levels can sell the ensuing emissions 'credits';
- \* A new currency is emerging in world markets;
- \* Money is set to exchange hands for pollution; and
- \* Carbon credits are poised to transform the world energy system and thus the world economy.

A new international climate change agreement designed to replace the Kyoto accord when it expires in 2012 could move a step closer with the publication of the Intergovernmental Panel on Climate Changes' (IPCC) most current 4th Assessment Report.

*Useful web links*

- \* A summary of the IPCC's Fourth Climate Change Report focuses on new literature on the scientific, technological, environmental, economic and social aspects of mitigation of climate change:  
<http://www.resourcesaver.org/file/toolmanager/CustomO16C45F78472.pdf>
- \* The business resource for climate management, ClimateBiz is at:  
<http://www.climatebiz.com/sections/toolsresources.cfm>

For information on the Clean Development Mechanism visit:

- \* [www.carbonneutral.com](http://www.carbonneutral.com)
- \* [www.climatecare.org](http://www.climatecare.org)
- \* [www.carbontrust.co.uk](http://www.carbontrust.co.uk)

For information on carbon dioxide emissions trading visit:

- \* [www.chicagoclimateex.com](http://www.chicagoclimateex.com)
- \* [www.europeanclimateexchange.com](http://www.europeanclimateexchange.com)

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21

UK corporate governance: reforms in  
the wake of corporate failures and  
the Enron case study

# 21

## UK corporate governance: reforms in the wake of corporate failures and the Enron case study

### CHAPTER OVERVIEW

This chapter summarises the development of corporate governance in the UK. The overview has regard to corporate failures that have occurred and, in particular, to the Enron case study. Comments are also made bearing in mind the book's overall theme of sustainable risk management.

In the UK the corporate governance framework has evolved through:

- \* Systematic study of each aspect of corporate failures that have occurred in the UK by committees set up by government and various regulatory bodies;
- \* Their prescribing the Code of Best Practice; and
- \* The adoption of their recommendations in listing rules.

In this chapter some discussion refers to the hypothetical situation that Enron had taken place in the UK instead of the US. It is analysed to assess whether the UK's corporate governance framework would have been able to prevent it. An analysis of the UK's various reforms which have been affected post-Enron then follows, that is:

- \* The legislative approach of the UK in the form of the Companies (Audit, Investigations and Community Enterprise) Act 2004 and the proposed Company Law Reform Bill; and
- \* Its traditionally followed approach of comply or explain codes.

In particular, the provisions of the main instrument which regulates corporate governance, the Revised Combined Code 2003, are discussed. At the end of this chapter the provisions of the Company Law Reform Bill 2005, which affects corporate governance, are mentioned in brief to show the shift in approach of the UK from self-regulatory to legislative. (Further comment on aspects of due diligence and corporate governance can be found in *Due Diligence and Corporate Governance 2004/2005* by Dr L. S. Spedding.)

It should be noted that a comparative analysis covering US reforms post-Enron occurs in Chapter 22 with a view to assessing the risks posed by a new era of stricter governance standards in the context of a sustainable approach to business risk management.

## Corporate governance and sustainable risk management

When reviewing the aspects of sustainable risk management, which have been considered in earlier chapters, it is evident that poor corporate governance has been a crucial cause of corporate failures. On the other hand, corporate successes have been due to good corporate governance and good strategy, especially in transactions such as mergers. These conclusions have been reached in SERM case studies, as well as in various reports of corporate commentators and advisors. Significantly they were also two of the main findings of a report *Enterprise Governance – Getting the Balance Right* published by the International Federation of Accountants and the Chartered Institute of Management Accounting (CIMA) (the CIMA Report).

### *The CIMA Report: Enterprise Governance – Getting the Balance Right*

This report looked at 27 international case studies – 11 outstandingly successful companies and 16 failures – by analysing literature such as inquiries and newspaper articles. It then rated factors behind success or failure for each company in a number of matrices which revealed some clear similarities. Failures studied include Ahold, Enron, WorldCom and Vivendi. Successes included Tesco, Southwest Airlines and Unicredit Group in Italy.

The CIMA Report analysed corporate governance facts in relation to well-known organisations that had been noted for their success or failure internationally. One key consideration was the culture of the organisation (see also Chapter 12) that affects also its brand and reputation (see Chapter 9). The analysis considered each company in the light of the following issues:

- Whether the role of the chairman and chief executive was split;
- How long the chairman, chief executive and financial director had been in place and where they had been recruited from;
- The executive remuneration package;
- The composition and background of the board;
- Information about mergers and acquisitions;
- Strategy development and implementation; and
- The use of complex financial engineering techniques.

### *Enron's failure*

Key corporate governance factors – including its corporate culture – played an important role in the fall of mighty Enron which was once the seventh largest corporation in the United States; the corporation named six years consecutively as the most innovative company of the year by *Fortune* magazine.

Having regard to sustainable risk management, it is interesting to note that the report's findings demonstrated that the four key corporate governance factors underlying failure are interrelated. This was reflected in the case studies where it was found that no single issue dominated. The four key corporate governance issues that were found to underpin failure – the culture and tone from the top, effectiveness of the board, effectiveness of the chief executive and internal controls – were also significant in the cases of corporate success. Good governance is seen to add value to an organisation:

Academic evidence suggests companies with better corporate governance will deliver higher returns. (Philip Coggan, 'Lombard', *Financial Times*, 7 August 2003)

Moreover, this is clear regardless of location, as was seen in the Bangkok Mass Transit case study (see box below): this is relevant to the conclusions discussed in Chapter 23 as regards the application of corporate governance principles in emerging markets.

*The Bangkok Mass Transit System case study: a successful company*

In the successful companies analysed, a virtuous circle emerges. This is based upon a decision to take good governance seriously because it is good for the company rather than necessary to comply with legislation. The CIMA Report highlighted the Bangkok Mass Transit System in Thailand as a good example of this: 'The case of the Bangkok Mass Transit System is one where, through the awareness of the professional management and the self-discipline of the shareholders, key principles of good corporate governance were established well before the subject was widely discussed in Europe, America or Asia. It is through this early awareness of the importance of corporate governance that the company gained trust and confidence from investors and lenders and hence was able to weather the financial dark years of Thailand.'

## Risk management and the Turnbull recommendations

There is no doubt that the area of risk management is one of increasing concern to business, regardless of where it operates and its apparent size. It has been noted in earlier chapters that off balance sheet risks in particular have become key issues. Moreover there has been a particular push to understand risk management following the Turnbull Report and the implementation of the recommendations that risk management should be embedded in corporate policy at board level (see also box below). As a result of supply chain, competition and related requirements such recommendations have vast repercussions nationally and internationally.

### *Risk*

Risk is part of the entrepreneurial culture needed by any organisation that wishes to develop, expand and improve. An effective risk management structure allows an organisation to understand the risks in any initiative and to take informed decisions on whether and how the risks should be managed. Risk management is now a practical feature of doing business in today's world, just as due diligence should be recognised as another proactive tool that is of vital assistance in the management of risk. Nowadays no matter where an organisation operates – and whatever its size – risk management is becoming an increasingly essential part of today's business environment and is of interest to:

- \* CEOs, financial directors, other executive and non-executive directors;
- \* Company secretaries;
- \* Heads of internal audit, risk management or other assurance functions; and
- \* All managers with an interest in risk management.

Risk management should be regarded as an opportunity to improve not only the management of the particular risk or uncertainty in a specific project but also the business as a whole.

As is recognised in the UK, controlling risk requires an understanding of the dynamics of change and a healthy respect for the unexpected. The discipline of risk management extends to matters such as environmental management (see Chapters 18 and 19) and provides an armoury of tools and techniques to help organisations, and the individuals within them, to succeed in a complex world. Whereas risk management will never be a substitute for prudent judgement, it can sharpen innate wisdom and improve decision making to help organisations both survive and thrive. This is very important in the UK in the light of the Turnbull Report. The date for compliance with Turnbull was 23 December 2000. This has required that any programme should focus on the way to achieve full disclosure to ensure that risk management processes are embedded in corporate policy at board level for listed companies. Any additional practical advice on how to create an embedded and ongoing risk management process should be valuable. Benchmarking with other companies is a valuable tool to help in this endeavour.

## **Internal controls**

The CIMA Report referred to above showed that internal control weakness is a logical outcome of various failings in risk management. This is crucial to sustainability and was clearly demonstrated in the Enron case study (below).



For example, Enron's emphasis on earnings growth and individual initiative meant that inexperienced managers were allowed too much leeway without the necessary controls to minimise failures.

As the Enron case study also shows, it is important not to overlook the role of executive remuneration in a company's performance. In particular, a poorly designed rewards package – including, for example, an excessive use of share options – can distort executive behaviour in the direction of aggressive earnings management so that the long-term interests of shareholders are compromised. As the SERM case studies have also shown there have also been many well-publicised instances recently where executives have, in effect, been rewarded for failure. This often causes outrage among stakeholders, affects corporate reputation and impacts on business sustainability.

*Aggressive earnings targets: the WorldCom case study*

According to the CIMA Report, fraudulent accounting tended to occur when aggressive earnings targets were not met. This was apparent in the three highly publicised US cases of Enron, WorldCom and Xerox as well as Ahold in the Netherlands. WorldCom, the US telecoms giant, became the world's biggest bankruptcy case.

In mid-2000, with the telecommunications industry in a severe slump, WorldCom announced that the company's results for the second half of the year might fall below expectations ... Thus began the process of managing earnings. In order to hit the 2000 year-end profit target, reserves were used to cover line charges. The establishment of these reserves had been questionable at best, and the use of reserves to cover current expenses was in clear violation of accounting rules. When mid-level accounting personnel raised objections to this strategy, the CFO assured them that this was a one-time event that would help WorldCom over a rough place in the road.

Indeed many issues arose about the role of accountants and investment banking representatives, as well as the unhealthy relationships that were not at all transparent. It was reported that Lynn Turner, Chief Accountant of the SEC from 1998 to 2001, who was previously a partner in Cooper & Lybrand, admitted in a television interview: 'All the Big Five accounting firms helped Wall Street investment banking firms to engineer hypothetical transactions to make companies look better than they actually were.'

The general lack of participation, accountability and transparency were interrelated key concerns that, as seen below, have led to reform. Yet significantly it was the complex performance-related culture that also led to dishonesty. For example, it was reported in *Business Week* online:

Enron didn't fail just because of improper accounting or alleged corruption at the top. It also failed because of its entrepreneurial culture. The unrelenting emphasis on earnings growth and individual initiative, coupled with a shocking absence of the usual corporate checks and balances, tipped the culture from one that rewarded aggressive strategy to one that increasingly relied on unethical corner-cutting.

In an article by Professor Jensen and Joseph Fuller of the Monitor Group it was argued:

As the historic bankruptcy case of Enron suggests, when companies encourage excessive expectations or scramble too hard to meet unrealistic forecasts by analysts, they often take risky value-destroying bets. In addition, smoothing financial results to satisfy analysts' demands for quarter-to-quarter predictability frequently sacrifices the long-term future of the company. Quarterly reports therefore are the biggest bane of the corporations. It is the fear of the quarterly results that drives CEOs to inflate earnings.

## The Enron case study

As has been indicated Enron was one high profile failure in a series of internationally reported corporate failures which also included WorldCom and Marconi. Moreover these were not isolated cases. They all had several reasons for failure. Yet if there is one lesson to be learned from them it is that as part of its risk management an organisation cannot have a box ticking approach to corporate governance. Indeed Enron had ticked every box and the chairman of its audit committee was a person of irreproachable reputation and no less than the Dean of Stanford Business School. Despite other key case studies, it is through the penetrating analysis of Enron that an opportunity to make change in the world of corporate governance occurred in most jurisdictions.

### **The rise and fall of mighty Enron**

Enron was founded in July 1985 as an interstate and intrastate natural gas pipeline company with InterNorth acquiring Houston Natural Gas (HNG). InterNorth was renamed as Enron Corporation by Kenneth Lay, CEO of HNG who became CEO after the merger. Initially the business of Enron was:

- \* To transmit and distribute electricity and gas within the US; and
- \* The construction and operation of pipelines, power plants and other infrastructure internationally.

### *The growth of Enron*

In 1989 Enron started trading natural gas commodities and went on to become the largest natural gas trader in North America and the UK. In 1994 it began trading in electricity and became the largest trader of electricity in the US. In 1997 Enron further diversified its business by entering into the trade of weather derivative products, coal, pulp, paper, plastics, metals and bandwidth. Enron's wealth kept growing and it was named the most innovative company by *Fortune Magazine* from 1996 to 2001. This was the peak period when its executives behaved as superstars and hobnobbed with the people in power. It was reported that its offices were so opulent that they were cause of envy for even the cream of the financial world. This was the time when it was considered one of the hundred best companies to work for in America.

*The fall of Enron*

In 1998 Enron ventured into the water sector by creating Azurix Corporation, which ultimately failed, and in April 2001 the decision to sell its assets was announced. Meanwhile EnronOnline, which was launched in November 1999 and facilitated buying and selling worldwide through web transactions, was a huge cash drain for Enron. Its major weakness was that it allowed transactions with Enron only. Enron's wealth shrank as the major source for generation of cash, its pipeline service, had already shut down.

Enron in fact became rich primarily through creative accounting. This fact became evident when the financial statements for the last five years were revised on 8 November 2001 stating the loss of \$586 million. After only 11 days the third quarter earnings were restated. It was disclosed that an attempt to restructure obligations worth \$690 million was made. On 28 November 2001 Dynegey Inc., which was purchasing Enron, backed out and the share value plunged below \$1. Enron collapsed and finally analysts announced that Enron's bankruptcy was likely. The inevitable happened and the mighty Enron filed for bankruptcy in December (see <http://www.scripophily.net/encorlarbusf.html> accessed on 15-5-06, <http://en.wikipedia.org/wiki/Enron> accessed on 15-5-06 and <http://business.guardian.co.uk/story/0,3604,1496488,00.html> accessed on 15-5-06). Enron's Auditors, Arthur Andersen, formerly one of the big five group of auditors, were convicted by jury on account of obstruction of justice as they destroyed the documents relating to Enron's audit (though the Supreme Court of US reversed the conviction in July 2005 and ordered retrial on the ground of flawed instructions to the jury by the judge: too late to save the company). The superstar executives of Enron faced civil and criminal trials. For example, Jeffrey Skilling, former CEO, faced 35 charges, including conspiracy and fraud.

The prosecution alleged that Skilling attempted to fool investors into thinking that Enron was a healthy company while he and other Enron executives lined their pockets. In their view a web of complex and self-serving financial frauds had been weaved by the executives. Kenneth Lay, the former chairman who has since died, faced seven counts of fraud and conspiracy. The prosecution alleged that Lay perpetrated Skilling's scheme as Enron tumbled toward bankruptcy. Enron was the first to fall in the wave of corporate crimes that shook the US after the millennium.

The world started assessing the reasons for the fall of Enron, not only the US, where Enron was based, but also other countries like the UK. They began to overhaul their rules and regulations related to corporate governance. The repercussions of the Enron collapse have not come to a halt even several years after its fall; such was the shock effect of the fall of the once great Enron.

### *What caused Enron's fall?*

Despite extensive debate over what caused the fall of mighty Enron, it is still relevant to clarify what led to the collapse, as well as to consider how the governance shortcomings have been rectified in the US and the UK and to consolidate the different reasons which were thought to be the cause of failure of Enron by different scholars and analysts.

If the reason for the Enron collapse is to be given in one sentence then it may be said that Enron's inside monitors, directors and outside monitors, auditors, stock analysts, credit agencies failed miserably in being independent and objective while performing (or not performing) their duty towards investors. Conflict of interest meant that they lost all objectivity.

In the following paragraphs the major causes that were instrumental in the fall of Enron are borne in mind while considering the UK corporate governance background and framework. It may be recalled that:

- The immediate cause for collapse was the revelation that creative accounting helped Enron to hide its losses through the extensive use of SPEs (see also below); and
- The bankruptcy was the result of cumulative failure of its gatekeepers such as directors, auditors, lawyers and analysts.

As indicated, in the next chapter the US reforms are considered by way of comparison.

## **The background and framework**

In the UK the corporate governance regime is controlled by common law rules, that is:

- Case law largely relating to the fiduciary duties of directors; and
- Statute, in particular the Companies Act 1985 and the Companies Act 1989, which apply to both listed and unlisted companies.

In addition, listed companies must comply with the requirements of:

- The Combined Code on Corporate Governance;
- The Listing, Prospectus and Disclosure Rules issued by the Financial Services Authority (FSA); and
- The City Code on Takeovers and Mergers.

Accordingly there is no single source of law from which the rules governing corporate governance emanate but a range of sources (e.g. Kay and Fowler 2005) are available. In addition to these sources of law, the regulations and reports

discussed below have a significant effect on the way in which corporate governance in the UK has been shaped into a self-regulatory form of governance (Law and Wong 2005).

The equivalent corporate collapses in terms of well-documented cases of corporate mismanagement of Enron in the UK – the Maxwell and Polly Peck debacles – had already taken place in 1991. These debacles led to re-evaluations of aspects of corporate governance frameworks such as:

- Board and structure independence;
- Financial reporting;
- Executive compensation;
- Shareholders' rights; and
- Company's ethical, social and environmental responsibilities and reporting.

It is for this reason that it may be said that the UK government was in certain ways more advanced in carrying out corporate governance reforms in comparison to the US.

Prior to the Enron collapse corporate governance reforms in the US were more at state level, such as the reforms in the state of Delaware. In contrast corporate governance reforms have been consolidated at national level in the UK and have been systematic through a committee process. Unlike the US, where corporate governance is focused on shareholders, in the UK the approach has recently been in favour of combining shareholder and stakeholder perspectives.

Companies in the UK and the US have been found to have differing approaches to corporate governance in that in 90% of the UK's largest companies the CEO and chairman have distinct roles whereas in the US that is the case in only 19% of companies. Executive compensation (referred to above) in the US is twice that of their UK counterparts. Moreover long-term incentive plans and stock options as a corporate governance measure to balance the interests of shareholders and executives equates to 161% of the average salary of CEOs in the US whereas in the UK it is only 44% (Williams and Conley 2005). A brief overview of the relevant UK reforms follows.

## The Cadbury Report

### *UK corporate collapse*

The early 1990s had witnessed a series of corporate failures and there were government-supported systematic studies of corporate governance to address the causes of collapse. However, with hindsight the recommendations made by government-supported committees did not prevent further collapse though these were adopted by self-regulating businesses.

The fall of Robert Maxwell's media empire led to the Cadbury Report which addressed the role of directors and also reviewed the auditor's role. The Cadbury Report concluded that the most basic requirement for good corporate governance is the accountability of the board to investors. The Cadbury Committee was of the view that the foremost duty of the board is to provide investors with all relevant information and recommended segregation in the roles of CEO and chairman of the board.

## The Greenbury Report

This report was published three years after the Cadbury Report. It was the Greenbury Report which concentrated on compensation and recommended the appointment of a remuneration committee consisting of nonexecutive directors, as well as the participation of investors in decision making as to compensation.

## The Hampel Review

The Hampel Review in 1998 reviewed both the previous report and endorsed the recommendations of both the reports regarding:

- The duty of the board to provide shareholders with all relevant information;
- A separate role for CEO and chairman; and
- The importance of the role of non-executive directors.

Since the recommendations made in all the three reports were not converted into legislation they did not require legal obligation on the part of companies to comply with them. The recommendations proposed by the Cadbury Report and the Greenbury Report were included by the London Stock Exchange in its Listing Rules as Best Practice Code and those of the Hampel Review into the Combined Code.

## Modern company law for a competitive economy

The fourth report, entitled *Modern Company Law for a Competitive Economy*, focused on disclosure and called for legislative action. It differed from the previous reports which did not propose statutory reform.

Despite all these systematic studies and evaluations of corporate governance, collapses have not continued. Moreover, in spite of the controversy over the role of non-executive directors in such collapses and risk management failures, the number of non-executive directors (NEDs) was not less in failed companies than successful companies. This is best illustrated by the fall of Marconi which is set out in the box below.

### *The Marconi case study*

Telecoms equipment group Marconi recorded a £5.1 billion loss before tax for the six months to September. The loss occurred after the company partly wrote off expensive acquisitions it made at the height of the technology boom. The company, which lost its top executives as its share price sank from a high of £12 to around 30p, saw sales fall 19% from last year to £2.58 billion.

With sales falling, the company's debt – a key source of concern for investors already overburdened with bad news – ballooned to £4.28 billion from £3.17 billion at the end of March. The losses prompted investors to sell Marconi shares in early trading. The roles of CEO and chairman were well separated.

The non-executive directors were not in any real sense independent as the company influenced them bearing in mind their very high salaries (as later recommended in reports of corporate governance).

The shareholders awoke only when the company was in financial distress and needed capital. The three issues that came to light with the fall of Marconi were:

- \* The role of non-executive directors;
- \* Computation of termination compensation; and
- \* Executive stock options.

Therefore the conclusion is that the UK was not necessarily faring better than the US although of course the magnitude of fraud by the management was not as high as in the US (Dickerson 2003).

Meanwhile the conclusion of the study of UK companies by a professor of Brauch College, Jay Dhaya, revealed that the separation of the CEO and the chairman of the board did not bring significant improvement in functioning or performance of the price of stock. In his view, although the split does not affect the value of the stock, in particular circumstances the division may help. One case in point is that of those companies that face heavy regulatory scrutiny. They may have the chair focusing on government relations or having global experience whereas the CEO concentrates on domestic business. Evidently the split should be done if the specific circumstances of the company ask for and support the separation (Pozen, Robert C. *Harvard Business Review*, April 2006).

## The Enron case study: dimensions of risk management and corporate governance

An important question that arises for consideration is whether the corporate governance system regulating corporations in UK, if applied to Enron, would have prevented the collapse of Enron. With this in mind, an attempt has been

made below to analyse the major causes of the fall of Enron bearing in mind the UK corporate governance framework. It is also made bearing in mind the issues of sustainable risk management in the context of this book.

## *Board oversight*

One of the main causes of the fall of Enron was the close involvement of the directors with the management or, put another way, their lack of supervision of the malfeasance of the management on account of:

- Conflict of interest;
- Insufficient financial knowledge to understand the complex accounting of Enron; and
- The star status of the executives of Enron which gave them an aura of being unable to do wrong.

In the UK while the board may have a non-executive chairman, insiders may be in the majority on the board who will side with management. Moreover the requirement of shareholders' acquiescence in transactions involving conflict of interest may not be effective due to the extensively dispersed ownership structure in the UK. This may lead to voting in favour of the management by default. Therefore it is unlikely that the board structure in the UK could have prevented the circumstances of Enron (Thorburn 2003).

### *Eversheds survey*

It was reported in the *Law Society Gazette* that in a survey carried out by the national firm Eversheds more than three-quarters of board directors (78%) at public companies believed that increasing corporate regulation had improved transparency. However, only 36% of those directors – and 42% of equity analysts – considered that the current regulatory environment reduced the risk of an Enron-style scandal in the UK.

Meanwhile they thought that the increased regulatory burden imposed in recent years was damaging corporate profitability and growth. Almost three-quarters of the analysts (73%) and four out of 10 directors believed that an increase in red tape had a negative impact. Steven Francis, a regulatory partner at Eversheds, commented: 'Given that much business regulation introduced in the last few years has been designed to improve governance, protect investors, employees and customers and prevent another Enron or Worldcom, this lack of confidence among UK plc's is very worrying.'

## *Lack of auditor independence*

In the Enron case the auditors lacked independence since the provision of consulting services to a corporation increases the influence of the executives over



the auditors. In the UK, therefore, the principle-based accounting rules could have prevented an Enron-like collapse as they put more pressure on the corporation to consolidate off balance sheet transactions. The mandatory requirement of consolidation not only makes the financial condition of the corporation transparent to investors and directors but also lessens the problems associated with conflict of interest with auditors.

## *Executive compensation*

Executives' pay in the UK is not based on share price, unlike the US. This means that the framework does not induce executives to go for short-term gains by getting stock price moved for some time. Hence there is less risk of executives minting money by moving up the stock price for a short term and gaining profit even when the corporation is on the verge of collapse (Thorburn 2003).

Although no corporate collapse of the magnitude of Enron and WorldCom had occurred in the recent past, the Enron collapse did not leave the UK unaffected. The UK embarked on its traditional systematic approach of addressing the causes of the failures of the corporations by study and revaluation by committees constituted of corporate experts.

In its pursuit to reform corporate governance and keep it up to date the following proposals were introduced by the UK government:

- The Companies (Audit, Investigations and Community Enterprise) Act 2004 was introduced for better regulation of the accounting and audit profession, to enhance the confidence of investors in company reporting and enforcement and to add to investigating powers;
- Under the Directors' Remuneration Report Regulations 2002 quoted companies were required to disclose and seek shareholder approval to remuneration policies and to divulge how salaries connect with performance; and
- In addition to legislative measures, the UK government also introduced non-statutory measures like oversight and enforcement powers for the Financial Reporting Council (FRC) to improve and reform company law (Sheikh, Saleem. 'Company law reform: Part-1', *International Company and Commercial Law Review*, 2006, 17(1), 13–21).

It was proposed that all quoted companies should produce the Operating and Financial Review (OFR), a type of report (referred to earlier) required to be produced by the company mentioning future strategies, resources, risks and uncertainties. This requirement has been repealed by SI 2005 No. 3422, the Companies Act 1985 (Operating and Financial Review) (Repeal) Regulations 2005 which came into force on 12 January 2006. However, these companies are still under an obligation to produce a business review as part of the director's report and such review must be in compliance with the Companies Act 1985 (see further comment below and *Butterworths Corporate Law Update*, February 2006). Moreover, since its repeal there has been extensive discussion regarding the best practice that companies should observe as many had prepared in advance for the OFR and had developed their corporate approaches with this in mind.

### *Proposals for change*

The FRC is seeking views on proposals to introduce some changes to the 2003 Combined Revised Code (Butterworths *Corporate Law Update*, February 2006) such proposals include:

- \* Relaxing existing provisions to allow the company chairman to sit on the remuneration committee;
- \* Providing shareholders with the ability to vote by proxy with the choice of withholding their vote; and
- \* Making it obligatory for companies to publish the results of resolutions voted on a show of hands.

In response to the Enron collapse the UK government set up one review to look into accounting and audit issues and another one to focus on the FSA Listing Rules. The changes were adopted in the Combined Revised Code on Corporate Governance 2003 ('Code') which came in force in November 2003 (Falencki, Corinne A. George *Washington International Law Review* 2004).

## The Combined Code

The Combined Revised Code on Corporate Governance 2003 (the Combined Code) is the current authority on corporate governance in the UK, reflecting its 'comply or explain' approach in dealing with Enron-like frauds. Its enforcement does not come through statute but through the obligation imposed on companies to comply with the Code in order to be listed with the London Stock Exchange (Lunt, M. *Journal of Business Law* 2006).

The important features of the Code are summarised below followed by a discussion on how the Code affects corporate governance:

- The Code splits the role between the chief executive officer (CEO) and chairman and provides that the number of independent non-executive directors (NEDs) should be 50% of the board, excluding the chairman. Therefore the independence of the board is emphasised;
- There are also provisions for the best or most appropriate person to the board, for informing them of relevant management issues and for induction and training to ensure that their duties are carried out properly;
- It provides for self-evaluation and for performance review of individual directors;
- It requires a contractual notice period of a year or less and that the outgoing director should mitigate the loss by receiving reduced compensation;
- There are also provisions as to financial reporting, requiring the board to present a proper and comprehensible evaluation as regards the company's prospects and position along with the maintenance of annual internal control review;

- The audit committee should consist of only independent NEDs of whom at least one has recent and relevant experience;
- The audit committee is to oversee the auditors but can only make recommendations to the board to hire or fire them;
- To maintain transparency, the role and responsibilities assigned to the audit committee have to be disclosed on the company's website and in its annual report;
- There is no prohibition on the supply of non-audit services although it has to be explained how independence can be maintained in such circumstances;
- The audit committees are responsible for entertaining complaints from whistleblowers and for taking follow-up action; and
- There is also provision for dialogue with institutional shareholders and the attendance of all directors at the annual meeting is required (Waring and Pierce 2005).

#### *The Combined Code*

The Combined Revised Code 2003, the result of the Higgs and Smith Reports in January 2003, is considered to be well thought through as a non-legislative response to Enron in comparison to America's SOX (Solomon, *Aris International Company and Commercial Law Review* 2004). The focus of the Higgs Report was the role of non-executive directors whereas the Smith Report concentrated on accounting standards. The UK government, in response to Enron's collapse, had set up one review to look into accounting audit issues and the other one to focus on Financial Services Authority Listing Rules.

## Listing Rules: comply or explain

In order to be listed, companies in the UK are required to comply with the Combined Code. Although the Combined Code is not binding on the companies in the way that legislation is enforceable, nevertheless it is obligatory on them to:

- Comply with the principles set in the Code and explain how those principles were applied; and
- Explain the reasons for non-compliance if there is no such compliance.

This kind of 'comply and explain' approach gives sufficient information to investors about the company's corporate governance practices and an opportunity for them to respond in an informed manner (Mdntysaari 2005).

#### *Comply and explain*

Listed companies are required to confirm that they have complied with the provision of the Code and – if the provisions are not complied with – then it has to be explained why not.

The FSA's Listing Rules require companies to file a two part corporate governance statement:

- In the first part they state how the provisions of the Code were complied with; and
- In the second part they state the confirmation of the compliance or explain the reasons for non-compliance (Waring and Pierce 2005 – see the Web links at the end of the chapter).

The approach may be compared with the regulatory approach of SOX in the US. Therefore, for example, whereas Section 301 of SOX (see Chapter 22) specifically forbids companies to provide certain non-audit services, the Code merely asks companies to explain in their annual reports how independence can be maintained if non-audit services are provided with audit services. Whereas the Code emphasises the significance of NEDs to maintain the confidence and trust of the investors like SOX instead of a regulatory approach in the UK this objective is achieved by means of stock exchange listing requirements (Waring 2005). Sir Higgs has therefore said that the Code describes the best practice to be followed by listed companies in the UK (Newing, R. *Financial Times*, 16 January 2004).

## Corporate governance in practice

The Combined Code is the sum total of the wisdom of all the Reports which had dealt with specific aspects of the corporate governance. As explained, compliance with the Code is made essential by Listing Rules of the LSE which demand explanation for non-compliance. The narrative statement must be included by the company in its annual report as to how the provisions of the Code have been complied so that investors can establish the extent to which compliance has been made (para. 12.43A of the London Stock Exchange Listing Rules).

While the provisions contained in the Code seem to be soft and non-obligatory when compared with SOX, in practice strong market forces ensure compliance with the provisions contained in the Code instead of leaving it to companies to fabricate excuses for non-compliance. As noted, the Code requires the chairman to be an independent non-executive director and half of the members of the board to be non-executive (excluding the chairman). The requirement for a listed company to have audit, nomination and remuneration committees is also laid down. It has been argued by some practitioners that the overemphasis on the need for a dominance of NEDs on the board may lead to poorer performance of the company. The effectiveness of the supervisory and monitoring functions of the independent NEDs may be affected by such factors as their:

- Obtaining information prepared and received by the management;
- Lack of knowledge of the company's business; and
- Lack of time or commitment.

The independent non-executive may indeed turn out to be a professional whistleblower who abandons the collapsing company to avoid personal liability.

In practice it is difficult for so-called independent non-executive directors to avoid the influence of the management (Plessis *et al.* 2005). Therefore critics in the UK seem to be concerned regarding the dominance of independent non-executive directors on the board just as in the US. The apprehension is that a lack of cooperation between the board and management will lead to poor performance of the corporation.

The Code also addresses the problem related to compensation of executives, which was highlighted in Enron where the executives capitalised on a short-term rise in stock in order to pocket millions from the sale of inflated stock (see box above). The code requires long-term incentive plans to be approved by shareholders. In addition the compensation report to shareholders must be approved by them (Garrett 2004).

#### *Key changes*

The significant changes brought about by the Code in UK corporate governance include:

- \* The importance of the role of non-executive directors;
- \* Their relationship with shareholders; and
- \* Representation of the shareholders at the board.

The Code also addresses the audit issues which were at the core of the fall of mighty Enron. The audit committee is conferred with a supervisory and monitoring role to rein in external auditors and – like SOX in the US – provisions have been laid down to ensure the independence and competence of the audit committee. The principles laid down in the Code not only help to improve corporate governance by laying down specific requirements to be followed by listed companies but will also provide further guidance to courts when deciding on issues like directors' duties (Morse 2005).

Therefore, it has been concluded by commentators that, despite the fear of over-reliance and overemphasis on the role of non-executive directors, the Code undoubtedly enhances good corporate governance. It achieves a positive step towards the UK's systematic strategy to curb frauds and malfeasances of management, thereby protecting investors.

## **The Company Law Reform Bill**

The collapse of Enron and other companies have brought not only fraudulent executives and false accounting into scrutiny but also the role of directors. The Companies Act Reform Bill (the Bill) introduced in House of Lords on 1 November 2005 sought to codify duties owed by the directors to the shareholders and creditors (Swain 2006). It is the result of the study of British company law by *Company Law Review* that was established in 1998. The Bill once enacted will not replace the Companies Act 1985 but will only affect provisions

common to large and small companies or only relating to small companies (Mayson *et al.* 2005–06).

The Bill is expected to come into force as the Companies Law Reform Act 2006 in 2007 and its main objectives are to:

- Simplify the administrative burden on smaller companies;
- Facilitate shareholder engagement especially in quoted companies; and
- Update and clarify the law in key areas specifically with regard to director's duties.

The Bill has been the subject of extensive debate and comment here is limited to aspects of corporate governance and risk management. It should be noted that the duties of the directors, as laid down by the courts in various judgments, are being codified in the Bill, with the objective to make them clearer and more accessible. Existing rules prevent a director from taking advantage of an opportunity which a company cannot avail of. It has been proposed to change this in certain circumstances so that start-up business activity is not hindered.

The rules regarding transactions between directors and companies have been considerably changed and duties of the directors have been codified in the Bill (the codified duties of the directors are stated in clauses 154–170 of the Bill). In particular there has been much lobbying by the Core coalition – a grouping of over 100 green groups, charities and other lobbyists – to seek to use the Bill as a lever to impose tougher statutory duties on directors in relation to environmental and social issues (see box).

#### *Business review Core amendment*

The Labour MP Jon Trickett, working with Core, put down an amendment requiring the business review that directors will have to produce each year to be audited:

- \* Follow standard reporting rules; and
- \* Include information on the supply chain.

This brings back the information disclosure requirement that had led to the repeal of the OFR.

## Transactions of the company with directors

Certain transactions need to be approved by the shareholders. These include:

- Substantial property transactions;
- Payment for loss of office;
- Long service contracts;
- Credits; and
- Quasi loans.

Therefore when the Bill becomes law loans to directors will be permitted only with the approval of the shareholders. Also compensation will not be granted to a director on account of loss of employment without shareholders' approval (Clauses 171–204 of the Bill).

## Transactions by directors with the company

Transactions or arrangements by directors with the company are not prohibited (Clause 159 of the Bill). The directors are not required to take permission of members or the board for entering into them. However, any interest the directors have in those arrangements or transactions must be disclosed unless an exception applies (Clauses 161 and 165 of the Bill).

## Directors' dealings with third parties

Transactions with third parties are not prohibited unless the company's objectives restrict them. In the Bill most of the conflicts of interests that may arise in the context of directors' dealings with third parties are permitted with the authorisation of the board. However, such board authorisations are permitted only when the director does not participate in decision making or – if he participates in the decision – it would have been valid otherwise (Clauses 159 and 160 of the Bill).

## Derivative actions

In the UK it can be very difficult for shareholders to institute an action against directors due to the costs of legal proceedings and the heavy burden of proof. The law requires that the director is proved to have acted illegally or fraudulent conduct on the part of directors must be established. The Bill will change this by enabling shareholders to bring derivative suits against directors.

### *Derivative actions*

The general rule is that only the company can bring an action if some wrong is committed to the company and not the shareholders. In reality it is the directors who take the decision in this regard and not the shareholders. Therefore if the directors are the ones who do wrong to the company the shareholders cannot do anything about it. This anomaly has been rectified by the Bill which permits the court to entertain derivative actions by shareholders by taking into account factors such as the true motive of the shareholder, importance of the claim to the company and if shareholders in their own right can bring a claim against the company. As a matter of fact the court will have to put itself in the position of the independent director to come to a decision whether it is prudent to pursue the derivative claim.

In the case where the decision of the director has been ratified by the shareholder majority then the court cannot permit proceedings in such a lawsuit (Clauses 239–243 deal with derivative actions stating the circumstances in which they can be brought).

In spite of the government's assurance that the change of law in this respect is not major and its objective is not to adopt a US type class action – there is controversy over the possibility of an increase in the number of claims against directors as to their negligence and breach of duty. This could be true without having to prove fraud on minority. There is also discussion over how far the minority shareholders will find it difficult to satisfy the court that they are acting in the interests of the company or to enhance the success of the company. In any case the shareholders will still be free to threaten the litigation in order to influence the board and to pressurise the directors.

Moreover the shareholders will also be able to bring action for directors' breach of duty in order to recover the money paid by the company for breaching rules of listing, health and safety or environmental regulations. Any damages awarded in such actions will, of course, be made to the company.

The government has dropped a proposal providing for jail sentences for directors who approve defective accounts: the maximum penalty will be an unlimited fine. The FSA has been conferred the power to make or amend the handbook rules. For example, amendments in the listing rules to implement EU directives in relation to corporate governance applying to companies listed in regulated markets.

Under the Bill there are provisions relating to the audit. These include:

- The limitation of the liability of the auditor firm (Clause 519 of the Bill);
- Criminal liability for misleading the auditor as to company's accounts (Clause 494 of the Bill); and
- Improperly influencing the auditor's report (Clause 489 of the Bill).

In essence the Bill is intended to overhaul company law by increasing shareholder participation and codifying directors' duties. It makes them clearer than before, thereby providing for an efficient basis for corporate governance (*Accountancy Ireland*, April 2006).

## Chapter summary

The above discussion demonstrates that the overall approach to corporate governance in the UK has reduced the risk of a collapse of the type that occurred in Enron. While the approach adopted so far has its critics, there is no doubt that for an organisation to be successful in the UK, having regard to this framework, it must take an increasingly enlightened view to both governance and risk management. Bearing this in mind the comparative approach of the US is considered in the next chapter.



*Useful web links*

- \* Waring and Pierce (eds) (2005) *The Handbook of International Corporate Governance*, Institute of Directors Publication, p. 167; [http://www.mazars.com/news/corporate\\_governance\\_gb.php](http://www.mazars.com/news/corporate_governance_gb.php) accessed on 16-5-06.
- \* United Kingdom: *The Company Law Reform Bill* by Peter Bateman and Simon Howley available at <http://www.mondaq.com/article.asp?articleid=36286&hotopic=1> accessed on 29-4-06.



22

Legal risk management in the  
US – the United States' response to  
the Enron collapse

# 22

## Legal risk management in the US – the United States' response to the Enron collapse

### CHAPTER OVERVIEW

In the previous chapter the UK's response to corporate failures was considered. The comparative approach of the US is explored in this chapter. The United States reacted to the series of corporate debacles at the beginning of this century – and particularly Enron – by reforming its corporate regulatory framework. In particular it:

- \* Reformed its corporate governance law by enacting the Sarbanes-Oxley Act of 2002 (SOX); and
- \* Applied to listed companies rule changes proposed by the Security and Exchange Commission and New York Stock Exchange (NYSE) and the National Association of Securities Dealers Automated Quotation System Stock Market (NASDAQ).

Therefore SOX is the key US legislative response to the Enron failure while the recent corporate governance NYSE listing requirements also consist of regulatory reform. Both legal and regulatory reforms aim to provide for more independence of the board and the auditor's lack of oversight which played a key role in the collapse of Enron (Elson, C. and Gyves, C. 'The Enron failure and corporate governance reform', *Wake Forest Law Review Fall* 2003, 92 GEOLJ 61). Traditionally in the US corporate law is under the jurisdiction of the states and federal law has merely played a supporting role. However, in the post-Enron corporate world corporate governance has become a collaborative process between federal law, state law and organisations which are self-regulatory such as stock exchanges. In short it can be said that the fall of Enron led to federalisation of American corporate law as discussed in this chapter (see also Thompson 2003).

### Sarbanes-Oxley Act (SOX)

In effect SOX brought about the federalisation of corporate law in the United States. Prior to that case it had been a matter for the jurisdiction of states. In

particular it was the domain of the state of Delaware in so far as around 30 000 companies are incorporated in Delaware, including more than half of the 500 top fortune companies, and thereby under the jurisdiction of Delaware courts (Delaware Business Central, available at web link at end of chapter). Set out below are the key features of SOX.

## The PCAOB

One of the major reforms introduced by SOX was the creation of the Public Company Accounting Oversight Board (PCAOB has been created under Section 101 of SOX). Its objective was to oversee accounting, thereby:

- Providing for an independent audit committee;
- Setting standards for corporate governance and responsibility;
- Enhancing financial disclosure requirements;
- Reducing the potential for conflict of interest; and
- Introducing criminal punishments for fraudulent and misleading financial reporting (Zolkos 2003).

In essence SOX brought an end to self-regulation of the accounting profession by creating the PCAOB to oversee the profession. The PCAOB also has the responsibility to further the public interest by ensuring that audit reports are independent and accurate. The registration of accounting firms is now mandatory (Section 102 of SOX) and registered firms become subject to the auditing, quality control and independence standards set by the PCAOB (Section 103 of SOX).

### *Repercussions of Arthur Andersen conduct*

It can be said that creation of the PCAOB is very effective to rein in the likes of Andersen who have been criticised for compromising the standards of the audit to serve their selfish interest. As a result of their role in the Enron failure the PCAOB is to set standards for and discipline accounting firms. The PCAOB is empowered to inspect (Section 104 of SOX) and conduct investigations (Section 105 of SOX) if there is violation of SOX securities law and the rules framed by it so that it is ensured that accounting firms adhere to standards set for them to provide accurate and independent audit reports. The PCAOB has been conferred power under SOX to punish erring accountants and firms in case they do not comply with SEC rules (Pritchard 2006). The punishment can range from fines, limitations on activities, suspension from audit functions on a temporary or permanent basis, censures and removal from clients’ arrangements (Lucci 2003).

## Conflict of interest: auditor independence

SOX deals with the problem of conflict of interest that arose in Enron as a result of which Enron’s auditors did not fulfill their responsibility of protecting the

interest of investors and declaring the true financial condition of Enron. The provisions of SOX prohibit auditors from providing nine types of non-audit services (Section 201 of SOX). Those non-audit services that are not banned under SOX will still need to be approved (Section 202 of SOX) by audit committee and disclosed to the public (Lucci 2003). The auditors are required to report to the audit committee of the company for which they are performing the audit:

- Critical accounting policies and practices affecting the financial statements;
- Any accounting disagreement with management; and
- All material written communications with management (Section 204 of SOX).

To maintain the independence of external auditors there is one more important provision of SOX. This requires for the rotation of the lead partner and review partner so that they are not auditing the company for more than five consecutive years (Section 203 of SOX). This provision of rotation is to prevent auditors from being too familiar and getting influenced excessively or captured by management.

#### *Impact on auditors*

Now auditors cannot be goaded or persuaded by greed to conceal the true condition of their corporate client in fear of losing benefit they get from providing non-audit services to it. In the case of Enron, the auditors, Arthur Andersen, were providing non-audit services worth fees far in excess of their audit fees. The conflict was that they did not want to lose the consultancy fees in non-audit services. As a result they did not carry out their responsibility towards investors. This cannot happen now.

SOX also changes the rules concerning the constitution of the audit committee. Now the audit committee is constituted of independent directors only and is directly responsible for hiring and firing of auditors. SOX also makes the audit committee completely independent by such provisions and the requirement that no fees can be accepted by its members other than by virtue of being a member on the board of directors (Section 301 of SOX). Accordingly, the audit committee is free of the influence and any sort of control of the management (Lucci 2003).

## Off balance sheet accounting

SOX requires the disclosure of off balance sheet transactions that have a material effect on the current or future financial condition of the company (Section 401(a) of SOX). In Enron millions of dollars were concealed to give the impression of profitability leading investors to buy Enron shares. These new disclosure requirements are to prevent off balance sheet transactions to hide losses

and present a strong financial state of the company to mislead investors (Kim, B. ‘Recent development Sarbanes-Oxley Act’, *Harvard Journal on Legislation*, Winter 2003). Now audit committees are entrusted with the role of overseeing the corporation’s financial reporting system and therefore have to play a crucial part in the protection of interests of shareholders (Vera-Munoz 2005).

The CEO and CFO are required to certify the financial statement personally and, in case of false certification, will be liable to face criminal penalties (Section 302 of SOX). The criminal penalties are enhanced to deter erring executives to commit fraud on the company. Moreover, if the corporation files a restatement of its finances the executives will forfeit the bonuses or profits gained in that year through the sale of stock (Section 304 of SOX).

#### *Insider dealing*

In Enron insiders were selling their shares and minting millions just before the filing of the bankruptcy in full knowledge of what was about to come but they were depraved and ethic-less to put a ban on employees. Now if this were to happen all the profit earned would be forfeited.

## Disclosure requirements

SOX imposes stringent disclosure requirements. The result is that all material off balance sheet transactions and special purpose entities are required to be disclosed in annual and quarterly financial reports. In addition:

- All financial trading by executives or directors has to be disclosed within two days;
- The current financial condition needs to be disclosed;
- In the event of the use of pro forma numbers by the corporation, then what would be the financial results by using generally accepted financial principles must be shown; and
- A code of ethics for finance officers, or its waiver, should be disclosed (Bumgardner, Larry ‘Reforming Corporate America’, available on website link at end of the chapter and on the CD-Rom).

#### *SOX reforms*

The SOX reforms were in direct response to the malfeasance of executives and utter disregard of their duties by directors of Enron. Now any executives certifying the financial statements personally should be aware that misrepresentation and misleading can land them in prison for even 20 years. The CEO and CFO could go to jail for 10 years and/or face a fine of up to \$1 million if they are aware of any false statement and a fine of up to \$5 million and/or 20 years of confinement in jail if the false statement is signed by them willingly (Section 309 of SOX dealing with criminal certification).

SOX requires executives to make honest disclosures as to the financial state of the company and not allow personal financial interest or conflict to creep in while making any decision on behalf of the company. They are accountable for the financial dealings of the company. Executives now face enhanced criminal penalties for up to 20 years in respect of mail or wire fraud (Section 903 of SOX). The destruction of documents in order to obstruct justice is now a criminal offence and accounting records are not to be destroyed until five years have elapsed following the completion of the audit (Duffey 2002).

### *Impact of SOX*

In total it can be said that executives and accountants have to be very careful in carrying out their duties towards the shareholders. Otherwise they will suffer the same fate as the superstars of Enron and Arthur Andersen have had to suffer, that is criminal trials, convictions, civil liabilities, loss of reputation and livelihood, etc. SOX makes executives, directors and auditors face dire consequences if they carry out fraud upon investors.

The disclosure requirements mean that the executives cannot keep investors in the dark: as noted, in the case of Enron for almost four years unscrupulous executives were able to hide the true financial state of Enron through off balance sheet transactions and SPEs.

The disclosure requirements are also made mandatory for corporate attorneys under the provisions of Section 307. It has been commented that SOX has in fact treated lawyers lightly in comparison with the accounting profession. They are only the subject of this section which has placed lawyers practising before the SEC under an obligation to report corporate wrongdoings. The light handling of attorneys by SOX is attributed to the scope of the self-monitoring and regulatory discipline systems already existing within the profession (Anello 2004).

## *Reforms of the New York Stock Exchange and NASDAQ Listing Rules*

These new rules particularly affect the constitution and conduct of the board. As a result:

- The boards of listed companies must have boards with a majority of independent directors;
- The audit, compensation and nominating committees must consist only of independent directors; and
- There must be a semi-annual executive session in the absence of management.

The rules provide for objectivity in oversight by the board by requiring independent directors to be in the majority on the board and to be the only ones to constitute the committees mentioned above. Now audit committee members

cannot draw any fee other than director’s fees. In Enron the board lost its independence by drawing compensation in addition to their directors’ fees, such as consultancy fees.

#### *The Compensation Committee*

The rules lay down guidelines for the Compensation Committee to determine the compensation for the CEO and require it to have a charter setting out its purpose, duties and responsibilities. Enron’s directors could not oversee effectively the excessive compensation of its executives on account of their lack of independence.

The sole responsibility of selecting and nominating directors and members of the committees lies with the governance/nominating committee. Therefore the CEO does not have the power to remove any director at his will. This provision gives absolute independence to independent directors without the fear of being removed through management opposition.

#### *Executive sessions*

The regular executive sessions without the presence of management enable more frank and unrestricted interaction among themselves. These interactions provide for more effective monitoring of management unlike the case in Enron where executives were present at the meetings of the board (Elson and Gyves 2003).

The rules also require corporations to disclose how the shareholders can interact with the independent directors to express their concerns in confidentiality. The code of conduct and ethics for management, directors and employees is required to be made public and all relevant information has to be provided on the company’s website.

#### *Nominating committees*

The NYSE and NASDAQ Listing Rules did not provide for the disclosure of the functioning of the nominating committees. Therefore in November 2003 the SEC approved new proxy statement disclosure rules requiring for the disclosure of the functioning of nominating committees and for interaction between security holders and the board. The enhanced disclosure requirements put security holders in a better position to analyse and understand the nomination process (DeGaetano 2005).



As regards executive compensation, the NYSE has made it obligatory to have compensation plans approved by shareholders (Garrett 2004).

## The positive effects of post-Enron reforms

The effects of the changes that have been introduced to improve corporate governance by the legislative and regulatory reforms in post-Enron corporate America are discussed below. These changes relate to:

- The independence of the audit committee;
- The increase in criminal penalties for white collar crime and the effects on directors;
- The creation of PCAOB for enhanced regulation of auditors;
- The prohibition of non-audit services;
- The prohibition of loans to directors and executives;
- Various kind of disclosures to provide transparency as regards the functioning of the company;
- Making attorneys liable for not reporting wrongdoing;
- The attempt to eliminate any conflict of interest affecting analysts;
- A prohibition on insider trading;
- A prohibition on improperly influencing an audit report;
- Making executives liable for false certification of corporation statement; and
- The protection of whistleblowers.

Further comment on the impact of key changes follows:

- Independence of the audit committee:
  - This has been examined above and has been considered to be very positive.
- Enhancement of criminal penalties for the commission of white collar crime:
  - It has been recognised in the US that white collar crimes can harm a society socially and economically and are comparable to the crimes committed by organised gangsters and drug traffickers. Therefore the sentence for wire and mail fraud has been increased from five to 20 years (Section 903 of SOX) and for security fraud the sentence has been increased to 25 years (Section 807 of SOX). The view is that executives who indulge in insider trading and betray the trust of investors are much more depraved than ordinary gangsters, because they are misusing their position of trust. The increase in criminal penalty is a step in the right direction to deter those executives who are tempted to commit fraud to earn a personal fortune.
- Effect on directors:
  - The provisions of SOX have affected directors considerably. In all boards of listed companies, the majority must be independent directors so that there is independence and objectivity in oversight. Some of the committees are to be constituted only of independent executive directors. The audit committee will be constituted only of independent directors of whom at least one should be a financial expert and will be responsible for the oversight of the external auditor. Under SOX specifically, the issue of directors'

independence from the influence of management has been effectively addressed by different provisions so that directors are not marred by conflict of interest and do not have a problem in asking difficult questions from management.

- The creation of the PCAOB:
  - The collusion of Arthur Andersen with executives of Enron brought to light the need for regulation of the accounting profession. The PCAOB is now responsible for registering accounting firms, inspecting their work and disciplining if they go off track under the influence of executives of the company they audit. The PCAOB is to supervise and monitor the working of external auditors to safeguard the interest of investors (Sections 101–105 of SOX).
- The prohibition on non-audit services:
  - Most of the non-audit services which accounting firms used to provide to a company that they were auditing have been prohibited. This prohibition is advantageous in two ways, first, the auditors can concentrate on auditing and second, the chances of their being persuaded by executives of the company and acquiescing to their fraudulent demands are eliminated since the fear of losing their engagement as providers of consultancy services is removed (Section 201 of SOX).

*New rules for special purpose entities (SPEs)*

Enron was able to transfer its losses to SPEs to appear to be a profitable company. Now it is not possible because companies have to disclose the SPEs’ results in their financial statement if the company is a de facto beneficiary and imbibes the gains and losses of the SPE.

Companies are also required to state off balance sheet transactions (Section 401(a) of SOX).

In the light of these two new rules related to SPEs, companies will not be able to shift their debt to SPEs which are in fact owned and controlled by them to deceive the investors and the public that the company is in a sound financial position when in reality it is not.

- In the post-Enron era the resources available to SEC have been increased by Congress and, in turn, SEC has decided to apply some of its resources to review the filings of fortune 500 companies (Section 408(c) of SOX).
  - Steps to eliminate analyst’s conflict of interest:
    - The Wall Street firms settled charges of \$1.4 billion with the New York Attorney General and SEC when they were accused that stock research activities were manipulated by them in order to gain fees for their banking divisions;
    - They also agreed to provide their client with independent research in addition to the research provided by them;

- Title V of SOX prevents banking firms from striking back against their analyst if the client companies are criticised by them in their reports and banking executives are not allowed to set the compensation for their firm's equity analysts; and
- The New York Attorney's litigation and SOX enable more independent and unbiased research from banks (Section 501 of SOX).
- Prohibition on loans:
  - SOX prohibits the extending of loans to the directors and executives of the company (Section 402(a) of SOX).
- Prohibition on improperly influencing audits and reimbursement:
  - The directors and officers are prohibited from influencing the audits of the company: if they do so then it is illegal under SOX (Section 303 of SOX). In the case of filing of any restatement of the company's finances then all bonuses and compensation based on equity and profits earned by way of sale of securities in the previous 12 months prior to the restatement of finances will have to be reimbursed to the company; and
  - This provision will protect investors from unscrupulous insiders who – as in the case of the Enron executives – know that the company is about to collapse and mint money as a result of having internal information (Section 305 of SOX).
- Prohibition on insider trading in pension fund blackouts:
  - This provision of SOX is also in direct response to the misdeeds of the directors and executives of Enron. They sold the company's equity securities during the period when employees of Enron were barred from doing so. Now SOX bans directors and executives from selling companies' equity securities during pension blackouts (Section 306 of SOX).
- Certifications by CFO and CEO:
  - The CFO and CEO are required to sign and certify the company reports to SEC and, in the event of false statement; they will be liable for civil and criminal liabilities (Section 302 of SOX).
- Enhanced corporate attorney's responsibility:
  - The corporate attorneys are required to report to the chief legal officer or chief executive officer of any material violation of the fiduciary duty or of US law; and
  - In the event of the management not responding to their complaints appropriately, they should report the matter to a committee constituted of independent directors or board of directors (Section 307 of SOX).
- Disclosure requirements:
  - SOX requires that material changes in the financial condition or operation of the company should be disclosed as per the rules specified by the SEC;
  - As discussed above, there has to be disclosure of any off balance sheet transaction which is material and also the relationship with unconsolidated entities having a significant effect on the financial status of the company has to be disclosed; and
  - Pro forma financial information has to be presented in a manner that is not misleading and should be reconcilable with the financial status of the company under GAAP (Section 409 of SOX).

- Internal control system:
  - The report has to be made as per the requirements of the SOX:
    - Containing a statement as to the responsibility of the management for setting up and maintaining procedures for internal control and procedures for financial reporting; and
    - Providing an evaluation of how effective the internal control structure and procedures for financial reporting are.
  - Such assessment of the internal control has to be attested by the auditors of the company (Section 404 of SOX); and
  - There has been some criticism regarding the impact of internal control structure requirements on small-sized and medium-sized companies and the benefit of auditors attesting the reports (since they were one of the main parties accused in the collapse of Enron) (see below).
- Code of ethics:
  - The company is required to disclose if a code of ethics is in existence for compliance by its executives and, if not, then why not (Section 406 of SOX);
  - Waivers also have to be disclosed; and
  - This provision has in fact proved to be counterproductive given that it leaves a lot of scope for manipulation by the draftsman of the company code to suit their requirements.
- Non-destruction of the audit record:
  - The auditors have to be careful that they retain the audit records for five years (Section 802(a)(1) of SOX) and do not let them be altered, destroyed or falsified in any manner that could cause an obstruction in investigations. Otherwise there is a likelihood that they will suffer the same fate which Arthur Andersen suffered for destroying the records related to the audit of Enron. The imprisonment prescribed is up to 20 years (Section 802(a) of SOX).
- Whistleblowing:
  - SOX provides protection to employees who report the wrongdoing and fraudulent conduct of the company from any retaliation by the company against them;
  - There is criminal liability for those retaliating against employees who blow the whistle; making discrimination against a whistleblower illegal (Sections 806 and 1117 of SOX); and
  - It should be noted that the same protection is not granted to the overseas employees of the companies listed in the US (see also comments on whistleblowing in Chapter 7 and further below).

*Food for thought*

It should be appreciated that had these steps been taken earlier perhaps Enron would not have happened. However, this is, of course, with the benefit of hindsight after witnessing the extent of corporate greed in cases such as Enron. It is at least better to take lessons from the previous mistakes than sit back and let other debacles happen without taking any action to prevent further failures (Kroger 2005).

## Overview of the reforms in the US

It is intriguing how – apparently – the corporate law in the US suddenly became inadequate to deal with the greed of executives and auditors of corporations in the new millennium. The last regulation affecting company law to a great extent in the US was in 1934. There have been divergent views on this issue. According to some commentators there were already existing laws and SEC was entrusted with sufficient powers that could have prevented such collapses, whereas other scholars and commentators of company law believe that the reforms in law were needed to prevent other Enron-like collapses to occur.

The enactment of SOX is welcomed for reinstating faith of investors in corporate America by majority of corporate experts. However, some have reservations about its worthiness. Various experts are of the view that SOX was passed in haste and therefore it has created unnecessary difficulties (Perino 2002). For example, SOX does not have the effect it was expected to have in protecting shareholders from corporate abuse because compliance with its provisions cost public companies too much money and time. As a result, instead of achieving the desired effect of protecting investors from corporate misbehaviour, it has ended up being too burdensome for the public market, especially for small and medium-sized companies (Bernstein 2006). Some of the key points are considered below:

- The major criticism of the reforms relates to Section 404 of SOX as large expenses are incurred in its compliance;
- The other problematic area is the effectiveness of the audit committee. Several experts consider it to be lacking sufficient financial expertise and information independent of management to be effective;
- The independence of external auditors is being questioned in the absence of any prohibition on the supply of tax services to the company for which the audit is being done;
- There are no specific regulations to improve governance, but, rather, rules to prevent bad governance; and
- The position of corporate attorneys is the same as it was before the reforms. The abetting of fraud was a crime even then and it is so after the reforms. No right has been conferred to lawyers under the reforms to raise objections to corporate decisions and to persuade clients to change them.

These criticisms of the reforms are discussed below in more detail.

### Side effects of Section 404

Going public has many advantages for small and medium-sized corporations, such as:

- Access to more capital;
- More liquidity;
- Improved exposure; and
- The potential to attract more suitable and qualified employees.

Despite these advantages, going public for these small and medium-sized firms will now involve the extra cost of compliance with the strict regulations of SOX. This is in addition to the expenses required for maintaining the public status of the company, the loss of control and flexibility and the time consumed in going public. All of these factors will neutralise any advantage that the small and medium-sized companies would gain by going public.

#### *SOX costs*

Foley & Lardner, a Chicago law firm, state that an average medium-sized company will be required to spend 90% more in the post-Enron era than it did in the pre-SOX period on account of compliance with stringent regulations.

Whereas larger companies can absorb the extra cost of compliance with SOX, small and mid-sized companies generally cannot as the law costs them so much monetarily and in terms of human capital. Though the intention of SOX in checking and controlling companies defrauding the investors is noble, its broad regulation restricts companies. As a result they have fewer routes to raise capital for investment. At the same time investors are left with fewer choices to invest in. Criticism has emerged on the issue as to whether on account of a few defrauding companies the whole class of companies should be punished. The argument or debate is that in the end it is always the market that decides the price and brings forth the irregularities. For instance, it should be recalled that even in the case of Enron it was not the regulators who exposed the corporate abuse but the market itself (Wilkins 2005).

It is believed by many experts that SOX was enacted in haste because of political pressure, without proper research and analysis of its provisions. Section 404 of SOX imposes too stringent compliance. It burdens the corporations with high costs because of high audit fees and in developing and maintaining an internal cost system. This is opposed to the objective of the maximisation of the shareholders’ wealth. It is ironic that the external auditors are the winners because of Section 404 (Huffman, T. *Brandeis Law Journal* 2004–05).

## Effectiveness of the audit committee

SOX requires external auditors to report to the audit committee of the company instead of reporting to management. There is no doubt that this new provision of giving oversight powers to the audit committee prevents collusion of external auditors and management. However, it also gives management the opportunity to take a factual defence before any jury that the audit committee was the one who was responsible for carrying out supervisory function over audits and not them. They could argue that the directors have been burdened with more responsibilities without making it effective for them to shoulder new extra

responsibilities as they have neither the competence nor the inclination to understand the intricacies of accounts (Kroger 2005).

SOX requires audit committees to have at least one financial expert and, with regard to this, disclosure is to be made. If the requirement is not complied with then the reason for non-compliance must be given. It is similar to the UK's comply and explain approach. However, this requirement does not serve the purpose as the audit committee members need to be expert in finance to understand the complexities of accounts so that they can recognise any kind of deception committed by management or auditors (Cunningham, Lawrence A. *Connecticut Law Review*, Spring 2003).

Under SOX audit committees are made responsible for supervising the audits of the company but, apart from the non-independent directors, the members of the audit committee remain ill-informed as to the affairs of the company. They are in the same position as the accounting firms which are carrying out the audit of the company. There is no provision in SOX for enabling them to be informed as to what is going on in the company through internal channels (Morse 2004).

## The independence of public accounting firms

SOX has especially provided for the independence for accounting firms so that there is no conflict of interest and no repetition of Enron and Arthur Andersen circumstances. However, one major flaw in this reform has been reported by several commentators. The tax services are not included in the non-audit services which have been prohibited by SOX. There is inherent conflict of interest in providing tax services to the company for which audit is being provided. The independence of accounting firms will be best served if there is a total ban on them from providing any other service than an audit service. There is general belief by investors that auditors should not provide any other service than audits (Barrett 2004).

## The effectiveness of the disclosure of waiver of ethics code

Section 406 of SOX was enacted to require companies to disclose the waiver of codes of ethics. The reason for such enactment is that the Enron board waived the code of ethics to facilitate the CFO in participating in the LJM-party-related transaction. The logic is that if this waiver had been disclosed then investors would have closely looked into these shady transactions. This reasoning does not; however, seem to be convincing bearing in mind that the regulators and analysts were indifferent to Enron's way of functioning for so long. This small disclosure is unlikely to have affected their attitude towards Enron. Moreover there is no elaboration in Section 406 as to what kind of code of ethics there should be and what waivers need to be disclosed. This uncertainty gives companies the opportunity to form such kind of code which requires minimum waivers. In reality this kind of ambiguity can lead to the lowering of moral and

ethical standards in the corporation (Kroger, J. *University of Colorado Law Review*, Winter 2005). This is because dishonest executives’ intent on abusing the code will not be deterred as codes can be rewritten to satisfy the bare minimum of the subjects mentioned by SEC. Meanwhile honest executives will also try to rewrite the codes in order to evade litigation. These are some of the negative signals to the market which a disclosure of the waivers can cause. This is one of the provisions which can be best described as an example of a counterproductive law (‘The good, the bad, and their corporate codes of Ethics’, *Harvard Law Review*, May 2003).

## No guidelines for good governance

SOX protects investors from corporate abuse because of mal-governance but does nothing to improve governance. It intends to prevent corporate misbehaviour but does not strive to introduce good governance (Carver, J. *Now Let’s Really Reform Governance*, available at business premier).

## Can lawyers be gatekeepers?

It has been argued that corporate governance cannot be resolved by assigning lawyers the role of corporate gatekeepers and information intermediaries without proper incentives to corporate attorneys, directors and managers. Under SOX corporate lawyers are required to report any misconduct to corporate officers and directors. The failure to do so attracts liability under federal law. The mandatory reporting by lawyers under Section 307 of SOX to prevent fraud will not be effective unless corporate attorneys are conferred the right to raise objections to corporate decisions and to persuade change. The abetting of fraud by lawyers was illegal before the collapse and it remains illegal also after the collapse. SOX does not affect the role of corporate attorneys in corporate governance (Fisch, Jill E. and Rosen, Kenneth M. ‘Is there a role for lawyers in preventing future Enrons?’ *Villanova Law Review* 2003).

## Chapter summary

No doubt the recent US reforms have imposed harsher criminal penalties upon erring executives to deter them from committing fraud and enhanced the independence and responsibility of independent directors. Yet these reforms have weaknesses. Whereas unethical executives still work for their selfish interest at the peril of investors (Ronen and Berman 2004) no guidance for others on good governance has been made available. While it is important to have a tough regulatory environment that allows competition to thrive, excessive and costly regulation – however well meaning – is having a stifling effect on capital formation and economic growth, especially on smaller businesses. In the following chapter some comment on the comparative approaches in the light of emerging



economies and the way forward for sustainable risk management will be made having regard to the relevance of corporate responsibility and corporate governance.

*Useful web links*

- \* Delaware Business Central, Fortune Special Sections: available at [http://www.timeinc.net/fortune/services/sections/fortune/region/2002\\_12delaware.html](http://www.timeinc.net/fortune/services/sections/fortune/region/2002_12delaware.html) accessed on 14-5-07.
- \* Bungardner, Larry 'Reforming Corporate America': available on <http://gbr.pepperdine.edu/031/sarbanesoxley.html> accessed on 28-3-06.



23

Corporate responsibility, corporate  
governance and emerging  
jurisdictions

# 23

## Corporate responsibility, corporate governance and emerging jurisdictions

### CHAPTER OVERVIEW

Having considered the differing approaches of the UK and the US to corporate governance in the era of global business and trade post-Enron it is useful to consider how key emerging jurisdictions such as India should respond and adjust to a more transparent era. It is to be hoped that they can benefit from the lessons learned by the jurisdictions considered in previous chapters. This discussion prioritises the relevance of corporate responsibility (CR and also known as CSR, corporate social responsibility) in the debate, bearing in mind that CSR has been said to have originated in India. Historically industrialists had to earn the licence to operate through a demonstration of CSR in the form of providing community facilities such as schools, places of worship, etc. In this chapter it is also argued that in order to draw CSR more into the area of sustainable risk management it should be considered in the light of corporate responsibility and in the light of various codes and models that respect sustainable development. Comparisons are also made in the SAARC region. Illustrations of codes and models included in the Appendices – such as G and H – can assist in this debate.

### Differing approaches to CSR

Bearing in mind the comparisons made regarding corporate governance in the UK and the US it is important to be aware that case studies have found major differences in approach in relation to corporate social responsibility. In the UK the approach is to consider both the shareholder and the stakeholder. There are legal and market drivers for companies to recognise and report the risks with regard to society and environment. In the US companies have not been obliged to disclose non-financial information (Williams, Cynthia and Conley, John 'An emerging third way? The erosion of the Anglo-American shareholder value construct', *Cornell International Law Journal* (2005) 38 CNLILJ 493). Instead of shifting towards the US approach of corporate governance discussed in Chapter 22, the UK is also inclining towards CSR in its measures to reform corporate

governance. For instance, the UK government relaunched its CSR website ([www.csr.gov.uk](http://www.csr.gov.uk)). The website sets out what the government is doing to achieve CSR goals, including policies and legislation, national initiatives and information on best practice. An Academy for Corporate Social Responsibility has been established ([www.csracademy.org.uk](http://www.csracademy.org.uk)) as a resource for organisations wishing to develop their CSR skills, providing information on training and development so that CSR can be incorporated into everyday business practice. In addition, a ‘competency framework’ has been developed to help managers assimilate corporate social responsibility within their organisation. The framework has six core characteristics that can be downloaded from the CSR Academy website:

- Understanding society;
- Building capacity;
- Questioning business as usual;
- Stakeholder relations;
- Strategic views of the business environment; and
- Harnessing diversity.

#### *CSR Competency Framework*

The CSR Competency Framework aims to help integrate CSR in the organisation. It is a flexible tool that can be used:

- \* As part of an organisation’s performance review process;
- \* For incorporation into an organisation’s existing competency models;
- \* As a self-development tool for targeted managers; or
- \* As part of a staff induction programme.

It provides a set of core characteristics designed to help managers integrate responsible business decision making. Different levels of attainment are set out together with detailed behaviour patterns and case studies from companies already engaged in CSR activities.

In contrast, the US framework is more shareholders oriented, with the objective of maximising the wealth for shareholders. Meanwhile in the UK the shareholder approach is converging with the stakeholder approach of European countries. Indeed the EU CSR Alliance is addressed to individual businesses. This reflects the European Commission’s view that CSR takes primarily a voluntary approach, encouraging engagement from a diversity of European businesses. The success of the Alliance and the effectiveness of its outcomes also depend on business engagement with other stakeholders, who are invited to make full use of the opportunities the Alliance offers, by working closely with businesses who would like to take part. Any business, whatever its size, can become involved.

*The EU Business Alliance on CSR*

On 22 March 2006, the European Commission published a communication on CSR, and launched the European Alliance for CSR. It is an umbrella network for discussion and debate on new and existing CSR initiatives by large companies, SMEs and their stakeholders. The Alliance establishes the foundations to promote CSR by:

- \* Raising awareness and improving knowledge on CSR and reporting on its achievements;
- \* Helping to mainstream and develop open coalitions of cooperation; and
- \* Ensuring an enabling environment for CSR.

The Commission adopted this approach as it is convinced that companies' CSR activities can contribute to a number of its policy objectives, from increasing European competitiveness to progression towards the Millennium Development Goals.

It is intended that the Alliance will be the focus for European activity on CSR by enabling networking across a range of businesses and facilitating the exchange of experiences and knowledge of CSR practices. According to the stated aims it will mobilise the resources and capacity of businesses and their stakeholders in order to:

- \* Provide a valuable forum for generating dialogue;
- \* Fertilise ideas and stimulate new CSR activity; and
- \* Build partnerships between businesses and stakeholders.

While the Alliance is principally business led and business run, it provides an opportunity to create partnerships and develop opportunities with other stakeholders – charities and other civil society organisations that benefit from such CSR programmes.

*The role of institutions*

Institutions such as the UK government, the EU, institutional investors, NGOs – shaping the rules and regulations governing corporate governance in the UK – are leading the shift of the UK in a direction which takes into consideration the needs of stakeholders. Institutional stakeholders play a large part in this shift by requiring and encouraging companies to recognise social and environmental risks and disclose the ways in which they manage them.

As is discussed also above the proposed operating and financial review (OFR) and directors' report required companies to disclose their social and environmental responsibilities. Whereas it was a solid step in the direction of stakeholder interest it has been scrapped by SI 2005 No. 3422. Nevertheless under the Companies Act 1985 (Operating and Financial Review) (Repeal) Regulations 2005 which came into force on 12 January 2006 directors are

required to produce a business review in compliance with the Companies Act 1985. It can be said the market forces are compelling companies to be concerned about their social and environmental responsibilities. This approach is considerably different from the US approach which is more focused on shareholder wealth creation and is quite indifferent to a company's social and environmental responsibilities. There is no clear liability on companies to disclose information related to such responsibility.

#### *Key CSR codes and reporting initiatives*

Key codes include well-known codes such as:

- \* The Ceres Principles (written in response to the *Exxon Valdez* oil spill);
- \* Sullivan Principles (conceived in response to South African apartheid);
- \* MacBride Principles (addressing corporate involvement in Northern Ireland);
- \* The Global Exchange/International Labor Rights Fund;
- \* US Business Principles for Human Rights of Workers in China – given recent and long-standing reports of human rights abuses in China;
- \* The Equator Principles (EP), a banking industry initiative covering project finance;
- \* The Collevocchio Declaration on Financial Institutions and Sustainability, which non-governmental organisations prefer;
- \* The EP are mentioned under the UNEP Statement by Financial Institutions on the Environment and Sustainable Development, which at this point is much less widely recognised than the EP; and
- \* There are some very significant reporting codes such as the Global Reporting Initiative (GRI), Social Accountability International SA8000, and AccountAbility AA1000 standards.

## **Relevance of UK developments and the OFR for CSR and governance**

Under the proposed OFR directors of listed companies were to have the additional duty to present qualitative, quantitative and forward-looking information and analysis. In accordance with the OFR they were to consider what information to provide on a wide range of 'non-financial' factors which would be relevant to understanding business performance. These non-financial elements represented the first attempt at mandatory reporting requirements of these issues in UK company law. They included information about employees, environmental matters and community and social issues. In this context SERM research has found that commentators have often referred to the combination of the non-financial areas as CSR. Moreover the EU definition mentioned above may provide a useful starting point for a definition to understand how CSR non-financial issues and risks need to be considered as part of the OFR requirements.

All of these issues are relevant to the concept of governance and sustainable risk management. Good governance is crucial to maintain market confidence and to improve company performance and returns on investment which are made through pension funds and other savings or investments. Moreover, good corporate governance enables corporations to meet wider public expectations about the behaviour of businesses as employers, suppliers and consumers of natural resources with social and environmental responsibilities. It is important to note that OFRs were going to be produced after ‘due care, skill and diligence’ had been applied and would have to address environmental, social and community or CSR issues where applicable. It was to be the ultimate responsibility of the company directors to sign off the content. Moreover if they decided not to report on various issues, such as the non-financial aspects of the OFR they would have had to make a statement that they had considered these issues in detail and decided that they were not material to the business. Thereafter the auditors were to be required to express an opinion on whether the directors had prepared the OFR after ‘due care, skill and diligence’ – the same terminology as that required in the annual report and accounts produced by companies. This emphasis on directors’ duties remains relevant in terms of sustainable risk management in the light of the Companies Bill (referred to in Chapter 21).

## Corporations, economic drivers and directors’ duties

Initially business organisations were generally motivated by the one and only goal of economic development. In order to attain competitive economic superiority, some believe that they forgot core values such as human rights, environment and ethics. Economic success seemed to be the priority of the corporation in the furtherance of pure capitalism. However, the growth of corporations reached a stage where they attained the status of legal entities regulated by laws and regulations (see Chapter 6). Stakeholders started playing an important role in the construction and destruction of the corporate power. In other words, just as power comes with huge responsibilities, social responsibilities were handed over to the corporation. CSR therefore became a management technique to balance economic growth and investment on the one hand and social, environmental and ethical concerns on the other hand. In the post-Enron era where corporations strive to regain shareholder confidence, it is therefore feasible for CSR to be a viable tool of transparency in emerging jurisdictions.

### *India case study*

Global interest in the linkages between investment, corporate responsibility (CR) and sustainable development (SD) is increasing and India is part of this movement. In India, the business community acknowledges the need to involve financial markets in their efforts to integrate responsible business practices into corporate strategy. Moreover, The Energy and Resources Institute (TERI) is evidently launching the first assessment of

the potential for socially responsible investment (SRI) in India. Supported by the Global Opportunities Fund of the UK FCO, the project seeks to assess how to merge sustainability and responsibility factors with investment decision making in the Indian context. It considers ways in which the investment community can be mobilised to support the progress of enhanced practices that are aligned to India's wider development needs. The initiative will build on the growing awareness of the investment relevance of issues such as good governance, business ethics, human resources, environmental management and energy use, as well as community impacts. In addition, foreign portfolio investors are introducing environmental, social and governance (ESG) factors into their investment decisions. A steering group of members from the Indian and European investment communities will guide and evaluate the content of the project. The project will study the current state of ESG in the investment chain in India and review the relevance of international experience in SRI for India.

## Global application of CSR

In the US the largest corporation employing the largest number of employees in the world is Wal-Mart. It has been reported that Sam Walton, the founding president of Wal-Mart wrote in his book, *Made in America*, that he avoided various issues like employee welfare and environmental development in his struggling years. However, as Wal-Mart started becoming a phenomenon in the retail world, he realised that CSR management techniques would make Wal-Mart No.1 in the world.

The West was not the only place where CSR played a revolutionary role in the corporate world. For example, in the 1970s, being struck between capitalism and socialism, major Indian business houses like TATA or Jindal in the private sector and HMT or NTPC in the public sector played a revolutionary role in applying CSR management techniques.

SERM case studies have revealed that CSR can be applied in:

- Private sector corporations;
- Public sector corporations;
- Semi-public corporations; and
- Cooperative corporations.

The applicability of CSR can vary from corporation to corporation. However, the most important task in business sustainability remains to find the right mixture for CSR applicability with the ultimate aim of shareholder satisfaction. As the EU initiative shows, CSR techniques can be applied in all countries whether developed, developing or underdeveloped. The corporation can be large scale or SME. However, in the context of sustainable risk management the greatest challenge for a corporation would be for the risk manager to realise



the need for CSR. There are key mechanisms for corporations to consider in this situation:

- Laws and regulations formulated by the state requiring the companies to apply CSR to ultimately become the role model for corporate citizens. Various countries in the world have already started formulating and applying the rules and regulations of this nature. The enforcement of these laws can be by:
  - Making directors being accountable for inaction of CSR;
  - Taxing the corporations who do not maintain a CSR norm;
  - Exempting the corporations not maintaining CSR levels from competing to attain governmental projects, etc.; and
  - Giving incentives to the corporations applying CSR techniques.
- Shareholder regulations: the regulations to be set by the shareholders or share trading agencies whereby the corporations are rated by their CSR techniques. CSR should be one component with other traditional components for evaluation of share value;
- Peer group regulations: a CSR norm to be set by the groups or lobbies of corporations such as chambers of commerce; and
- Transnational regulations: countries formulating an international regulatory pattern to rate the CSR of the corporations that will regulate the transnational trade, import/export duties, etc.

## CSR and sustainable development

For some time, sustainable development has been a concept that is leading most of the international organisations. As was indicated in Chapters 18 and 19 sustainable development is about ensuring a better quality of life for everyone, now and for generations to come. Thus, combining CSR and SD means combining the ecological, social and economic concerns, and offers business opportunities for companies that can improve the lives of the world's people. This is crucial for emerging jurisdictions.

### *Balancing issues in India: Vedanta case study*

Vedanta signed an agreement with the eastern state of Orissa in 2004 to set up an alumina refinery in bauxite-rich Lanjigarh, also home to one of India's most primitive tribes, the Dongaria Kondh. The state government also recommended giving mining rights to the company to extract bauxite required to make alumina, but this prompted environmentalist groups to oppose the project and move to court. Activists say that mining in the nearby Niyamgiri hills would displace thousands of tribal people and destroy the fragile eco-system of the region. Legal wrangles have since stalled the project. However, Vedanta officials said they would commission the refinery by last December. The company would source bauxite

from other states if it did not get mining rights in Niyamgiri. The state government said it expected the protest to evaporate as the tribals would be resettled and rehabilitated.

It has been reported by Reuters that thousands of tribal people armed with bows and arrows came out of their hill-top homes in eastern India to protest against an alumina refinery being set up by Britain's Vedanta Resources plc. The protesters, along with environmental activists, marched to the refinery site in Orissa, about 600 km (375 miles) southwest of the state capital Bhubaneswar, and vowed to stop the US\$874 million project. Dressed in their traditional clothes and wearing colourful headgear, they held placards that read 'Vedanta Go Back', and burnt effigies of senior state government ministers. The protesters also briefly blocked roads in the area, disrupting traffic on a national highway. The tribal peoples mostly live on the hills and depend on fruit and vegetables grown there. 'We would rather die than give up our homes', said Kumuti Majhi, a tribal spokesman, raising his fist in the air. This type of incident clearly affects the reputation of the company. The balance is again a sensitive one.

It should be emphasised that individuals are the points of connectivity between the real world and the board room, in addition to the pre-eminence of government. As is well understood when businesses have strong views that they want to see enacted in the world, they lobby government in order to achieve legislation to back their position. Similarly as regards CSR, several advisors have argued that businesses should lobby government in turning their values into law. A company's CSR strategy exists at the point where the need to adapt in the world, and the ability to adapt, coincide. This should take into account the features of the rich, industrialising and poor countries. Against this backdrop, decisions surrounding risk management adaptability would be made in the future. In the context of sustainable risk management and CSR strategies, facts in the real world would be brought to bear, and the knowledge economy would dictate the pace of that process. This raises key questions such as:

- Where should sustainable development be on the agenda of a middle manager? and
- How should these possible abstractions from everyday working lives as risk managers fit with our annual objectives and professional evaluation?

CSR may be defined as an evolving business practice that integrates governance, management and investment of a corporation with the social and environmental concerns in its business practices and thereby formulating a socially responsible, productive and human friendly corporate structure. As the climate

change debate has also witnessed, corporations have a greater role to play in sustainable development, as the potential markets attain sustainable development. It could be argued that CSR with a view of sustainable development would build up a respectable, responsible and thriving management technique. The whole concept of CSR and SD can be divided into two, as advocated in the EU Green Paper on CSR, that is:

- Internal CSR and SD:
  - CSR towards human resources: applying management techniques by investing in human resources of the corporation. Corporation being socially responsible towards its employees;
  - CSR towards the suppliers and distributors;
  - CSR towards the health, safety and development of the internal society; and
  - CSR towards the environment of the immediate communities.
- External CSR and SD:
  - CSR towards the global environmental concerns;
  - CSR towards the human rights;
  - CSR towards the replenishment of natural resources; and
  - CSR towards the non-renewable energy resources.

## How to implement the CSR and SD

- By pressurising governments to reorganise the existing corporate governance regulations to implement the CSR and SD;
- By shareholder education to make them aware of the long-term benefits by investing in the CSR and SD compliant corporations;
- By developing a system where corporations can be rated for their CSR and SD initiatives;
- By developing a CSR and SD mark (similar to the ISI mark or EURO1 marks) and making companies compete to get the mark;
- By developing ready to fit CSR and SD management and investment techniques to different corporations of different size, geographical setting or management philosophy; and
- By sensitising the corporate world to the concepts of CSR and SD and educating them on the long-term and short-term benefits.

## The business case for CSR

It is well known that the spirit of capitalism drives business, and forms the framework within which it operates. The potential for cross-pollination of ideas from sector to sector is encouraging in light of the ultimate intentions that different corporations might have for their CSR strategy, because it suggests that there is something convergent in how different sectors define their responsibility. In other words, for its advocates CSR has become much more than about philanthropy – any company that wants to revitalise their strategy should also recognise CSR as part of their business risk strategy. It is about how a

company's operations are performing at the interface with the real world, where various business sectors do co-habit, in which the grey area between political and corporate power is blurred, and in which future generations will live.

*The business case for CSR*

We live in a world more fragile and fragmented than before the experience of globalisation, the end of the cold war and the events of 9/11. Exactly because of globalisation and the encroachment of corporations into that grey area once occupied by governments, it is a world in which there is less certainty about who or what is accountable for society's well-being. There is a growing obligation on business to recognise the need to dedicate internal resources to more thoroughly and completely understand the world in which they operate, so that they can respond accordingly. Engaging this new form of CSR – beyond philanthropy – is called the 'business case', not just because it offers an opportunity for value creation, but also because without engaging the supply chain, cross-sector alliances, external verification, transparency and lobbying for new laws to define the framework in which to operate, business fails.

## CSR Performance

When looking at the CSR performance of companies, the price/earnings (P/E) ratio has particular significance. It is defined as:

$$\frac{\text{Market capitalisation}}{\text{Company earnings}} \quad \text{or alternatively as} \quad \frac{\text{Share price}}{\text{Earnings per share}}$$

Typically P/E ratios range from 4 to 30, and, within reason, higher numbers are indicative of greater investor confidence. They also vary from sector to sector.

The P/E ratio combines two key aspects of a company's financial situation: the company's executive team is responsible for, and can influence, the company's earnings through the strategies they adopt. Market capitalisation on the other hand is set by the attractiveness of the company shares in the market, and the extent to which investors trade them. Investor views on the attractiveness of the shares are influenced by the prospects for the sector, the competitive position of the company within it, and, perhaps most importantly, by their perceptions of the competence of the executive team. Judgements on these factors

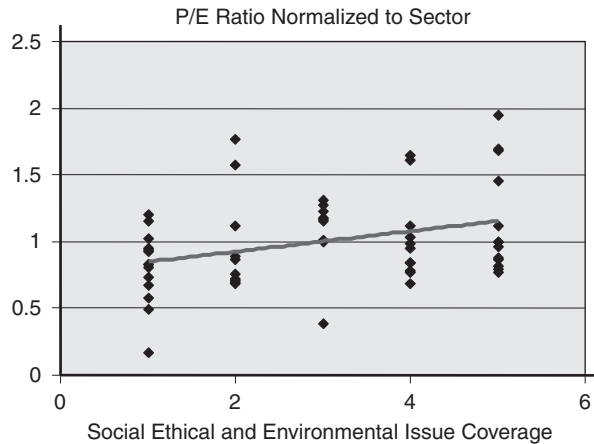
can enhance or depress the P/E ratio of a company relative to its sector peers, and so affect the relative and absolute value of the company.

The basis of the analytical tool, supported by statistical analysis, is that companies having a superior coverage of social, ethical and environmental (CSR/CR) matters will, on average, have a higher P/E ratio relative to their sector. From this derives some general considerations, applicable to all companies, and some specific ones.

## The model basis

Figure 1 illustrates a correlation between P/E ratios and the extent to which companies cover their CSR issues. One question is: what comes first, strong CSR reporting or share price outperformance? The coverage of CSR issues was assessed by taking the quintile position of companies within the UK's Business in the Community and Business in the Environment surveys. While these surveys relate to companies quoted on the UK Stock Exchange, the general principles will apply to other markets, and the correlation is borne out with other comparable surveys.

To remove sector to sector differences the individual P/E ratios are normalised to their quoted sector means, all data being taken from the *Financial Times*.



**Figure 1:** Normalised P/E ratio versus SEE issue coverage.

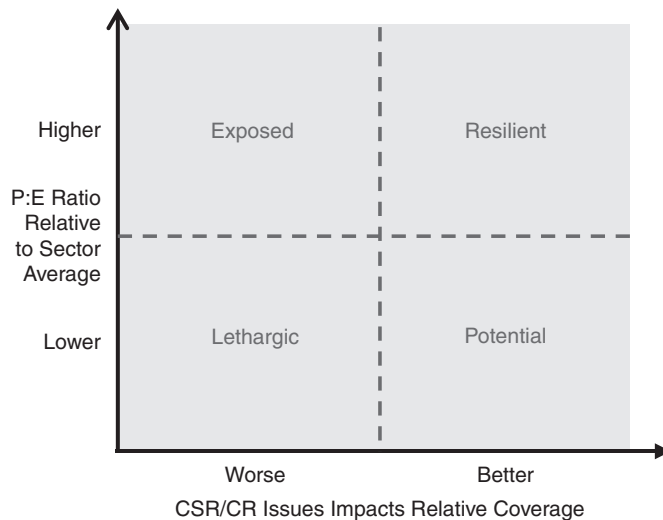
Figure 1 illustrates a weak statistical correlation between P/E ratio and the coverage of CSR issues. This indicates that those companies having a better grasp of CSR matters (higher number on the x-axis) will on average show higher P/E ratios relative to their sectors. While the correlation is somewhat tenuous, it is indicative that executive teams having the time and confidence to put in place governance systems for the key issues facing the company will also have in place sound commercial strategies and have a good understanding of the company's competitive position. In essence it acts as a surrogate for the quality

of the executive team, and as such is an indicator that they are doing a competent job of directing the company.

*Bearing in mind the fact that the price relates to the future and earnings relate to the past performance, it is a useful model to assess the quality of the hands-on management of the business and therefore its sustainability.*

## The management tool

It is possible to develop the correlation in Figure 1 more generally into a simple tool for management. This is illustrated in Figure 2, following the lines of the well-known Boston Consulting Matrix. Use of the tool requires that the company assesses its P/E ratio relative to the sector and its peers and also to benchmark its governance and reporting systems on CSR-related matters. This would include social, ethical and environmental matters in so far as they are important for the delivery of the company's strategy and strategic objectives. Whereas it is evident that more detailed attention to CSR matters will not dig a badly managed organisation out of a financial hole the summary of issues offers practical suggestions to balance the organisation's objectives and to improve performance. This analysis will position the company in one of the four quadrants of the matrix in Figure 2.



**Figure 2:** Schematic action diagram on the coverage CSR/CR issues.

Depending on the quadrant that a company falls within will raise different questions for the company executive team to consider. These are summarised in the table below.

### Summary of issues relating to Figure 2

Quadrant descriptor	Commentary	Issues to consider
<b>Resilient</b> High relative P/E High relative CSR coverage	Companies are generally aware of and taking action on their key CSR issues and reporting on them	Maintain position as market drivers develop Ensure continued consistency between statements and actions. Ensure all actions and programmes support delivery of company strategy
<b>Exposed</b> High relative P/E Lower relative CSR coverage	Likely that company has suddenly developed in market cap and not responded appropriately to expectations on CSR matters	Support position by an appropriate consideration of the key CSR matters relating to the delivery of company strategy Report on the issues and actions appropriately
<b>Potential</b> Low relative P/E High relative CSR coverage	Companies seem to have coverage of CSR matters but not to be achieving commercial benefits from what they are doing	Review the coverage of CSR topics and realign to commercial objectives Ensure all actions support company strategy and leverage the actions which are being taken
<b>Lethargic</b> Low relative P/E Low relative CSR coverage	Limited evidence that the company appreciates the key CSR factors and is addressing them	Ensure that the CSR market development implications for the company are not being overlooked Set up programmes to cover any gaps and report appropriately on the issues and actions being taken

#### Generic issue

*It is important to recognise that whatever quadrant a company finds itself in, it has value to protect. Programmes that are ill-considered and public statements that are not fully backed up by actions, programmes and policies will potentially lead to reputational damage, a loss of management credibility and consequently reduction in company value. If such difficulties arise other than very infrequently, the depression in share price will be considerable and sustained. This will mean a long-term loss of shareholder sentiment. Reputational issues are playing an increasingly important role in terms of a company's brand, its differentiation strategy and its market positioning. Building the reputation of an organisation is one of the main challenges facing a CEO and the senior management team. Reputation has become one of a company's most significant intangible assets, particularly in the face of recent regulatory demands such as Sarbanes-Oxley in the US and the debated reporting requirements proposed in the OFR in the UK, as well as likely developments in the EU and other major trade jurisdictions. Smaller organisations are impacted as a result of supply chain and other market pressures.*

The generic issue is critical and applies equally to all companies, irrespective of their position within the matrix. This relates to the implications of general, wide-ranging statements on CSR matters which are not fully supported by systems, programmes and actions on a day-to-day basis. Great care should be taken when reporting and using such all-encompassing statements as:

'CSR is central to our strategy' or 'CSR is at the heart of our business'

if they cannot be justified in all respects.

For example, a company may state that ‘safety is paramount’. This implies that safety is the pre-eminent consideration in all strategic and operational decisions, and that among other things the company target setting and remuneration systems reinforce this. If there is not this thorough alignment and consistency, this will lead to the potential for investors and other stakeholders to be misled as to the actual priorities within the company. In the unfortunate circumstance where a serious safety-related incident arises, shortcomings in policies, their implementation, or the support systems will reflect badly on the competence of the executive team, and could end up with legal proceedings against them either individually or collectively. Unfortunately corporate history is littered with examples of just such shortcomings.

## Practical considerations

For quoted companies the P/E ratio is a matter of fact, being quoted in numerous sources of financial information. Establishing the sector average can either be taken from the published information in such sources as the *Financial Times*, or can be derived if the company considers that their sector peers are more specific.

The assessment of the company’s relative position on CSR governance and reporting is more subjective. There is a wide range of methodologies available on the market, though there is often little consistency between them. It is relatively common to find a company as the sector leader in one index but towards the bottom in another. This is to be expected since they frequently take a ‘one size fits all’ approach assuming that all issues are equally as important to all companies in all sectors. While this situation is improving, progress is slow. In these circumstances companies should assess the key social, ethical and environmental risks to the sector and the company, and use these to benchmark the relative position of the company using publicly available data. This will ensure a like-for-like comparison. Any other basis is likely to produce spurious results. The company can then position itself on the matrix and begin examining the questions and their implications.

Application to non-quoted companies, especially the larger ones, requires an assessment of the P/E ratio. This can be established from the company earnings, and the value from an assessment of the discounted cash flow of future earnings – essentially the enterprise value of the company. Such companies will have peer comparisons on CSR issue coverage in the range of publicly quoted companies. It will then be possible to provide a rough estimate of the position of the company on the matrix.

For small and medium-sized companies a similar procedure can be followed. However, the key factor here is to use the matrix to look at the issues which follow, rather than seeking necessarily to report on them. Reporting should be judged on the basis of what could be judged to be either ‘necessary and sufficient’ and/or ‘minimum and adequate’. In this context economic and



market pressures such as the supply chain will also again be relevant. It is generally not necessary for SMEs to expend resources in reporting their issues and progress on CSR matters unless commercially necessary.

Overall then the matrix can provide some insights into the actions a company needs to consider protecting and enhancing its commercial value. Necessarily the answers will raise potentially complex issues to be addressed, specific to the company and its sector.

## The value-added model

The discussion of self-regulation by organisations remains controversial in considering the responsibilities of the board, regardless of the legal duties imposed on company directors. The main issue facing directors, both individually and collectively, is whether it is in their best interests as a director to ensure that they carry out their duty of care to the highest degree possible within the board structure. As this book demonstrates risk cannot be factored out of business life, it can be managed more effectively. The aim is to add value, rather than merely to go through the hoops of a compliance exercise, as pointed out by Sir Brian Jenkins in his Foreword to *Implementing Turnbull: A Boardroom Briefing* by Martyn E Jones and Gillian Sutherland (available from [www.icaew.co.uk](http://www.icaew.co.uk)). By taking a realistic view of the risks faced by the company, the members of the board can improve practices, procedures and planning in many aspects of strategic business planning.

### *The case for CSR*

CSR addresses the nature of the linkage between the activities inside a firm and the activities outside it. Social and environmental impacts flow in one direction (from the firm to the outside world), while business value is enhanced by benefits that flow in the other direction (retention of customers, attraction of high-calibre employees, a licence to operate, etc.). The conduit is called 'The Business Case', the engine for exchange is a company's vision and values, and the benefits accrue for shareholders and the public. In today's business climate the dichotomy that Vanderbilt identified has collapsed: serving the public and stockholders can actually benefit both.

## The impact on corporate governance

This difference in approach of the UK and the US regarding a company's responsibility towards society and environment has a major impact on the systems of corporate governance and the way companies are run in the two countries. This is because the disclosure on the information about the activities of

the company in its surroundings make it responsible for its acts to society at large and also, in return, makes the public aware and cautious of the actions of the company. With the requirement in the UK for companies to identify and disclose to society their behaviour affecting the surroundings of the company no doubt this has made companies behave more responsibly than companies in the US. The UK approach of balancing shareholder interest and stakeholder interest is better for society at large (Williams and Conley, 'An emerging third way? The erosion of the anglo-American shareholder value construct', *Cornell International Law Journal* (2005) 38 CNLILJ 493).

## Corporate governance and emerging jurisdictions

Every country, of course, has its own particular set of circumstances. It would be unwise to make comparisons based on general perceptions without taking into account whether that system is working efficiently for that country. For instance, the UK approach of comply and explain is very different from that of the US which is legislative.

As discussed in Chapter 21 in the UK the 'comply and explain' approach has worked well and there have been fewer major corporate disasters compared with the US. This may be attributed to the methodical and systematic response to earlier corporate failures in the early 1990s by way of setting up committees and acting on the recommendations made by them. Moreover, as indicated, the response of the UK to the collapse of Enron has been thoughtful and logical. It has been a well-balanced reaction of comply or explain and legislative compliance. For example, the Revised Code 2003 stuck to the comply or explain approach whereas through the Audit, Investigations and Community Enterprise Act 2004 legislative reforms were brought about.

### *The SOX debate*

The Sarbanes-Oxley Act of 2002 (SOX) contained the most sweeping revisions to United States securities laws since they were enacted in the 1930s. The revisions, aimed at protecting investors by improving the accuracy and reliability of corporate disclosures, include provisions that impose criminal liability and personal financial liability on public company officers, directors and counsel whose conduct runs afoul of the Act.

Although heralded as a cure-all for the spate of corporate scandals that burst into public consciousness commencing with Enron's implosion, there is a perception that SOX, while replete with procedural mechanisms, has little substance.

However, as regards which system of corporate governance would work better in general in emerging jurisdictions, having regard to sustainable risk management,

various advisors have suggested that the corporate governance system in the US may be better since laws can deter erring executives from exploiting corporation resources to their advantage by committing fraud on investors and society at large. For the purpose of this debate the US corporate governance model could serve the developing countries better as they provide clear cut laws to be followed without any confusion with regard to what will be right and to what extent the compliance of guidance is required. The legislative approach does not give the liberty and flexibility to officers in power to use a self-regulatory system to manipulate the rules to their advantage and exploit the corporate resources for their own benefit by indulging in self-dealing. This is subject to what is mentioned below in the South Asia case study.

### *Codes of ethics*

Wherever an organisation is located the code of ethics should outline a set of fundamental principles, although a company should avoid drafting policies with too many aspirations, or avoid setting practically unworkable standards. Code drafters are encouraged to think in terms of values, beliefs and expectations; draft simply and concisely so as not to obscure fundamental points; use the active voice so as to convey ideas more clearly and with fewer words; and generally make the code easy to read (see also Chapter 12). This is most important in the context of sustainable risk management.

Multiple approaches can be taken in drafting codes of ethics and business conduct to comply with the applicable SEC and stock exchange/market requirements. A typical issuer may adopt up to three separate codes solely to satisfy the SEC and stock exchange/market requirements:

- \* A code of ethics for the chief executive officer and principal financial officers only, designed specifically to satisfy the SEC requirements regarding a code of ethics for the designated officers;
- \* A code of ethics and business conduct applicable to all officers and employees, meeting the applicable stock exchange/market requirements (as well as SEC requirements); and
- \* A code of ethics for non-employee directors only, considering the very different role outside directors serve compared to employees (i.e. supervisory rather than active involvement on a day-to-day basis in the company's operations) and the resulting fact that much of what is in a comprehensive code of conduct for employees may not be applicable to the outside directors.

## South Asia: key trends and issues

A number of overarching themes and critical factors for good corporate governance are of particular importance in developing practical policies in South Asia.

An analysis of developments in South Asia underlines the point that corporate governance cannot be introduced in isolation from a range of other reforms (macro-economic, micro-economic, accounting, legal, banking and institutional) – nor can these other reforms achieve all their objectives without corporate governance initiatives. The experience of India and Pakistan highlights the problems and market distortions which have built up from decades of varying government policies and from strong entrenched structures and interests of the private sector, and the complexity of picking apart the range of policies and targeting the reforms. Reform is a cumulative process, and one set of reforms uncovers the need for other reforms, so the challenges lie in policy management – in conceptualising and implementing a road map of parallel and sequential reforms which constitute a comprehensive programme. Experience shows that this can be achieved, especially in vibrant democracies, but there is also the bitter experience that liberalisation reforms without effective regulatory systems and agencies may have very high transitional costs (as India learned after 1994).

A second theme, closely associated with the first, is the need to monitor the trends in different sectors of the markets so as to try to avoid (or at least prepare for) a situation where a combination of several negative trends, which individually might be manageable, together form a crisis. Again, the India, Pakistan and Sri Lanka experience shows the dangers of multiple ‘fault lines’ in the financial and corporate sectors, such as the burden of non-performing loans, dependency on formal and informal protection and on state development finance institutions, structural imbalances between ownership and control and high agency costs, outmoded laws, and lack of inflow of investment capital.

A third theme is the need for a range of players to improve corporate governance, and the indication that a degree of ‘stick’ may be needed together with the ‘carrots’ of increased investment and performance. It is noticeable that in India the initiative for improved corporate governance came from the Confederation of Indian Industry, who produced a voluntary code and which they encouraged their members to follow and to demonstrate in highly advanced model annual reports, again designed by the CII. These model reports included sections of corporate social and environmental responsibility as well as corporate governance, and set out rigorous points of detail such as the board attendance record as well as the remuneration of individual board members. However, only about 20 companies followed these guidelines, and it required the intervention of the regulator (in the form of SEBI, the Securities Exchange Board of India, and the Ministry of Company Affairs) to significantly widen the application of corporate governance. Even then progress has been slow, and both the Indian and Sri Lankan experience reveal the significance of ratings agencies in demanding good corporate governance as well as financial management systems for better credit ratings. Sri Lanka in particular shows the roles of the regulators and credit agencies, combined with professional institutions such as the chartered accountants, chartered company secretaries, institutes of directors and chambers of commerce.

A fourth theme is the critical importance of the company and contract laws and the efficacy of the legal system. It is notable that most of the SAARC countries have developed special commercial courts of one sort or another to handle commercial disputes, but the reports all generate a sense of gloom when it comes to the efficacy of the law, and of the need to modernise bankruptcy and liquidation proceedings.

This is linked with the fifth theme, which is the critical importance of the traditional family ownership and control structures, and the concern that corporate governance is observed more in form than substance. In Pakistan, the family control system and the prevalence of the pyramid structures of control is a major factor (higher than countries in South East Asia), while in India there is a contrast between the costs of the conventional model of the separation of ownership and control, and the model of interlinked ownership and control which characterises Asian companies. The way forward may lie in a new focus on 'growing the pie' even if it involves dilution in share ownership, so that families can increase and diversify their wealth by becoming investors in other companies instead of concentrating only on control of their own company.

A sixth theme is the significance of corporate governance for other types of enterprises such as the state-owned enterprises (SOEs), which still loom very large across South Asia. In India, for example, SOEs account for 34% of India's corporate paid-up capital. In other countries there is also a need for good corporate governance practices for medium enterprises and for non-governmental organisations, which often form important trading enterprises as well as crucial social development agencies.

These realities would compel a sense of caution about expectations of rapid improvement, but given the expanding body of experience and expertise in this area it is reasonable to expect progress.

## An approach to corporate governance

An approach to corporate governance by the Commonwealth Business Council (CBC) has been developed through the CBC's Working Group on Corporate Governance, which is chaired by Mr James Smith, chairman of Shell UK. The Working Group has consulted widely with businesses and put forward a set of principles and recommendations to Commonwealth finance ministers at their meeting in September 2006. The approach set out below is drawn from that work.

At its core, corporate governance is about creating value from the quality of decision making and leads to better business performance. This in turn can increase the attractiveness of a business for investments. In those developing Commonwealth countries where the regulatory environment or institutional capacity is still developing, a specific policy framework for investment, through a whole of government approach, can encourage a focus on corporate governance as a basis for business performance.

A good corporate governance framework has the potential for these benefits:

- Enhancing overall performance;
- Preparing a small enterprise for growth, and so helping to secure new business opportunities when they arise;
- Increasing attractiveness to investors and lenders, which enables faster growth;
- Increasing the company's ability to identify and mitigate risks, manage crises and respond to changing market trends; and
- Increasing market confidence as a whole.

The CBC Business Principles govern how a company conducts itself and are based on the firm belief that application of good principles is fundamental to business success. They consist of core values, responsibilities to stakeholders and a set of principles for how a company conducts its affairs. All companies and entities – no matter their size – should adhere to these business principles. The principles apply not just to private sector entities but are relevant also to public bodies and in the voluntary sector.

The CBC Business Principles are established under three headings:

- Core values;
- Responsibilities to stakeholders; and
- Principles.

It needs to be emphasised that leadership is key to driving these principles. A proper mechanism for people to internalise core values is necessary and needs to be reflected through, for example, role modelling of behaviours by current or potential senior managers. One way of embedding the principles is through stronger links between talent management and leadership development.

#### *Core values*

- \* Honesty, integrity, fairness and openness, respect for people, clearly stated and followed in practice;
- \* A commitment to contribute to sustainable development. This requires balancing short- and long-term interests, integrating economic, environmental and social considerations into business decision making;
- \* Transparency: being actively involved in structure, process and disclosure; establishing and maintaining communication with key stakeholders;
- \* Tackling corruption: adopting agreed codes; being persistent in enforcing them internally and in external dealings; and
- \* Human rights: recognising the implications for the business of respect for human rights; having a policy and acting on it.

*Responsibilities to stakeholders*

Recognising five areas of responsibility, it is the duty of management, through an accountable board, to discharge these inseparable responsibilities.

To shareholders:

- \* Protect shareholders' investments and provide a competitive long-term return;
- \* Conduct operations in accordance with internationally accepted principles of good corporate governance; and
- \* Provide timely, regular and reliable information on activities, structure, financial situation and performance.

To customers:

- \* Provide products and services that consistently offer value in terms of price and quality and which are safe for their intended use; and
- \* Listen to customers' views and continually strive to improve the company's performance.

To employees:

- \* Respect the human rights of employees. Provide good and safe working conditions;
- \* Provide competitive terms and conditions;
- \* Ensure a workplace free of harassment;
- \* Invest in the development and best use of the talents of employees;
- \* Create an inclusive work environment where every employee has an equal opportunity to develop his or her skills and talents and encourage diversity;
- \* Understand and value cultural differences;
- \* Encourage the involvement of employees in the planning and direction of their work. Provide them with channels to report concerns; and
- \* Recognise that commercial success depends on the full commitment of all employees.

To those with whom a company does business:

- \* Establish mutually beneficial relationships with contractors, suppliers and in joint ventures; and
- \* Promote the application of these business principles or equivalent principles in such relations. The ability to promote these principles effectively will be an important factor in the decision to enter into or remain in such relationships.

To society:

- \* Conduct business as a responsible corporate member of society, in accordance with internationally accepted norms;

- \* Comply with applicable laws and regulations;
- \* Support fundamental human rights in line with the legitimate role of business; and
- \* Give proper regard to health, safety, security and the environment.

### *Principles*

#### 1. Economic (Part B)

- Profits and a strong financial foundation provide a basis for fulfilling a company's responsibilities; and
- Criteria for investment and divestment decisions include sustainable development considerations (economic, social and environmental) and an appraisal of the investment risks.

#### 2. Competition (Chapter 10)

- Free enterprise and fair competition are supported; and
- Operations are conducted in accordance with the principles of fair and ethical competition and within the framework of applicable competition laws and regulations.

#### 3. Business integrity (Chapters 7 and 12)

- Honesty, integrity and fairness are applied in all aspects of business and the same is expected in relationships with business partners;
- The direct or indirect offer, payment, solicitation or acceptance of bribes in any form is unacceptable. Facilitation payments are bribes and should not be made;
- Employees must avoid conflicts of interest between their private activities and their part in the conduct of company business;
- Employees must declare any potential conflicts of interest; and
- All business transactions must be reflected accurately and fairly in the accounts in accordance with established procedures and are subject to independent audit and disclosure.

#### 4. Public/political activities (Chapter 12)

- Legitimate business interests are promoted and defended;
- In the development of proposed legislation and other regulations, which may affect legitimate business interests, the company may engage with governments, both directly and through bodies such as trade associations. Such engagement must be in accordance with values and business principles;
- There is no engagement by the company in party politics;
- If payments or donations are made to political parties, they are fully disclosed as to amount and purpose; and
- Employees have the right to stand for public office provided it is appropriate in the light of circumstances.



5. Health, safety, security and the environment (Chapters 16–20)
  - A systematic approach to health, safety, security and environmental management is followed to achieve continuous performance improvement;
  - Health, safety, security and the environment issues are managed as critical business activities. Standards and targets are set for improvement. Performance is appraised and reported externally;
  - There is commitment to making continuous improvement in the management of a company's environmental impact and to the longer-term goal of developing a sustainable business; and
  - Ways are continually sought to reduce the environmental impact of a company's operations, products and services.
6. Local communities (Chapter 12)
  - The ways in which a company contributes directly or indirectly to the general well-being of the communities within which it operates are continuously improved in order to be good neighbours;
  - Social impacts of business activities are managed carefully. By working with others the company enhances the benefits to local communities, including through private sector and human development, and mitigates any negative impacts from its activities; and
  - A constructive, open dialogue with stakeholders is established, which aims to achieve a mutually beneficial outcome.
7. Communication and engagement (chapter 9)
  - Regular dialogue and engagement with stakeholders is essential;
  - There is commitment to reporting the company's performance, providing full, relevant information to legitimately interested parties, subject to any overriding considerations of business confidentiality; and
  - In interactions with employees, business partners and local communities, the company listens and responds in an honest and responsible manner.
8. Compliance/obeying the law (All chapters)
  - Laws and regulations are complied with; and
  - Constructive support is given, where appropriate, if institutional capacity to ensure compliance is weak.

Good corporate governance needs to be built on sound law, effective institutions and effective mechanisms for the resolution of disputes. These are necessary to ensure, for example, the equitable treatment of all shareholders and their reasonable rights to influence significantly the company. In addition, assurance is needed so that contracts, whether related to funding or to sale and purchase of goods, can be grounded in law and capable of enforcement.

The following ‘five pillars’ as set out by the OECD (2006) create a legal and institutional environment within which good corporate governance can flourish:

1. Comprehensive corporate law;
2. Strong and proactive regulatory authorities such as the Stock Exchange, Securities Commission, takeover mechanisms, etc.;
3. Internationally accepted accounting standards;
4. An entity that promotes good governance through education and information;
5. Effective remedy through the courts when necessary.

The corporate governance aspects of the OECD Policy Framework for Investment can be found in Appendix G.

The principles and approaches outlined above can also be adopted effectively by SMEs. Recognising the particular needs of SMEs, the CBC has developed a framework for SMEs which can be found in Appendix H.

## South Asia country profiles

### *Bangladesh*

In Bangladesh, there have been no serious corporate scandals that have been enough to send shockwaves to undermine confidence in the financial system, nor has the country found that it has reached the limits of conventional corporate financing mainly through bank lending. The relatively low level of international investment in Bangladesh does not provide a sufficient motivation for improving corporate governance, nor are there many traditional domestic motivations for improvement in corporate governance practices. Nevertheless, good corporate governance practices will help develop and stimulate better business management, strategic management and risk management, which, in the long term, will make Bangladeshi businesses more competitive. The lessons from the experience of the neighbouring countries in South Asia are such that Bangladesh can deploy good corporate governance to prevent the problems that have afflicted other countries rather than to solve them after the event.

The principle legal instrument for enforcing governance in Bangladesh is the Companies Act 1994 which is administered by the Registrar of Joint Stock Company (RJSC) and the Ministry of Commerce. In that respect the Securities Exchange Commission (SEC) has limited jurisdiction of enforcement of corporate governance. SEC is concerned with publicly limited companies only, the numbers of which are very insignificant (some estimates put this at only 5% of all companies). Close monitoring of leading companies is a disincentive for going public as there is a perception that this will create and raise unnecessary difficulties for companies to supply information as and when requested. Although RJSC has registered thousands of companies, vigilance is very weak; indeed their rules do not permit them to undertake close monitoring.

Lack of appropriate training, information and knowledge about company laws are key challenges. Ignorance of regulatory requirements is one of the

main detrimental issues. A recent seminar in Dhaka highlighted the need for services from people with adequate knowledge of the principles of corporate governance as well as security laws and regulations that are required for practising these issues.

The legal system is very weak and awareness even less so. Even a CEO of a company may not know enough about the company rules and regulations and this often hampers companies from taking a rule-based decision. This may depend on the whim of the chairperson, a situation made worse by the combination of CEO and chair position. However, progress is being made. In 2006 Apex Footwear, one of the country's leading textile and clothing exporters became the first listed company in Bangladesh to appoint an independent director in line with the corporate governance guidelines set by the SEC; with the new appointment, the size of the board stands at six. Key gaps in corporate governance centre on:

- Directors failing in their oversight function;
- Regulators lacking competent professionals; and
- Ownership policy being absent for SOEs.

Major initiatives on corporate governance include work by the Bangladesh Enterprise Institute and the Commonwealth, Bangladesh Bank Directives on Corporate Governance, a National Taskforce, the establishment of a Code of Corporate Governance for Bangladesh (2004) and SEC Guidelines on Corporate Governance (2006).

The way forward includes coordination among regulators, capacity building, the ownership policy for SOEs and donor coordination. There is also a need for an SME focus – ‘many would benefit if they are interfaced with the corporate governance issues of the big companies’, as one business leader on a CBC visit to the UK recently put it. Moreover with increasing investment in Bangladesh and South Asia there is an opportunity to develop and sustain interest about the prospects for corporate reform and good practice in corporate governance.

The drive for better corporate governance can come from shareholders, investor associations, institution investors and the financial press. Each of these potential actors should be strengthened. First, the financial press and the constituency for detailed financial reporting are limited. Furthermore, the information provided by companies and regulatory bodies is often inadequate.

Second, public shareholders do not join together in shareholder associations to demand better company performance or to assert their shareholder rights. Even in cases where the public holds a majority of shares, the treatment of shareholders is poor. Given that majority shareholders have not asserted their rights, minority shareholder rights are not a priority to most public corporations.

Third, there are only a few institutional investors in the country and they often do not exercise the power that they hold. In most capital markets, institutional investors like insurance companies, pension funds and mutual funds hold power over substantial sums of investment capital and demand strong performance and transparent corporate governance. In Bangladesh, there are

only a few institutional investors, most of which are state-owned enterprises (SOEs). State-owned institutional investors have no performance motivation to force companies to improve performance, voluntarily disclose information, or improve corporate governance. The few private investors do not have enough clout to force large-scale changes in the corporate sector. As a corollary, the venture capital industry also does not exist.

Most companies do not think they are candidates for foreign investment, so there is no push from the international economic community for better corporate governance. In 2005 Beximco, the pharmaceutical company, became one of the first Bangladeshi companies to be listed on an exchange outside the country (on London's AIM market). However, Bangladesh does not have a sovereign credit rating (SCR) provided by any of the international rating agencies. Multinational companies have emerged as a positive force in the general business environment creating pressure for others to conform. For instance, companies like British American Tobacco and Lever Brothers Bangladesh have proactively come forward with their own findings and statistics on tax evasion by competitors in their respective sectors. However, driven by their own self-interests, they have succeeded in bringing about redress at the National Board of Revenue.

A recent survey of the Dhaka Stock Exchange (Haque *et al.* 2006) found that better corporate governance enhances the firms' ability to gain access to equity finance and firm value, and thus contributes to the process of capital market development. The evidence has specific policy implications in relation to the significance of better firm governance in enhancing financial sector development, and avoiding potential vulnerability in the financial system. The strong governance role of the legal and regulatory institutions appears to be imperative to remove mass malfunctions at both the firm and operational level of the capital market in Bangladesh.

## India

The dramatic improvement of corporate governance in India is a consequence of the post-1991 economic reforms, the challenges of globalisation resulting in enhanced competitiveness, changes in the shareholding pattern, and growing importance of institutional investors and public financial institutions. It was also prompted by events such as the securities scam (involving a large number of banks) leading to the stock market crash in 1992. This was followed by the consolidation of equity ownership by multinational companies listed on the stock markets, and then by the stock market bubble in 1993 and crash of the 'disappearing companies' in 1994, which devastated the primary market until the end of the century. These led to the formation by the Confederation of Indian Industry (CII) of the Bajaj Committee (chaired by Mr Rahul Bajaj, chairman of Bajaj Auto and past co-chair of CBC) on corporate governance in late 1995, well before the East Asian financial crisis. In addition, the Indian capital markets had reached a crisis point where the accumulated distortions of decades of restrictive state policies and of corporate control had highlighted the need for urgent capital market reform (see also 'Due Diligence and Corporate Governance').

Equity holdings by non-financial corporations in India, which are primarily intercompany cross-holdings, are much higher than those in the developed economies. The participation of the small investor in corporate equity in India is at comparable levels with the US, with India having the largest number of listed companies in the world. Further, data on the 10 largest non-financial corporations reveals that the average concentration of shareholding among the top three shareholders is about 40%, which is much higher than in the US and the UK.

The Companies Act provides for disclosures of financial and non-financial information to all the stakeholders in terms of an annual balance sheet and annual report. India provides great protection of shareholders' rights on paper and recent efforts to strengthen enforcement have enhanced investors' trust in the market. The financial press is increasingly reporting violations of shareholder rights and issues of family ownership and control. These are positive drivers of change. However, enforcement and implementation of laws and regulations remain important challenges. Indeed the World Bank's *Report on the Observance of Standards and Codes 2004* (ROSC) found that while India observed or largely observed most of the principles, it could do better in certain areas.

The basic law governing the functioning of the corporate world is the Companies Act of 1956, which has been amended about 20 times. Steps made mandatory include having independent directors on company boards; boards meeting at least four times in a year with a maximum gap of three months between successive meetings; having audit committees; a corporate governance report to be included as part of the directors' report to shareholders annually; and detailed management discussion and analysis of the company's operations. The distinction between management and direction was recognised and respective duties articulated which call for robust systems to track KPIs and strategy assessment. A revised Companies Act is under development.

Companies are now required to provide specific information on corporate governance in their annual reports. However, information provided in annual reports is often sketchy and is not of much relevance to shareholders and would-be investors. Hence, there is a need for a reality check to ensure the quality of information given in the annual reports.

Traditionally, however, Indian organisations are prone to managing risks in a fragmented way through departments or functions. The traditional and fragmented risk management mechanism would focus on managing such risk through hedging activities. However, while managing risks is integral to management's day-to-day activities, the reality for many organisations today is that the risk management function is usually unsupported by a comprehensive risk management process. As a result, many exposures are managed on a one-off basis, leaving organisations vulnerable to harmful, unplanned, or unforeseen events.

Most recently the Securities and Exchange Board of India (SEBI) revised its Clause 49 of listing agreements (January 2006) with a view to enhancing the corporate governance requirements, primarily through increasing the responsibilities of the board, consolidating the role of the audit committee and making

management more accountable. There are no requirements for director training. However, guidance is weak in some areas. As one company secretary noted, there are four lines on risk management which means companies either do little or have to resort to consultant guidance at significant cost.

One of the main issues in India is that dominant shareholders in most of the non-government public companies are often family members of the original owner who set up the company. Even if the company is a public company listed on stock exchanges, the board of directors is typically made up of family members, a nominated director from the financial institutions, a government nominee and a few independent directors. By definition in Clause 49 in the listing agreement, dominant shareholders cannot be considered independent. So these companies had till 1 January 2006 to reconstruct their board of directors to at least 50% of independent directors. While some are in violation of the standard, these companies are slowly in the process of restructuring their board of directors.

Mere compliance with the existing legal and regulatory framework and protecting the majority shareholders interests alone is not a guarantee for long-term corporate survival. The bigger challenge in India lies in the proper implementation of rules at the ground level. More needs to be done to ensure adequate corporate governance in the *average* Indian company.

Availability of information with respect to the following needs greater attention: strategic review and guidance, and monitoring; selection, compensation and succession policies; risk policy and management; reviewing key executives and board remuneration; transparent board nomination process; monitoring and managing potential conflicts of interests; integration of accounting and financial systems and independent auditing including compliance with the legal requirements; monitoring effective corporate governing policies and practices; establishing appropriate systems of control; overseeing disclosures and communications; and ensuring access to material information of all stakeholders.

The corporate governance framework in India encourages public participation but unlike institutional investors, public shareholders are not in a position to influence managerial decision making. The right to vote according to the proportion of shareholding, proxy voting, the right to resolve disputes with the company, and the right to demand an independent audit do exist in the legal framework. On the other hand, the minority shareholders are not represented on the board. However, the shareholder's voice needs to be strengthened further to protect basic minimum rights as follows:

- Basic rights of ownership such as being informed of and participating in decisions to change the company statutes, capital structure or sell the company;
- Right to elect members of the board; equitable treatment of all shareholders including minority and foreign shareholding;
- Right to be ensured that members of the board and management disclose all material information regarding their interests in related party transactions;

- Employee share ownership representation on the board, creditor participation in insolvency proceeding; and
- Access to relevant information for the participating stakeholders to assist them in fulfilling their responsibilities.

## *Nepal*

Nepal has a small but active equity market. At the end of 2005 there were 124 companies listed on the Nepal Stock Exchange (NEPSE). Nepal's family owned business houses play an important role in corporate ownership. Most government and market institutions lack efficiency, predictability, transparency and accountability. The legal framework governing capital markets contains large and significant gaps. Critical institutions, including the securities board and company registrar, have few resources and little authority. The industrial activity of the country is concentrated in a small number of powerful families who own and control about 27% of total private sector assets in the country. In addition, a number of enterprises are still in the public sector and operate at a very low efficiency level. The country has experienced a sharp economic downturn since mid-2001, with GDP growth slipping mainly due to political uncertainty, escalating insurgency and social unrest.

The government has adopted a market economy and has a liberal policy towards foreign investors. However, foreign direct investment in the country is still very low. Weakness in corporate governance also accounts for one of the reasons.

Awareness of the importance of corporate governance is growing in Nepal. The government has adopted good governance as one of the pillars of its five-year plan, recognising its critical importance in achieving poverty reduction and economic development targets. The central bank has introduced higher corporate governance standards for banks and other financial companies as part of a wider programme of financial sector reform. Accounting and auditing standards are being developed. Also a number of draft laws have been prepared that, if passed and implemented, should deepen and accelerate the reform process.

Nepal has initiated corporate governance reform in the financial sector and draft legislation has been prepared to spread reform to other companies. Fully tapping the potential of capital markets and professionalising boards and management will require this legislation to be passed and implemented and overall reform efforts to continue.

### **Key issues**

1. Investor protection:
  - There are a number of weaknesses in the corporate governance framework that limit investor confidence;

- Shareholders can participate in the governance process; however, for some shareholders participation involves demanding money and other benefits at the AGM;
- Share registration is cumbersome and prone to abuse. Information on companies can be hard to access; and
- Change in control is not common. Related party transactions take place which are sometimes disadvantageous to the minority shareholders.

Minority protection is a problem when owner/managers solicit funds and then abscond or mismanage the company. Minority shareholders do not have easy access to legal protection in Nepal. The courts in Nepal are ill-equipped to deal with business problems. Judges and lawyers have not been trained to analyse the kinds of legal issues generated by a capital market. Judges should be further educated to respond to new demands, but that is a long-term solution.

## 2. Disclosure:

- Disclosure is poor especially for non-financial companies;
- Ownership disclosure is limited; and
- Standards for auditing and accounting are still being developed.

Poor disclosure of information is one of the impediments for gaining investors' confidence at a high level. The issuers publish overoptimistic forecasts of future profits and they often fail to publish annual accounts or hold annual general meetings, and even pay no dividends.

## 3. Effectiveness and ethics of the board members:

- Boards and management are under family control;
- Directors have limited guidance on their duties or powers; and
- Basic rules of conflict of interest are in place, but enforcement is limited.

Because of the relationship-based system in Nepal, most boards do not satisfy any of the conditions that accompany the principle of independent oversight. Although there is a clear distinction between full-time directors and non-executive board members, there is no legal definition of independence. Moreover, the non-executives are family members or nominees from the government or institutional shareholders. It is common for prominent persons to serve on the boards of several corporations simultaneously.

Management shares very little substantive information with the outside directors. Most of the nominee directors fail to understand that they are fiduciaries of the company. Most Nepali companies are driven by their management and not by their boards.

## 4. Enforcement:

- Key corporate governance institutions lack resources and authority; and
- Enforcement is largely left to the NEPSE, district courts and the central bank.



The affiliated company board, a part-time court-like body, hears a steady stream of cases, but these are regularly appealed. The standards developed by ICAN and the Accounting and Auditing Standards Boards remain voluntary, and only a fraction of registered accountants and auditors have been licensed by the body.

## Recommendations

1. Strengthen capital markets:
  - Nepal should continue the reform process and draft more effective company and security legislation; and
  - Strengthen the institutions which are in charge of enforcing the legislations and regulating the capital markets.
2. Protect shareholders' rights:
  - Stress should be given on strengthening shareholders' rights and more productive AGMs; and
  - Establishing transparent procedures for major and related party transactions.
3. Enhance transparency:
  - Ensure that high standards for accounting and auditing are introduced and enforced; and
  - Improve disclosure of ownership and control.
4. Increase the effectiveness and objectivity of boards:
  - Increase the effectiveness of boards through change in legislature and introduction of a 'code of corporate governance';
  - Specify the directors' duties and powers and introduce new codes for directors to behave ethically and be responsible to legitimate stakeholders;
  - Encourage the development of independent directors; and
  - Training for board members and creation of institute of directors or corporate governance.

## *Pakistan*

Pakistan commenced its corporate governance programmes later, following the Securities and Exchange Commission of Pakistan Act in 1997, the commencement of operations by the Commission in 1999 and the introduction of the national Code for Corporate Governance in early 2002. But despite the later start, initiatives in Pakistan were driven by homegrown realities, in particular the recognition that the traditional structures and operations of the capital market, especially lending from state-owned banks, could no longer sustain the financing needed for growth. This has led to a realisation of a critical need for reform of the capital markets in order to mobilise domestic savings and foreign portfolio investment (as there had been in India a decade earlier).

In fact, despite the later start with formal national policies, it could be said that Pakistan focused on corporate governance earlier than many countries in the world, not just the region – note the importance of the 1984 Companies Ordinance Act, which introduced a number of key features of good corporate governance, at a time when the very term ‘corporate governance’ had only just been coined and was still effectively unknown outside very specialised academic circles. Furthermore, during the mid-1980s there were some significant policy and training programmes to strengthen corporate control, board direction and chairmanship in both the state enterprises and the private sector, through the Expert Advisory Cell of the Ministry of Industry and the Lahore University of Management Sciences and Institute of Personnel, supported by USAID. Although these programmes were not described as ‘corporate governance’, they could be said to form part of the corporate governance heritage of Pakistan.

Assessment of corporate governance in Pakistan can be examined both in relation to listed companies and SMEs.

## Listed companies

There have been a number of achievements. Reform to improve corporate governance has been significant, including the introduction of a code of corporate governance and increased vigilance by regulators. Regulators, industry associations, academic institutions and non-governmental organisations have raised awareness of the value of good corporate governance practice, and have established the Pakistan Institute of Corporate Governance (PICG), which aims to build understanding and provide training in an innovative public/private partnership. The PICG is a dedicated centre established in Karachi, the business and financial centre. This is supported by regulators such as the Securities Exchange Commission and the private sector such as Citibank as well as an international professional accountancy body and aims to provide training and act as a centre for sharing best practice nationally. Crucially it also has strong links to the leading research centre for corporate governance based in one of the country’s leading business schools (Lahore University of Management Sciences).

Among multinationals, corporate governance benchmarks, internal reporting and disclosure requirements are set out by the parent company and this translates to practices that go beyond regulatory requirement. Such companies, though few, are becoming effective drivers for corporate governance.

Basic shareholders’ rights are in place. Changes to company articles, increasing authorised capital and sale of major corporate assets all require shareholders’ approval. The regime for related party transactions and conflict of interest is developed in the law and requires audit committees to concur with any departures from arm’s length pricing and super majority of shareholders in case of investment in an associated company or an associated undertaking. Quality and timely financial disclosure have improved over the past few years. Shareholders owning 10% or more of voting capital must disclose their ownership and the annual report includes the pattern of shareholdings. The

Code of Corporate Governance (2002) strengthens the role of non-executive directors, restricting the percentage of executive directors to 75% in non-financial companies.

There are a number of enforcing institutions in part reflecting the government's strong commitment to economic reform:

- The Securities and Exchange Commission (SECP) is committed to enforcing corporate governance regulations;
- The State Bank of Pakistan (SBP) has also been instrumental in improving corporate governance in the banking system, by requiring non-listed banks to adopt the Code of Corporate Governance;
- The Pakistan Institute of Corporate Governance (PICG) has been created with the goal of training directors and building more awareness; and
- The Institute of Chartered Accountants of Pakistan (ICAP) has been an important force for corporate governance reform in Pakistan. It has some self-regulatory functions and stock exchanges are responsible for overseeing listing requirements.

Key obstacles include highly concentrated control by significant shareholders, which has limited the objectivity of boards and reduced the impact of some of the recent reforms. More generally, many smaller and family-owned companies have a limited awareness of the potential benefits of improved corporate governance. Remuneration paid to directors has traditionally been token.

## SMEs

Almost 90% of businesses in Pakistan are SMEs, mostly working in the undocumented sector. They are run as family businesses lacking standard entrepreneurial and managerial skills. Concerns about 'standards of financial reporting', 'effective accountability' and transparent management and business conduct are increasing. In this regard the Securities and Exchange Commission of Pakistan (SECP) has laid down a specific code of conduct to be followed by the corporate sector to improve the state of corporate governance in the country. As per prevailing guidelines one of the non-executive directors on the board of a company should be the professional lawyer/legal advisor but many SMEs have been avoiding this clause for some time.

Geopolitical factors also have an impact. As one business leader noted in a CBC workshop in 2006, 'the law and order situation due to the US led war on terror is also impeding corporate governance and is a risk factor to our corporate sector. The advent of Reconstruction Opportunities Zone (ROZs), a US sponsored mechanism to quell poverty, is a program which will try to encourage economic stability for the individual thereby digging out poverty, the root cause of terrorism [and] the corporate sector of our region will definitely be improved.'

Corporate governance reform needs to percolate throughout the corporate sector – listed companies and unlisted companies/SMEs, including family-owned businesses. Further steps need to be taken to protect shareholders'

rights, including disclosure of beneficial ownership. Boards must become more effective, with stronger fiduciary duties and more capable independent directors.

Compliance needs to be improved in three areas – disclosure of beneficial ownership and control by shareholders; reporting of related party transactions; and compliance with regards to the AGM. Independent oversight for accounting and auditing should be introduced to enhance credibility. There should be enhanced provisions for majority board independence (currently voluntary). Institutional investors should adopt and disclose their corporate governance and voting policy. The move towards a central registry should be accelerated. Provisions for independent directors are relatively weak; in practice only direct ownerships are reported, although law requires disclosure of direct and indirect. The requirement for shareholders to disclose indirect ownership should be clarified. Distance voting for the AGM, by post or electronic means, should be introduced. Companies should disclose significant shareholders in their annual report and all shareholder agreements. Thresholds for shareholder action should be lowered (the threshold for filing lawsuits of 20% is high). The Companies Ordinance (CO) could be amended to include the concept of independent directors as opposed to non-executive directors, making it a requirement to have up to 25% certified directors with a minimum of one independent director.

## *Sri Lanka*

In Sri Lanka, the concern for corporate governance originated in the numerous company failures, especially finance companies, in the late 1980s and early 1990s, which caused investors to lose faith in the regulatory and semi-regulatory frameworks, as well as the standards of financial reporting. Accordingly, the Institute of Chartered Accountants of Sri Lanka set up a task force in 1992 (about the same time as the Cadbury Committee in the UK) to enforce Sri Lankan accounting standards, and then extended this initiative in 1996 (again before the East Asian financial crisis) to set up a committee to make recommendations on the financial aspects of corporate governance.

Many Sri Lankan publicly listed companies have subsidiaries in which the directors of the holding company have significant shareholdings. Some of the subsidiaries purport to perform management services, computer services and similar types of services. Because of the significant financial interest of the directors in these subsidiaries, it is possible for the boards of the holding companies to make decisions in favour of the subsidiaries to the detriment of the other shareholders of the holding company. Non-executive directors are often not effective in controlling such practices, as the board appoints them.

The Sri Lankan equity market does not have active independent shareholders. Unit trusts and other forms of fund management have not developed to a significant degree to influence the decisions of the management. As shareholdings of most companies are concentrated in few shareholders who are also directors, the directors are able to make decisions which are favourable to

themselves and unfavourable to minority shareholders. Therefore, the minority shareholders are largely at the mercy of the directors, and it is unlikely that the market forces would change the situation.

Minority shareholders who participate in general meetings often feel that they do not have a significant voice at these meetings. There is little shareholder participation in important decisions, and in particular on material-related party transactions. In the plantation sector most companies have delegated management to other companies in which directors of the plantation company are the shareholders and directors. The delegated company enjoys substantial management fees. Most minority shareholders feel that this arrangement is disadvantageous to the company and its shareholders and have been done to benefit the directors.

Company legislation as well as accounting standards require disclosure of related party transactions. However, Sri Lanka accounting standards, as well as international accounting standards on which the Sri Lanka standards are based, exclude intercompany transactions between members of a group of companies from this disclosure requirement. Many minority shareholders feel that the directors of companies use this exclusion to avoid disclosing transactions with companies of the group in which directors have a large financial interest.

The 2003 Revision to the Corporate Governance Code of 1997 contained several key enhancements. The voluntary Code of Best Practice was updated to be in line with the Combined Code of UK. Clearly defined functions of the board were set out. The 'lead director' concept was introduced if the chairman is also the CEO. There was guidance on non-executive directors, independent directors' and board balance. Other areas covered included appraisal of the board and CEO, disclosure of directors' remuneration, constructive use of the AGM and disclosure of major transactions. In the 2004 Guidelines for Listed Companies on Auditor and Audit Committees, the Voluntary Code of Best Practice took into consideration certain provisions of the Sarbanes-Oxley Act.

The guidelines are now focused on two areas: auditors of listed companies (their qualifications, appointment, powers, audit partner rotation, independence of auditors, disclosure of fees for other services, restricted and permissible non-audit services) and audit committees of listed companies (their composition, objectives, powers and duties). Most recently in the 2006 Revisions to the Code of Best Practice on Corporate Governance several further steps were taken. Mandatory rules are to be introduced in the first quarter of 2007. There is enhanced guidance on non-executive directors, independent directors, and disclosures relating to directors. The role and responsibility of the remuneration committee, audit committee and nominations committee is further set out with the appraisal of the board and board committees. There is a definition of independence and self-declaration of independence required of non-executive directors. There is a Voluntary Code of Best Practice formulated by a select committee, taking account of corporate governance standards in several jurisdictions including the UK (Combined Code) and New York (New York Listed Company Manual).

In October 2005 the Asian Development Bank 'found accounting and auditing in Sri Lanka to be of a generally good standard with the exception of

public sector entities’. It noted that ‘there are two major challenges to establishing effective financial sector governance in Sri Lanka. One is the significant role played by state-owned institutions, and the second is the prevalence of complex and interrelated corporate groups in the private sector.’

## Recommendations

The CBC has made the following recommendations to governments and business for further action to strengthen corporate governance in South Asia:

1. Adopt the ‘CBC Business Principles’ as a standard applicable for all businesses and other relevant entities in Commonwealth countries;
2. Endorse the legal and institutional environment advocated in the OECD Policy Framework for Investment;
3. Agree the need for the private sector and government to work together in pursuit of better corporate governance;
4. Allocate specific responsibility at cabinet level for enhancement of corporate governance;
5. Reinforce good corporate governance through enhancement of the legal and institutional framework as described in the CBC approach above. Of particular importance are listing rules and codes of practice of stock exchanges and financial regulatory authorities;
6. Support and encourage development of a best practice national body in each country for advancement of good corporate governance, bringing together business, professions, regulators, investors and financiers, academia and policy-oriented research centres;
7. Support regional centres of excellence possibly associated with regional institutions, such as SAARC, to promote awareness, education and training;
8. Ensure a focus is also maintained on significant groups beyond listed companies as these are important in South Asia, i.e. unlisted companies, state-owned enterprises and SMEs.

## Chapter summary

In order to achieve a sustainable approach to business risk, varying drivers and approaches must be considered, as well as differing standards that exist. An awareness of strengths and weaknesses of problem-solving efforts in different jurisdictions is required. For example, the US corporate governance reforms may be insufficient to prevent future corporate failures like Enron (see Chapter 22). These reforms were brought in haste and therefore they have had unintended consequences on corporations, causing them hardships to achieve compliance. On the other hand the UK approach, being self-regulatory, allows some scope for manipulation of rules and regulations by fraudulent geniuses, although it has worked well to date as there have been no corporation collapses of the magnitude of Enron. This reality is evident more in the case of developing countries where the law enforcing machinery is unlikely to be as efficient as in a developed

jurisdiction like the UK. Apart from the recommendations referred to in this chapter another could be that before rules and regulations are made mandatory they should be tested by incorporating them in a code adopting a comply and explain approach as done in the UK. This kind of test and legislate approach may assist corporate governance in developing countries and enable sustainable risk management. One point is very clear: this is an ongoing and vital debate in today's era of global business expansion and change.



24

Conclusions and future trends



# 24

## Conclusions and future trends

### CHAPTER OVERVIEW

At the early stages of the new millennium, there is little doubt that certain major risks will dominate global business affairs in the years to come; in particular sustainability related risks covered in previous chapters. This final chapter reviews some of the themes and trends affecting organisations and the risk levels that pose a threat to value. By structuring your risk management activities into a more cohesive and sustainability orientated process you can reduce your risk levels.

The essence of this book is to protect the average 12.5% of market value at risk from sustainability issues by bringing together various elements of risk management into a sustainable and economic/enterprise risk management system.

We hope the book is a one-stop resource that helps business, non-profit, and government organisations to improve the economic, environmental and social conditions of their organisations and increase their “capital” in these areas. This chapter provides a brief overview of the business case, its implementation, and monitoring, which demonstrates that improved risk management and better relationships with stakeholders can ultimately build more sustainable organisations and economies.

### Introduction

The business case for sustainable and economic risk management of a wide range of contemporary issues has been outlined in the previous chapters and is summarised in this chapter.

The main message is that whatever the current trends for describing new methods for assessing companies – business ethics, corporate social responsibility, corporate responsibility, corporate governance and accountability, best practice, sustainable development and other methods – the broader view is that there is an increased interest in the value of values and the benefit of viewing sustainability issues as business issues.

There is an increasingly wide definition of what constitutes value as intangible assets (also called non-financial and extra-financial) gain in importance, such as:

- Brand value and reputation;
- Goodwill;
- Stakeholder and shareholder value; and
- Customer loyalty, retention and value.

As mentioned in Chapter 9 these intangible assets are quite often of a higher value than tangible assets, i.e. 71% of the value of the UK's largest listed companies is estimated to be linked to the above factors. The essence of this book is to protect this value by bringing together various elements of risk management into a Sustainable and economic/enterprise risk management system. The sustainability approach is summarised well by Patrick Cescau, Group Chief Executive of Unilever:

“The agenda of sustainability and corporate responsibility is not only central to business strategy but will increasingly become a critical driver of business growth... I believe that how well and how quickly businesses respond to this agenda will determine which companies succeed and which will fail in the next few decades.” (Speech by Patrick Cescau, Group Chief Executive of Unilever, at the 2007 INDEVOR Alumni Forum in INSEAD, Fontainebleau, France (25 May 2007))

The following framework can be used to review the chapter:

- Identifying, trends, themes and risks;
- Building the business case for action;
- Implementing the business case; and
- Monitoring and controlling.

## Identifying trends, themes and risks

The farther backward you can look the farther forward you are likely to see. Winston Churchill

We hope this quote rings true for the reader and that the case studies and news items presented in this book help highlight risks that have occurred to others, and the hazard of their reoccurrence. Traditional risk management is closely linked to compliance and sustainability management is linked to having a more predictive ability to stay ahead of the competitive environment. Many of the hazards and risks we review are newly emerging and their frequency and severity are still unknown, we will bring greater clarification to future editions as research becomes available.

## Trends

Key trends are described in detail in Chapter 3 and with more specific reference in each Chapter. In summary, it is noted that the level of hazards and risk is increasing. The nature of the risk environment in which our organisations have

to operate is changing as well with challenges beyond the reach of even individual countries. This is exemplified by the fact that:

- The “Doomsday Clock” of the Bulletin of Atomic Scientists moved its hands forward two minutes from seven minutes to midnight to five minutes too, with midnight marking global catastrophe. This is to reflect what they call worsening nuclear and climate threats to the world.

An important trend on a global level, which we can respond to more directly, is the increased demands from stakeholders like shareholders, investors, lenders, governmental and non-governmental bodies. This trend is reviewed in Chapters 3 and 9 and discussed as a transparency theme in this Chapter. A sample of the issues raised is that there are:

- Increased governmental demands can be seen in the form of: corporate codes of conduct; tax increases, new taxation like carbon taxes; waste duties; fuel duties and other market mechanisms to drive organisations in the direction that governments deem the public wants them to go.

## Themes

### *Trust in organisations and business?*

The issue or theme of ethical business practice has transcended most of this book’s chapters. There is a real risk that the traditional trust in modern systems of business and management is being lost. Businesses and politicians rate as some of the least trustworthy entities in the world, whilst NGOs and campaigners rate amongst the highest. There are key factors underlying this. No doubt however future risks can be reduced by increasing the trust others have in your organisation. The Customer Trust Index contains a wealth of information, findings are:

- Nine out of ten people say trust is very or fairly important when they decide to buy products and services from a company. However the problem for business is that whereas 57% say they are inclined to trust companies in general this falls to a low of only 7% would trust on-pack information;
- Ethical behaviour counts – Advanced factor analysis across all 45 combined drivers of trust and mistrust showed corporate responsibility to be the most important overall driver; and
- It is clear that getting the basics right gives companies a good start. Of paramount importance – according to three quarters of people interviewed – is “keeping promises and delivering what it says it will.”

SERM has found that a key issue for companies is customer retention and that:

- Having earned trust, over half of consumers (54%) would reward a company by personally recommending them to others.

So the key to the modern business arena will be winning and keeping the trust of consumers and – as a result – the wider society, which influences their

views on many occasions. It is estimated that a unit of trust is ten times easier to lose than to create; this is one of the key drivers behind reputation risk management as reviewed in Chapter 9.

## *Litigation culture*

Part of the response to this reduction of trust in business is that there is a growing regulation, compensation and litigation based culture – Legislative, regulatory and industry codes are increasing in number.

In the US the number of class-action lawsuits against US companies rose sharply in 2004 according to a report by Stanford Law School and Cornerstone Research, the “Securities Class Action Clearinghouse Report” cited a 17% increase in the number of actions filed for 2004 and that the companies being sued lost \$169 billion in market value. This figure was almost treble the figure for the previous year.

In the UK a recent litigation case highlights the trend of increasing fine levels as US and UK authorities have hit British Airways with £270 m worth of fines for colluding with competitor airlines over the imposition of fuel charges. The UK’s Office of Fair Trading (OFT) fine (£121.5 million USD\$ 246 million) was over ten times the level of the previous highest fine. The U.S. Justice Department levied USD\$300 million against BA and also levied a US\$300 million (€218.9 million) fine on Korean Air Lines Co. Ltd for colluding with competitors to fix fuel surcharges on cargo shipments to the U.S.

## *Transparency*

There are increased demands for greater transparency and accountability for the business community to justify their license to operate:

- Stakeholder involvement will continue for the foreseeable future through their support for a wide range of standards, codes of practice, laws and regulations covering the risk issues addressed in this book. There is confusion as to the variance between them, which is why this book focuses on the issue of risk which is common to all organisations. Current terminology varies as widely as do the types of codes as in addition to: accountability, responsibility and sustainability, there are also sustainable development; corporate governance, corporate responsibility (CR); corporate citizenship and the triple bottom line! A small sample of the terminologies in use by key organisations provides us with: the WBCSD referring to Corporate Social Responsibility; the UN Global Compact on Responsible Corporate Citizenship; the OECD Guidelines to Responsible Business Conduct; and AA1000 to Social & Ethical Accountability;
- There will be persistent calls to report verification and audit as well as the holding of standards that indicate reporting proficiency; and
- The volume and speed of media coverage will continue to increase: environmental and health and safety incidents; the levels of fines, loss of reputation

and financial impacts will both increase and become more apparent, as will the corresponding measurement and reporting of benefits that are derived from the good management of these risks.

Fortunately, SERM research has found that the world of business and industry is not phased by this overall trend. The response has generally been to get on with business whilst increasingly recognising that the issues represent not only unparalleled challenges but also unique opportunities.

## *Partnerships*

Today's risks are arising from the same types of pressures as many before them, from legislative and commercial or competitive drivers through to marketplace (i.e. customer) pressures. The main difference is that the added pressure of the risks arising from newer, often global, issues poses a potential threat to virtually all industrial and commercial activity in the current climate of growing environmental and social concerns.

Since many of these threats are deemed to be too large, complex or important to just be left to the authority that is invested in governments, dynamic partnerships are important. This means working with government bodies, critics and customers to sound out our organisation's place within this bigger picture.

The involvement of individuals and business organisations is seen as paramount to achieve our goals of long-term survivability and the sustainability of our societies and organisations within them. This is well phrased by Michael Porter and Mark Kramer writing in the Harvard Business Review:

“Leaders in both business and civil society have focused too much on the friction between them and not enough on the points of intersection;” and “The mutual dependence of corporations and society implies that business decisions and social policies must follow the principle of Shared Value” (Strategy and Society: The Link between Competitive Advantage and Corporate Social Responsibility, December 2006).

At the macro level the risks we face as individuals and organisations are too great for any of us to deal with individually and we will be required to work with stakeholders increasingly to help reduce these risks.

### *Global problems requiring global strategies*

“From an Asian perspective, I want to emphasise that there is no alternative to the preservation and strengthening of the multilateral system. All other solutions, including regional blocs and bilateral preferentialism, will inevitably generate fewer opportunities for business – especially for small and medium enterprises in the developing economies – less respect for rule of law in international trade and more trade friction, leading eventually to a significant decline in global economic growth.” Dr Victor Fung, Group Chairman, Li & Fung Group; and Co-Chairman, The Evian Group, based in Hong Kong.

## Risks

The significant problems we face cannot be solved at the same level of thinking we used when we created them (Albert Einstein)

### *Total sustainability related risk*

The SERM system of analysis has assessed the total organisational value at risk from sustainability related risks is 12.5% of market value for the 500 largest companies in the US and EU. The research from the issues quantified in this book is broken down into the three main headings of sustainability, which are then reviewed briefly.

Sustainability risk category	Net risk to value
Economic and socio-economic risk	2.0%
Social and ethical risk	5.1%
Environmental risk	5.4%
<b>Total Sustainability Risk</b>	<b>12.5%</b>

Stakeholder and reputational risk (Chapter 9) is present in all these sections of the book and accounts for about half of the total sustainability risk.

### *Economic aspects of business risk*

There is an average of 2% of risk to market value from the risk issues we have reviewed in Part B of this book. We have not included a review of many macro economic risks such as currency fluctuations, interest rates *et al*, but have limited ourselves to those we feel have a direct impact upon organisations from a sustainability related perspective.

We covered the key aspects of the emerging risks including: economic crime; fraud; business interruption and disaster planning risk with crisis management; stakeholder and reputation risk management; and business, marketing and new technology related risk. These risks are in addition to the more standard risks associated with business practice, accountancy and governance issues.

Economic and socio-economic risk	Net risk to value	Chapter reference
Economic crime, bribery & corruption	0.3%	Ch 7
Business interruption	n/a	Ch 8
Shareholder and reputation risk	Part of all risks	Ch 9
Use of corporate power	0.4%	Ch 10
Business practices	0.5%	Ch 10
Corporate Governance	n/a	Ch 21, 22, 23
Marketing practices	0.4%	Ch 10
New technology	0.4%	Ch 11
<b>Total</b>	<b>2.0%</b>	

## *Social and ethical aspects of business risk*

There is an average of 5.1% of risk to market value from the risk issues we have reviewed in Part C of this book. Social risks are as varied as the communities and cultural groupings from which they emanate. The risk to market value is mostly from health & safety of staff and customer issues. A SERM system includes a review of external issues such as product safety, human rights and employment law.

<b>Social and ethical risk</b>	<b>Net risk to value</b>	<b>Chapter reference</b>
Community investment	0.3%	Ch 12
Cultural due diligence	n/a	Ch 13
Human rights/resources (internal)	0.7%	Ch 14
Human rights (external)	0.3%	Ch 15
Health internal (workforce)	0.7%	Ch 16
Safety internal (workforce)	0.5%	Ch 16
Health external (public)	0.4%	Ch 17
Safety external (public)	1.0%	Ch 17
Historic liabilities from health and safety	1.2%	Ch 17
<b>Total</b>	<b>5.1%</b>	

## *Environmental aspects of business risk*

There is an average of 5.4% of risk to market value from the risk issues we have reviewed in Part D of this book. The term ‘sustainability’ often means a paradigm shift towards a greater understanding of things in the direction of natural processes, which are more durable in their efficient use of resources and inputs and outputs from systems.

<b>Environmental risk</b>	<b>Net risk to value</b>	<b>Chapter reference</b>
Environmental incident risk	1.3%	Ch 19
Historical environmental liabilities	0.8%	Ch 19
Air Pollution – from production	0.4%	Ch 19, 20
Air Pollution – from transport	0.5%	Ch 19, 20
Air Pollution – peripheral pollution	0.3%	Ch 19, 20
Resource use – materials	0.4%	Ch 19
Resource use – energy	0.4%	Ch 19
Resource use – natural resources inc land	0.4%	Ch 19
Resource use – waste generation	0.5%	Ch 19
Resource use – water use	0.2%	Ch 19
Resource use – waste water pollution	0.2%	Ch 19
<b>Total</b>	<b>5.4%</b>	

These findings may seem excessive, but the figures relating to climate change (Air pollution from production and transportation) have recently been echoed by other reporters, including the ‘Stern’ Report on the “Review of the Economics

of Climate Change.” Sir Nicholas Stern estimates that the costs of doing nothing about climate change are £3.68 trillion in damages, or approximately 5–20% of the global economy at risk.

### *Further emerging risk issues*

The example of the Stern Report findings show how the magnitude and impact of potential risks are material to organisations in that they will cause financial losses. Extensive work is being conducted to bring these to the readers’ attention in future editions. A recent example of research is that future risks were discussed at a conference on the subject of 21st century global risk management at the Evian Group plenary meeting in Montreux, Switzerland in 2006. Dr Steve Howard, Chief Executive, The Climate Group and Founding Member, HSBC Carbon Management Task Force summed up the importance of these types of reviews and research on emerging risks:

We live in times of unparalleled risks and opportunities. As greenhouse gas concentrations climb the search for creative solutions offered by the Evian Group is to be welcomed—there is nothing more important,

Their findings suggested that there are 10 big global risks, which demand innovation and shared action at national, regional and international level. They are:

- Climate chaos;
- Radical poverty;
- Organised crime;
- Extremism;
- Informatics;
- Nanotechnology;
- Robotics;
- Genetics;
- Artificial intelligence; and
- Financial systems.

(Keynote address by DK Matai, The Evian Group Initiative press release, 10 October 2006).

We have reviewed elements of these within the book and will continue this research in future editions.

## **Building the business case for action**

### **The purpose of a sustainable risk management approach: key points**

You *can* prevent the impacts upon your organisation from a wider range of risk issues, and develop a system for scanning the market environment. This will save you organisational value and capital in the long-term. You can also create new revenue streams for your business if you ask



yourself: ‘what can we do that is commercially viable and socially responsible (i.e. sustainable in the broadest sense)?’ and ‘can we do this whilst managing our risks in a sustainable manner?’

*Why?*

- Just asking yourself this question will help you innovate and come up with new ideas for risk management techniques and new products, services or revenue stream, often without diversifying; and
- There is a growing demand for corporate policies, products and services that make a difference to the lives of others.

*Why is this important?*

For the last few years’ sustainability has begun to equal survivability in the new market environment:

- 51% of the British public say they have chosen a product or service because of reputation for responsibility of the organisation in question. (Source: The Ethical Consumer, MORI/The Co-operative Bank 2002); and
- 86% of customers have a more positive image of a company that is seen to be doing something to make the world a better place. (Source: Business in the Community, the *Ultimate Win Win Win* (1999) supported by Research International).

*Extra benefit to your company*

- You can protect and improve your reputation if you show how your organisation products were produced or that your service is sustainable and has a responsible purpose; and
- You will attract the kind of human resources who share your belief in your products.

## Some benefits of a sustainable risk management system

The benefits of a Sustainable Enterprise/Economic Risk Management (SERM) system are wide and varied and samples of these include:

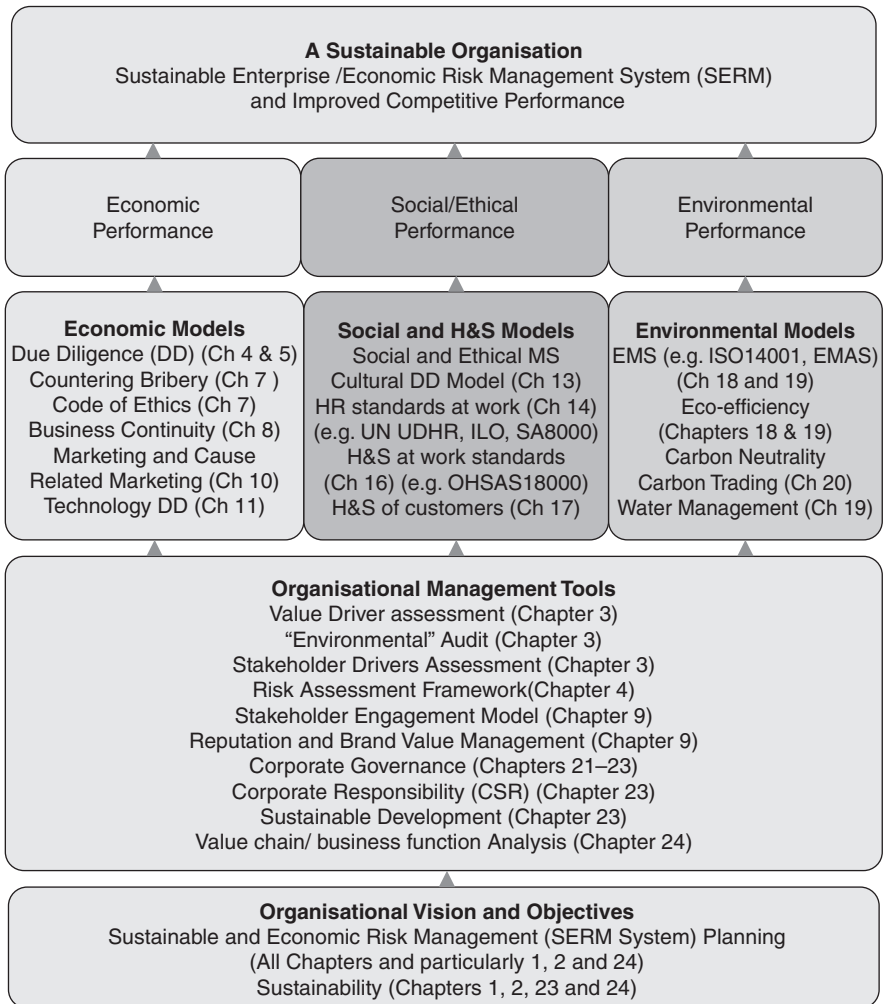
### *Strategic and corporate benefits (Book part A)*

These general risk issues are reviewed throughout the book and particularly in the Chapters in Part A, i.e. environmental scanning tools in Chapter 3 and the corporate governance Chapters from 21–23:

This is reviewed throughout the book and elements of part A of the book:

- Strengthened risk management systems, which incorporate the principles of sustainability through the organisation. These include items like those highlighted in the diagram below, including: risk management assessments of a wider range of risks emanating from economic, social and environmental

issues, environmental scanning; stakeholder and reputation analysis; and due diligence checks;



- Business value is enhanced: “The evidence is building that embedding universal principles and related environmental, social and governance policies into management practices and operations delivers long-term business value and is rewarded by markets”, said Georg Kell, Executive Director of the UN Global Compact. (CSRwire) July 5, 2007;
- Competitive advantage gains: With investment in the growth and preservation of economic, social/human, and environmental capital can come competitive advantages as reported by Michael Porter and Mark Kramer in the Harvard Business Review December 2006. The competitive advantages of price and technical innovation are being further eroded as key advantages are

copied with greater speed there will be more competition in key areas of differentiation such as brands value and values; and

- Financial benefits from various elements of sustainability risk management.

Business case issues	Sustainability factors					
	Governance and engagement issues	Economic factors	Social factors			Environmental factors
			Social factors	Human rights	Health and safety	
Chapter numbers	1–5 & 21–23	6–11	12–13	14–15	16–17	18–20
Access to Economic Capital	✓	✓	✓			✓
Brand Value and Reputational Capital	✓	✓	✓	✓		✓
Cost savings and productivity	✓	✓			✓	✓
Competitive Advantage Improvements	✓	✓				✓
Market access and growth	✓	✓				✓
Resource growth and Environmental Capital	✓	✓	✓			✓
Risk Management	✓			✓	✓	✓
Human and Social Capital growth	✓			✓	✓	

✓ = Evidence of financial benefits at the present time

## Stakeholder benefits

- Accurate and timely financial and sustainability reports and the communication of risks to stakeholders are also beneficial and protective of shareholders' interests. An example is a survey by UK pension funds called the Marathon Club that found that more than 88% of the investment industry agreed that good corporate governance helps to manage a fund's investment risks and long-term return prospects more effectively. In the same survey 80% of respondents said that good corporate responsibility adds value. (*Financial Times*, 17 October 2005);
- Corporate governance issues: good corporate governance can bring increased share value as investors are keen to pay premiums for investing in companies they deem to be well managed (Chapters 21–23);
- Trust and credibility can be increased among stakeholders. This may translate into brand value and a market reputation, as well as customer loyalty,

public credibility, and investor confidence, if the organisation is perceived to be doing things right;

- Investors strongly feel that environmental, social and governance (ESG) issues affect market value in over 50% of companies included in the FTSE All World Developed Index, reports London-based EIRIS; and
- Peer pressure: A McKinsey & Company survey of chief executives participating in the Global Compact revealed the following:
  - More than 90 per cent of CEOs are doing more than they did 5 years ago to incorporate environmental, social and governance issues into strategy and operations;
  - 72 per cent of CEOs said that corporate responsibility should be embedded fully into strategy and operations, but only 50 per cent think their firms actually do so; and
  - 59 per cent of CEOs said corporate responsibility should be embedded into global supply chains, but only 27 per cent think they are doing so.

## *Economic*

The price of greatness is responsibility Winston Churchill

Economic risk is reviewed throughout the book and particularly part B. Benefits include:

- Financial out-performance: A report released by Goldman Sachs, one of the world's leading investment banks, showed that among six sectors covered – energy, mining, steel, food, beverages, and media – companies that are considered leaders in implementing environmental, social and governance (ESG) policies to create sustained competitive advantage have outperformed the general stock market by 25 per cent since August 2005. In addition, 72 per cent of these companies have outperformed their peers over the same period;
- Size of the Market: The market opportunities for 'sustainable', 'ethical' and 'environmental' products and services is increasing:
  - A survey prepared by the former UK Department of Trade and Industry's Joint Environmental Marketing Unit (JEMU) in the forecasted that global environmental markets would grow to £439 billion in 2010. Certain geographical market areas, especially those with expanding or developing economies, show significantly higher projected annual growth rates of environmental expenditure, among them China (12%), Southeast Asia (14%), Russia and Eastern Europe (10%) and South America (9%). These figures clearly indicated that there would be an unprecedented demand for long-term solutions to pollution and other environmental problems.
- Future revenue: increased customer loyalty and faith and trust in the products and services offered can help ensure that there is a market for the organisations offerings in the future;
- Marketing niches: There are still first mover advantages to be achieved in the market place. For example Dell announced that it was the first global

technology company to offer customers the opportunity to offset the emissions associated with the electricity used to power their computers, thus trying to cost effectively boost their potential sales levels and reputation with customers (see also Chapter 10);

- **Market leadership:** Marks and Spencer has announced that it will spend £200 million (US\$392 million) going “green”, as it seeks to become the frontrunner among British retailers seeking favour with increasingly environmentally conscious shoppers. Its five years plan and budget aims to make sure that:
  - They become carbon neutral by 2012;
  - They will trial using food waste to power their stores;
  - Their packaging and clothing will be biodegradable or compostable;
  - All products that have been flown in from growers are labeled thus; and
  - None of its waste will be dumped in landfill sites.
- **Revenue growth and potential for increased profitability:** improved profitability can be gained from the reduction of waste or reduced turnover of trained key staff, the increased loyalty and reputation for quality with customers can also have an impact upon profitability through increased sales and the ability to charge premiums over other competitors; and
- **Protection of reputation:** Corporate identity and reputation, integrity and sustainability performance and thus the organisation’s standing in the community are likely to be key areas of competitive advantage. This was reviewed in detail in Chapter 9. Ethical due diligence issues include money laundering, bribery and corruption (Chapter 10), examples include:
  - Intangible value is quite often of higher value than tangible value, according to Interbrand 2000, 96% of the market value of Coca Cola, 97% of Kellogg and 84% of American Express is ‘intangible’. (Quoted in *Business Case for Corporate Responsibility*, by Arthur D. Little and Business in the Community, 2003);
  - Reputation and the view of stakeholders is now a critical competitive advantage in an age of instantaneous communications. This affects all organisations not just those with shareholders. It can even affect key elements of governments, as the former UN Representative to Bosnia, Paddy Ashdown, has noted. He said that even...: ‘Modern warfare is won on the battlefield of public opinion’; and
  - Suppliers’ and business partner integrity can impact upon the purchaser.

## Social

These risk issues are particularly reviewed in part C. Benefits include:

- Ethical and cultural due diligence (Chapters 5, 7 and 13) and its related areas of corporate responsibility, environmental and sustainability due diligence is becoming increasingly important;
- Communities’ investment and involvement benefits are reviewed in Chapter 12, including the potential for organisations to link their business plans with Cause Related Marketing. The ability to deal with local communities – quite

often where staff emanate from – can also bring a more stable basis to operations and more constructive dealings with this stakeholder group;

- Human resources and employment policy (Chapter 14): employees that are treated with equal opportunities measures are staff that gives their best. Fair remuneration, skill training and consultation schemes may well help to achieve staff loyalty and retention of the best talent, and may even assist in attracting high calibre employees in the future;
- Human Rights benefits are discussed in Chapter 15;
- Health and safety: it is also possible to have healthier, safer and cleaner working conditions that will help establish a happier work force for the provision of safer and high quality products that customers are happy to purchase (Chapter 16); and
- Customer health, safety and service: good relations with customers are fundamental to a long term business strategy, with good customer service operations and product and service offerings ensuring that customer trust and loyalty can be maintained.

## *Environmental*

These are reviewed in depth in part D. Benefits include:

- Cost reduction: the benefits of a Sustainable ERM system is that, as well as potentially reducing costs and overheads associated with waste, pollution, energy use, there is a reduced likelihood and severity of future “sustainability” related taxation. Any countermeasures already taken thus embed competitive advantage. While there is the likelihood that there will be the internalisation of otherwise external costs this can be turned into a competitive advantage at times;
- An enlightened approach to sustainability can benefit both core objectives and the bottom line. A good example is the International Chamber of Commerce (ICC) Business Charter for Sustainable Development which was developed to demonstrate business commitment to sound environmental management (see <http://www.iccwbo.org/home/environment/charter.asp>);
- Environmental expenditure continues to accelerate at an even greater rate among developing countries as they struggle to adopt the environmental programmes now regularly required for access to western aid programmes, or entry to global trade alliances and economic zones such as the EU; and
- In the last decade of the 20th Century, the environment caught the public imagination, harnessed public awareness and exerted public pressure to force governments to implement increasing national and trans-national environmental legislation, which prompted accelerating investment. Organisations can benefit from this trend.

## **Implementing the business case**

Difficulties mastered are opportunities won Winston Churchill

The next step is working towards the sustainable development of your organisation, ensuring sustainable risk management systems are in place and working

towards the wider sustainability of our marketplaces. The goal is a huge challenge to ensure that our actions today do not limit the economic, environmental and social possibilities for future generations and ourselves.

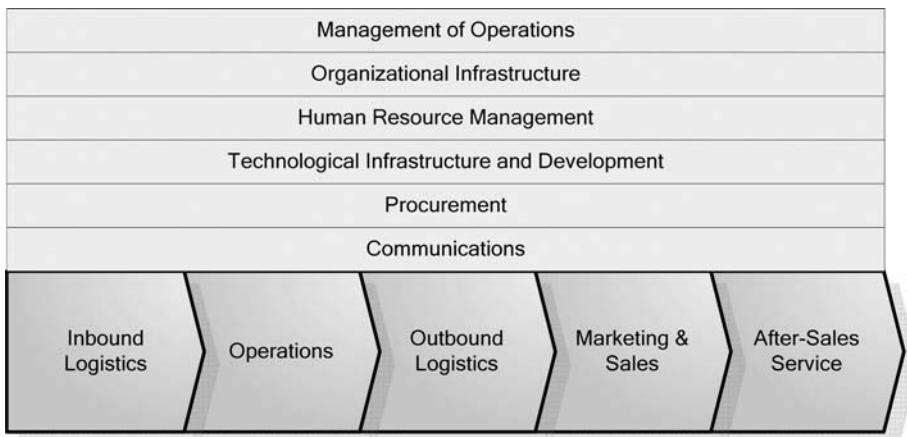
If as organisations we are not in greater balance with our market places, economies, communities and ecosystems then we will be poorer for it and the opportunities to prosper and make this prosperity durable and sustainable will be missed.

An approach for implementing a sustainable risk management system throughout the organisation is by a value-adding chain approach. The value chain (also known as the business system) is a sum of the activities that an organisation conducts. A typical system begins with: *inbound logistics* (materials and energy and other resources); which are then used by *operations* during the production process; *outbound logistics* facilitates the products/services transfer to customers through the *sales and marketing* functions and then the *after sales service* functions ensures the consumer remains satisfied and is a potential repeat customer.

Each part of this process is supported by secondary organisational activities:

- Management of operations (e.g. controls, monitoring system, planning and corporate governance);
- Organisational infrastructure (e.g. Accounting and financing);
- Human resource management (e.g. Recruitment, training and incentives);
- Technological infrastructure and development (e.g. IT systems, product research and design);
- Procurement (e.g. sourcing of materials, components and suppliers); and
- Communications (e.g. Stakeholder relations like: Investor and public relations, internal marketing).

The value chain can provide advantage if: a company is superior in one or more elements of the chain; their co-ordination of the value chain is more



streamlined and the management of the process ensures faster cheaper or better quality results. There is the view that the value chain can add value by managing the “values chain” at each stage.

It is hoped that the chapters go some way to help organisations add to implementing a sustainable risk management system to increase and protect their reputational, human, social and environmental capital, as well as preserving, and even adding to their economic capital resources.

The table below indicates which chapters can assist with the implementations of a Sustainable and Economic Risk Management System (SERM) at each value chain stage.

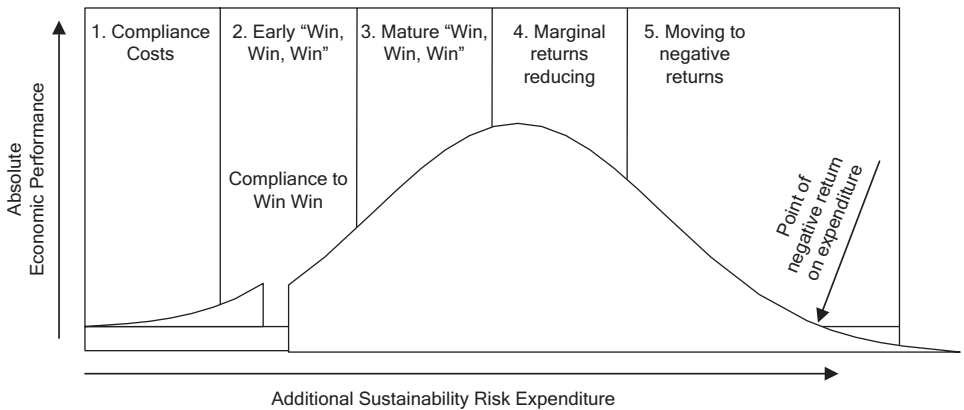
Value chain function	Sustainability factors																
	Governance and engagement issues	Economic, factors						Social factors					Environment factors				
		1–5 & 21–23	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Logistics	✓	✓	✓	✓			✓			✓		✓		✓	✓		
Operations and Production		✓		✓			✓			✓		✓		✓	✓	✓	
Marketing and Sales		✓	✓		✓	✓		✓	✓	✓	✓		✓	✓			
After sales service		✓	✓		✓	✓	✓			✓			✓	✓			
Management of Operations	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	
Organisational infrastructure i.e. Finance and strategy	✓	✓	✓	✓	✓		✓			✓	✓		✓			✓	
Human Resources	✓			✓		✓		✓		✓	✓	✓	✓	✓			
Environment, Health and Safety										✓		✓	✓	✓	✓	✓	
Technological infrastructure and R&D				✓			✓			✓			✓	✓	✓		
Purchasing/ procurement	✓		✓		✓	✓				✓				✓			
Communications, including IR and PR	✓		✓		✓	✓		✓	✓	✓	✓			✓			



## What is economic?

During implementation of plans there is the key question of financial viability of the drive towards sustainability. Risk itself cannot be removed and many resources are dedicated towards the task. The economic justification for each risk reduction strategy is included within the chapters of this book, and specifically the introductory chapters 1 and 2. The essence is that there is an optimum point where risk is reduced without undue or overly expensive investment. We would argue that there is an increased level of risk that is emerging and this would necessitate a proactive approach to investment to counter future hazards and risk.

This can be expressed in the following diagram:



Most organisations are at the first or second stage, where compliance with local laws is achieved (point 1) or initial benefits achieved from a strategic realisation that sustainability can also bring financial, social and environmental benefits (point 2).

A “win, win, win” scenario can be achieved (point 3) where by economic social and environmental capital can be preserved and enhanced. At points 4 and 5 there are reducing margins (at present levels of risk awareness) and over investment can lead to negative returns on investment. The business case for sustainability risk management needs to continually review the scale, magnitude and frequency of the risks posed to inform the level at which corporate strategy invests in processes.

## Monitoring and controlling

### How do you know if you're becoming sustainable?

Organisations seeking to benefit from sustainable systems often have a longer time-line and a broader set of goals than more ‘traditional’ ones. Typically they also value the well being of employees, customers, the wider society at large,

culture factors and future generations. Whilst they cannot afford to ignore short-term cash flow and profit (or surplus if a not for profit organisation), their definition of success is more long-term.

This broader vision of success requires new business tools, systems and relationships. Being proactive and innovative about dealing with potential risk issues and being receptive to new ideas and suggestions opens the door to an array of business opportunities. The organisation's approach to managing internal corporate governance (see Chapter 9) and indirect economic, environmental, and social impacts resulting from its activities should include the following Sustainability SERM comparison checklist:

The current failings of unsustainable vs. sustainable organisations are viewed as follows:

<b>Functions</b>	<b>Unsustainable organisation</b>	<b>Sustainable organisation</b>
Planning	<ul style="list-style-type: none"> <li>• Short term planning bias</li> <li>• Divided purpose: there is a lack of collective consensus of the long term view of the organisation and their role in making a sustainable future</li> <li>• Unsuitable values: the organisation's systems and values may be incompatible with becoming sustainable.</li> </ul>	<ul style="list-style-type: none"> <li>• Long term view on planning</li> <li>• Long term risk awareness</li> </ul>
People	<ul style="list-style-type: none"> <li>• There is a lack of sustainability awareness, education and training at all levels of many organisations</li> <li>• A reduced level of diversity can reduce innovation and flexibility to change and markets</li> <li>• Lack of incentives and leadership from bosses causes staff to leave their environmental conscience at home, leading to higher energy bills and emissions</li> <li>• There is a shortage of engagement with stakeholders both internally and externally</li> </ul>	<ul style="list-style-type: none"> <li>• Education and Training – Promote sustainability focused training</li> <li>• Promotes diversity, equality, innovation and meritocracy</li> <li>• Incentives in place to promote beneficial activities that add to economic, social/human and environmental/resource capital</li> <li>• Extensive engagement with stakeholders to scope the marketplace</li> </ul>
Processes	<ul style="list-style-type: none"> <li>• Short term structure: the organisation may have internal processes and systems that are biased towards short-term goals at the expense of more durable, long-term systems</li> </ul>	<ul style="list-style-type: none"> <li>• Long-term view and sustainable structure</li> </ul>

*(continued)*

**Table** (Continued)

Functions	Unsustainable organisation	Sustainable organisation
Performance	<ul style="list-style-type: none"> <li>• Limited measurements of sustainability. The variety and depth of current indicators rarely capture what is happening with key sustainability indicators</li> <li>• These indicators of extra financial performance should be indicators of the quality of management and have elements of organisational performance measurements and benefits systems attached to them</li> </ul>	<ul style="list-style-type: none"> <li>• Extensive measurement and reporting of performance of sustainability Key performance indicators (KPIs). The importance and relevance to profitability and other economic measurements of these sustainability factors are included in decision-making and investment processes</li> </ul>

## What organisations should be aiming for with their sustainable enterprise risk management systems

An expansion of the principles and characteristics of a sustainable organisation are expressed in the following format:

### People

- CEO and board support for the values of sustainable development helps, and indeed is said to be essential for benefits to reach throughout the organisation;
- Leadership: Organisations must demonstrate a commitment to the sustainability, environmental and energy agenda before employees will feel committed to take part. 80 percent of staff whose employers do not have an environmental policy say they would like them to have one. (Logicalis commissioned research, December 2006, reported in GreenBiz.com, 19 January 2007);
- Education and Training – Promote sustainability focused training. To educate, train and motivate employees and executives to conduct their activities in a sustainable (environmentally, economically and socially responsible) manner. These are not just specific training events on the big questions but also missing practical knowledge for example, Research shows that while three quarters of staff have access to double-sided printing and copying facilities, less than a quarter had been offered training in using the equipment;
- Openness to dialogue and the concerns of staff, the public, customers and other stakeholders. Anticipating the concerns and potential hazards, risks and impacts of your organisation's operations, products and services will reap long term benefits (see Chapters 9 and 14);
- Incentives: Organisations must look to offer incentives to employees to bring their good environmental practice into the workplace;
- Promote diversity, equality, innovation and meritocracy; and

- Supply chain engagement and training require promotion to help reduce indirect costs. Closer and more sustainable working relations with contractors and suppliers can be achieved through improvements to their processes as a result of adopting sustainability principles and processes.

## Planning

- Corporate policy should make sustainability one of the priorities of the organisation, encouraging policies, programmes, processes and practical action;
- There should be the development of organisation wide policies, aims, objectives and targets with regard to sustainability issues (economic, social and environmental);
- There should be the development of a long-term plan and an awareness of the long-term risks and opportunities available. This should include a declaration of the goals, principles and operating procedures of a company;
- Ensure that the values of sustainable development reach throughout the organisation. Executive commitment to accountability, good governance, transparency, stakeholder engagement and social and environmental responsibility are good starting points. There should be a Board or CEO statement to this effect;
- Ensure integration of the management of sustainability policies, processes and performance fully into each business unit as an essential part of management in all its function;
- Follow the *Precautionary approach* (Chapter 18) which should act as a principle for the development, manufacturing, modification, operational activities, marketing and use of products or services in line with the best of scientific and technical understanding of current hazards and risks;
- Develop a Sustainable Enterprise Risk Management (SERM) system with which to assess future risk taking options and management systems (see Chapter 2):
  - Use both *adaptation* (investing in measures to reduce risk incidence and impact) and *mitigation* methods (avoidance, reduction or delaying of impacts); and
  - Extend the sustainability risk assessment to reviews of new activities, projects and the development or decommissioning of facilities and sites.
- Ensure emergency preparedness, with the development and maintenance emergency plans where significant hazards exist in conjunction with the emergency services, authorities, local communities and other relevant stakeholders (see Chapter 8);
- Internal Governance: develop structures that foster organisational durability and sustainability as principles for progression. Keep management accountable to these long term goals and engage with staff on all relevant issues:
  - Values: embed sustainability values into the organisation's culture;
  - Changing a company's culture to become more sustainable requires a contribution from everyone, working as a team, and planning needs to embed processes to encourage this;

- Include more externalities and full cost accounting into investment decisions; and
- There should be a code of ethics and any governance structure to support this code of ethics should be disclosed. Any waivers to the code of ethics or the rules governing ethical procedures should be disclosed.
- External governance:
  - The board should disclose whether there is a mechanism protecting all stakeholders interests and mitigating their, not just shareholders;
  - The board should disclose its policy and performance in connection with environmental and social responsibility and the effect of this policy and any related performance upon the organisation's sustainability;
  - Engagement: Engage in dialogue with stakeholders and try to create a shared vision for your sustainable organisation; and
  - Contributing to stakeholders and the common effort to promote sustainability in the development of public policy, governmental and international programmes and educational initiatives that will enhance the sustainability cause, as well as technological transference where beneficial.

## Processes

Develop processes and programmes to improve performance with regard to:

- Improved risk management and other processes to assist with improving sustainability. These should take into account technical developments, research and technical findings, customer and stakeholder needs, and legal requirements;
- Products and services sustainability performance: to improve existing and develop new products and services that have a reduced impact. Products that have a reduced ecological and social impact footprint should be more resource efficient and can be repaired, reused, recycled, or disposed of safely;
- Operations and facilities management. Where the design, development and operation of facilities should take into consideration sustainability there should be aims such as: the minimisation of the potential for HSE incidents and accidents; the reduction of pollution to air, land and water; eco-efficiency, (energy and resource efficiency); the increased use of renewables and recycled and reclaimed materials; the reduction of waste, and the safe and responsible treatment of waste and emissions from these facilities if unavoidable (see Chapters 16, 18 and 19);
- Research and the application of technology (see Chapter 11). Can support the reduction of environmental and social impacts of products and services as well as increase their economic potential. Research can benefit the drive towards sustainability through a range of applications like reduced use of materials, reduced waste, streamlined processes and other trends reviewed in Chapter 3;
- Customer and stakeholder advice. Relevant customers, suppliers, distributors, vendors, and the public should be educated in the safe use, transportation,

storage, recycling and disposal of products and related service provision (see Chapter 17); and

- External legal compliance and the anticipation of future requirements with regard to each country of operation.
- There should be internal communication and training and the disclosure of the role of employees in the sustainability and corporate governance processes. Training of employees should especially include the executives of organisations;
- There could be an enhanced quantification of non-financial or extra financial factors like risks within organisations, and the enhanced valuing of items like brands as benchmarks of performance and market differentiators;
- There could be the establishment of ‘Sustainability’ teams, comprising personnel from different departments to ensure that ‘sustainability’ becomes embedded in the culture of the organisation as opposed to the preserve of one department. It is important that they have top-level support, adequate resources and ready access to all employees;
- Internal communication and informative materials for employees about economic, environmental and social trends will assist to keep them engaged. As a result they will be better equipped to promote company goals and to respond to major risks and trends. This could be in the form of books, articles, website information, guest speakers, training courses, or, like Ted Turner, the US media mogul, you could provide copies of the *State of the World* series by the Worldwatch Institute to all new producers and reporters. Regular staff meetings, e-mail bulletins, accessible managers and an in-house newsletter can also help improved communication and the achievement of objectives;
- External communications can improve the reputation and trust levels of the organisation. Helping with this process are good reporting channels including:
  - Openness to dialogue with the public, customers, staff and other stakeholders: Anticipating the concerns and potential hazards, risks and impacts of your organisation’s operations, products and services will reap long term benefits;
  - Engagement: A commitment to engage with stakeholders: on a range of issues is important for reputational reasons and to assist the company measure its potential risks on issues. Direct engagement like meeting investors more regularly or employee involvement with local communities can also have unforeseen benefits like tapping into the expertise of local groups and non-profit organisation’s who may know straightforward solutions to problems that the organisation may be facing;
  - A sustainable section in the annual report highlighting progress made towards improving economic, social and environmental performance. A clearly articulated set of internal goals and a method for measuring achievement, and openness about current failings can all help to make a company appear responsible and trustworthy;
  - There may be a more in-depth sustainability report or more extensive coverage on the Internet for example. Some companies are even experimenting with “real time” sustainability data being available to the public;
  - A commitment to honest and accessible public relations can help your organisation to convey corporate information to stakeholders, including

customers. Good press is an advantage, but bad press is bad for business. The latter can be avoided in part by effective risk management of these issues and the provision of readily available, credible information about successes and failures;

- Collaboration with critics, especially for companies that have experienced criticism from NGOs or human rights organisations. No tactic does more to convey the sincerity of a company's efforts than an invitation to critics to participate in the process of changing course;
- Sharing technological and processes benefits with the wider community will assist the overall sustainability of the marketplace and society, as well as potentially increasing reputational capital; and
- Supply chain engagement and training can lead to closer and more sustainable working relations.
- Executive, business unit and even staff remuneration could be more closely linked with these types of performance criteria as opposed to only traditional ones i.e. health and safety compliance could be rewarded at high risk vulnerable facilities rather than considering only the amount of units handled, etc.

## Performance

- Adherence to internal policies and external codes and standards, especially where the organisation has publicly committed itself to them. These include: codes of conduct; communication of standards through training; methods to encourage employees to report possible violations to management; enforcement mechanisms through investigation and discipline; and oversight and review to achieve ongoing improvement;
- Performance monitoring, measurement and reporting of the progress made towards: economic, social, environmental and governance issues. Internal and external communications can be used by the organisation to report on its progress in achieving social, financial and environmental goals;
- Internal and external auditing of performance data can assist senior management reviews;
- Using benchmark development by executives against which to measure progress, companies can reinforce their commitment to stated objectives, and alert employees and other stakeholders to areas where more effort is needed;
- There is the opportunity of more tailoring of product and service offerings to the specific needs of customers and countries;
- Compliance and reporting of sustainability performance to a range of stakeholders. This should include: a range of economic, environmental and human resources based audits and assessments to measure compliance with internal and external requirements. The results should be communicated periodically to: directors, employees, shareholders, the authorities, customers and other notable stakeholders; and
- You can become the best and more sustainable by working with the best and most sustainable. This could mean working to develop best practice with membership and business associations groups, hiring sustainability related consultants and selecting the most sustainable contractors for tasks. Such

suggestions are of course not exhaustive but rather by way of example or recommendation.

## Chapter summary

A person with a new idea is a crank until the idea succeeds Mark Twain

Sustainability is not a new idea, although to a lot of decision makers within society it is just that. Our wish is that the ideas set out within this book develop in future editions as the journeys of the readers develop as well.

Wherever the organisation is located – and regardless of its size or sector – risk exists and a sustainable approach is both topical and timely in today's global economic era. Engagement of all, from top to bottom, internal and external to the organisation, is crucial for sustainable risk management to fulfill its potential. Much of what is required to succeed in this endeavor requires a common sense approach that will achieve overall improvement and satisfaction for the organisation as a whole.

The philosophy of sustainability and the reduction of sustainability risks that reduces impacts upon the planet, the people within organisations and the customers of the same organisation should help to establish trust with customers and a reputation for being “fair” and doing the “right” thing. The organisation that can increase its profit, improve the condition of people and have a reduced impact upon the planet are on their way to becoming sustainable and durable.



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[http://www.workcover.vic.gov.au/dir090/vwa/home.nsf/pages/so\\_asbestos](http://www.workcover.vic.gov.au/dir090/vwa/home.nsf/pages/so_asbestos)
- Background information and guidance on asbestos issues. Includes, for example, in the UK a short guide on managing asbestos in premises
- The Asbestos Alliance – US: <http://www.asbestossolution.org/index.html>
- Home page of a non-profit organization comprised of asbestos defendant companies, trade associations and insurers
- International Ban Asbestos Secretariat: <http://www.ibas.btinternet.co.uk/>
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# Glossary of terms

**Abrupt climate change:** A change in climate over a widespread area that takes place so rapidly and unexpectedly that human and natural systems have difficulty adapting. An abrupt climate change occurs on the scale of decades, rather than centuries, and persists for years.

**Aerosols:** Solid or liquid particles suspended within the atmosphere (see 'Sulphate aerosols' and 'Black carbon aerosols').

**Afforestation:** Planting of new forests on lands that have not been recently forested.

**Albedo:** Refers to the ratio of light from the sun that is reflected by the earth's surface to the light received by it. Unreflected light is converted to infrared radiation (i.e. heat), which causes atmospheric warming (see 'Radiative forcing'). Thus, surfaces with a high albedo (e.g. snow and ice) generally contribute to cooling, whereas surfaces with a low albedo (e.g. forests) generally contribute to warming. Changes in land use that significantly alter the characteristics of land surfaces can therefore influence the climate through changes in albedo.

**Alliance of Small Island States (AOSIS):** A coalition of some 43 low-lying and small island countries, most of which are members of the G77, which are particularly vulnerable to the potential adverse consequences of climate change such as sea-level rise, coral bleaching, and increased frequency and intensity of tropical storms.

**Allocation:** Under an emissions trading scheme, permits to emit can initially be given away either for free, usually under a 'grandfathering' approach based on past emissions in a base year, or by using an 'updating' approach based on the more recent emissions. The alternative is to auction permits in an initial market offering.

**Analyst:** Employee of a brokerage or fund management house who studies companies and makes buy-and-sell recommendations on their stocks. Most specialise in a specific industry.

**Ancillary benefits:** Complementary benefits of a climate policy including improvements in local air quality and reduced reliance of imported fossil fuels.

**Annex A:** A list in the Kyoto Protocol of the six greenhouse gases and the sources of emissions covered under the Kyoto Protocol. See also 'Basket of gases'.

**Annex B:** A list in the Kyoto Protocol of 38 countries plus the European Community that agreed to QELRCs (emission targets), along with the QELRCs they accepted. The list is nearly identical to the Annex I Parties listed in the Convention except that it does not include Belarus or Turkey.

**Annex I Parties:** The 40 countries plus the European Economic Community listed in Annex I of the UNFCCC that agreed to try to limit their GHG emissions: Australia, Austria, Belarus, Belgium, Bulgaria, Canada, Croatia, Czech Republic, Denmark, Estonia, European Economic Community, Finland, France, Germany, Greece, Hungary, Iceland, Italy, Japan, Latvia, Liechtenstein, Lithuania, Luxembourg, Monaco, the Netherlands, New Zealand, Norway, Poland, Portugal, Romania, Russian Federation, Slovakia, Slovenia, Spain, Sweden, Switzerland, Turkey, Ukraine, United States.

**Anthropogenic emissions:** Emissions of greenhouse gases resulting from human activities.

**Assigned amount:** In the Kyoto Protocol, the permitted emissions, in CO<sub>2</sub> equivalents, during a commitment period. It is calculated using the Quantified Emission Limitation and Reduction Commitment (QELRC), together with rules specifying how and what emissions are to be counted.

**Balance sheet:** Also called the statement of financial condition, it is a summary of the assets, liabilities and owners' equity.

**Base year:** Targets for reducing GHG emissions are often defined in relation to a base year. In the Kyoto Protocol, 1990 is the base year for most countries for the major GHGs; 1995 can be used as the base year for some of the minor GHGs.

**Baselines:** The baseline estimates of population, GDP, energy use and hence resultant greenhouse gas emissions without climate policies, determine how big a reduction is required, and also what the impacts of climate change without policy will be.

**Basket of gases:** This refers to the group six of greenhouse gases regulated under the Kyoto Protocol. They are listed in Annex A of the Kyoto Protocol and include: carbon dioxide (CO<sub>2</sub>), methane (CH<sub>4</sub>), nitrous oxide (N<sub>2</sub>O), hydrofluorocarbons (HFCs), perfluorocarbons (PFCs), and sulphur hexafluoride (SF<sub>6</sub>).

**Best-in-class:** An investment approach where the leading investee companies with regard to SEE criteria from each individual sector or industry group are identified and included in the investment portfolio.

**Biodiversity:** The variety of organisms found within a specified geographic region.

**Black carbon aerosols:** Particles of carbon in the atmosphere produced by inefficient combustion of fossil fuels or biomass. Black carbon aerosols absorb light from the sun, shading and cooling the earth's surface, but contribute to significant warming of the atmosphere (see 'Radiative forcing').

**Book value:** A company's book value is its total assets minus intangible assets and liabilities, such as debt.

**Brand equity:** An intangible value-added aspect of particular goods otherwise not considered unique.

- Bubble:** An option in the Kyoto Protocol that allows a group of countries to meet their targets jointly by aggregating their total emissions. The member states of the European Union are utilising this option.
- Business case:** A rationale for making a business decision, usually involving quantitative analysis of costs, benefits and trade-offs.
- Business practice risk:** Losses arising from unintentional or negligent failure to meet a professional obligation to specific clients (including fiduciary and suitability requirements), or from the nature of design of a product.
- Buy side analyst:** A financial analyst employed by a non-brokerage firm, typically one of the larger money management firms that purchase securities on their own accounts.
- Capital stock:** Existing investments in energy plant and equipment that may or may not be modified once installed.
- Carbon dioxide (CO<sub>2</sub>):** CO<sub>2</sub> is a colourless, odourless, non-poisonous gas that is a normal part of the ambient air. Of the six greenhouse gases normally targeted, CO<sub>2</sub> contributes the most to human-induced global warming. Human activities such as fossil fuel combustion and deforestation have increased atmospheric concentrations of CO<sub>2</sub> by approximately 30% since the industrial revolution.
- Carbon dioxide equivalent (CO<sub>2</sub>e):** The emissions of a gas, by weight, multiplied by its 'global warming potential'.
- Carbon sinks:** Processes that remove more carbon dioxide from the atmosphere than they release. Both the terrestrial biosphere and oceans can act as carbon sinks.
- Carbon taxes:** A surcharge on the carbon content of oil, coal and gas that discourages the use of fossil fuels and aims to reduce carbon dioxide emissions.
- Cash flow:** Earnings before depreciation, amortization and non-cash charges (sometimes called cash earnings).
- Certified emissions reduction (CER):** Reductions of greenhouse gases achieved by a Clean Development Mechanism (CDM) project. A CER can be sold or counted toward Annex I countries' emissions commitments. Reductions must be additional to any that would otherwise occur.
- Chlorofluorocarbons (CFCs):** CFCs are synthetic industrial gases composed of chlorine, fluorine, and carbon. They have been used as refrigerants, aerosol propellants, cleaning solvents and in the manufacture of plastic foam. There are no natural sources of CFCs. CFCs have an atmospheric lifetime of decades to centuries, and they have 100-year 'global warming potentials' thousands of times that of CO<sub>2</sub>, depending on the gas. In addition to being greenhouse gases, CFCs also contribute to ozone depletion in the stratosphere and are controlled under the Montreal Protocol.
- Clean Development Mechanism (CDM):** One of the three market mechanisms established by the Kyoto Protocol. The CDM is designed to promote sustainable development in developing countries and assist Annex I Parties in meeting their greenhouse gas emissions reduction commitments. It enables industrialised countries to invest in emission reduction projects in developing countries and to receive credits for reductions achieved.

- Climate:** The long-term average weather of a region including typical weather patterns, the frequency and intensity of storms, cold spells and heatwaves. Climate is not the same as weather.
- Climate change:** Refers to changes in long-term trends in the average climate, such as changes in average temperatures. In IPCC usage, climate change refers to any change in climate over time, whether due to natural variability or as a result of human activity. In UNFCCC usage, climate change refers to a change in climate that is attributable directly or indirectly to human activity that alters atmospheric composition.
- Climate sensitivity:** The average global air surface temperature change resulting from a doubling of pre-industrial atmospheric CO<sub>2</sub> concentrations. The IPCC estimates climate sensitivity at 1.5–4.5°C (2.7–8.1°F).
- Climate variability:** Refers to changes in patterns, such as precipitation patterns, in the weather and climate.
- Commitment period:** The period under the Kyoto Protocol during which Annex I Parties' GHG emissions, averaged over the period, must be within their emission targets. The first commitment period runs from 1 January 2008 to 31 December 2012.
- Conference of the Parties (COP):** The supreme decision-making body comprised of the parties that have ratified the UN Framework Convention on Climate Change. It meets on an annual basis. As of February 2003, it is comprised of 188 countries.
- Core indicator:** Core indicators are those indicators identified in the GRI Guidelines to be of interest to most stakeholders and assumed to be material unless deemed otherwise on the basis of the GRI Reporting Principles.
- Corporate citizenship:** Company activities concerned with treating the stakeholders of the firm ethically and in a socially responsible manner.
- Corporate governance:** The system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation.
- Corporate social responsibility (CSR):** Commitment to uphold the rights of citizens and communities, behave according to accepted ethical standards, and contribute to socio-economic development and quality of life. Also known as Corporate Responsibility (CR) and Corporate Accountability (CA).
- Correlation:** A statistical correspondence between two or more variables.
- Corruption:** The abuse of entrusted power for private gain. It can hurt everyone whose life, livelihood or happiness depends on the integrity of people in a position of authority.
- Damage to physical assets:** Losses arising from loss or damage to physical assets from natural disaster or other events.
- Discounting:** The process that reduces future costs and benefits to reflect the time value of money and the common preference of consumption now rather than later.
- Downstream:** The term downstream relates to a production chain that extends from the extraction of raw materials to the use of a good or service by an end-user. 'Downstream' refers to those organizations that play a role in the distribution or use of goods and services provided by the organization.

- Early crediting:** A provision that allows crediting of emission reductions achieved prior to the start of a legally imposed emission control period. These credits can then be used to assist in achieving compliance once a legally imposed system begins.
- Earnings before interest, taxes, depreciation and amortization (EBITDA):** An indicator of a company's financial performance calculated as revenues less expenses, excluding tax, interest, depreciation and amortization.
- Earnings per share (EPS):** A commonly used financial indicator, calculated by dividing a company's net income by its number of outstanding shares.
- Eco-efficiency:** A measure of the resource intensity of a company's operations, including the inputs of materials and energy required to manufacture and deliver a unit of output.
- Ecosystem:** A community of organisms and its physical environment.
- Emissions:** The release of substances (e.g. greenhouse gases) into the atmosphere.
- Emissions cap:** A mandated restraint in a scheduled timeframe that puts a 'ceiling' on the total amount of anthropogenic greenhouse gas emissions that can be released into the atmosphere. This can be measured as gross emissions or as net emissions (emissions minus gases that are sequestered).
- Emissions reduction unit (ERU):** Emissions reductions generated by projects in Annex B countries that can be used by another Annex B country to help meet its commitments under the Kyoto Protocol. Reductions must be additional to those that would otherwise occur.
- Emissions trading:** A market mechanism that allows emitters (countries, companies or facilities) to buy emissions from or sell emissions to other emitters. Emissions trading is expected to bring down the costs of meeting emission targets by allowing those who can achieve reductions less expensively to sell excess reductions (e.g. reductions in excess of those required under some regulation) to those for whom achieving reductions is more costly.
- Employment practices and workplace safety:** Losses arising from acts inconsistent with employment, health or safety laws or agreements, from payment of personal injury claims, or from diversity/discrimination.
- Energy resources:** The available supply and price of fossil and alternative resources will play a huge role in estimating how much a greenhouse gas constraint will cost. In the US context, natural gas supply (and thus price) is particularly important, as it is expected to be a transition fuel to a lower carbon economy.
- Engagement:** Engagement is applied by some fund managers to encourage more responsible business practices and/or enhance investment returns. It relies on the influence of investors and the rights of ownership, and mainly takes the form of dialogue between investors and companies on issues of concern. Engagement may extend to voting practices.
- Enhanced greenhouse effect:** The increase in the natural greenhouse effect resulting from increases in atmospheric concentrations of GHGs due to emissions from human activities.
- Enterprise risk management:** A process used to manage risks that can have negative influence on the enterprise in question. By identifying and proactively treating the resources (human and capital), the products and services, and

customers of the organization, as well as external effects on society, markets or the environment.

**Entry into force:** The point at which international climate change agreements become binding. The United Nations Framework Convention on Climate Change (UNFCCC) has entered into force. In order for the Kyoto Protocol to do so as well, 55 Parties to the Convention must ratify (approve, accept, or accede to) the Protocol, including Annex I Parties accounting for 55% of that group's carbon dioxide emissions in 1990. As of June 2003, 110 countries had ratified the Protocol, representing 43.9% of Annex I emissions.

**Environment, health and safety (EHS):** A professional discipline concerned with protection of the environment, human health and safety through the application of scientific, engineering and management methods.

**Environmental performance:** The performance of a business or facility according to selected indicators of environmental impact.

**Ethical exclusions:** Reference to exclusions where a large number of negative criteria and/or filters are applied to manage funds to remove stocks deemed to be unethical (as opposed to just tobacco or weapons, for example).

**European Community:** As a regional economic integration organization, the European Community can be and is a Party to the UNFCCC; however, it does not have a separate vote from its members (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxemburg, the Netherlands, Portugal, Spain, Sweden and the United Kingdom).

**Evapotranspiration:** The process by which water re-enters the atmosphere through evaporation from the ground and transpiration by plants.

**External fraud:** Losses due to acts of a type intended to defraud, misappropriate property or circumvent the law, by a third party. These activities include theft, robbery, hacking or phishing attacks.

**Extra-financial performance:** Also known as non-financial performance. The performance of a business measured in terms of non-financial aspects such as environmental and social responsibility.

**Full disclosure:** A policy under which listed companies must disclose all material information that might affect investment decisions to all investors, at the same time.

**GDP:** Gross domestic product, a measure of overall economic activity.

**General Circulation Model (GCM):** A computer model of the basic dynamics and physics of the components of the global climate system (including the atmosphere and oceans) and their interactions which can be used to simulate climate variability and change.

**General Agreement on Tariffs and Trade (GATT):** GATT is an agreement, not an organization, originally created by the Bretton Woods Conference as part of a larger plan for economic recovery after World War II. Its main purpose is to reduce barriers to international trade through the reduction of tariff barriers, restrictions and subsidies.

**Generally Accepted Accounting Principles (GAAP):** A technical accounting term that encompasses the conventions, rules and procedures necessary to define accepted accounting practice at a particular time.

- Global Reporting Initiative (GRI):** GRI's vision is that reporting on economic, environmental and social performance by all organizations is as routine and comparable as financial reporting. GRI accomplishes this vision by developing, continuously improving and building capacity around the use of the GRI's Sustainability Reporting Framework. All Reporting Framework components are developed using a global, multi-stakeholder consensus seeking approach.
- Global warming:** Gradual increase in average temperatures at the earth's surface, believed to result from the 'greenhouse effect' due to increased atmospheric concentrations of carbon dioxide and other gases.
- Global warming potential (GWP):** A system of multipliers devised to enable warming effects of different gases to be compared. The cumulative warming effect, over a specified time period, of an emission of a mass unit of CO<sub>2</sub> is assigned the value of 1.
- Greenhouse effect:** The insulating effect of atmospheric greenhouse gases (e.g. water vapour, carbon dioxide, methane, etc.) that keeps the earth's temperature about 60°F warmer than it would be otherwise.
- Greenhouse gas (GHG):** Any gas that contributes to the 'greenhouse effect'.
- GRI Reporting Framework:** The GRI Reporting Framework is intended to provide a generally accepted framework for reporting on an organization's economic, environmental and social performance. The Framework consists of the Sustainability Reporting Guidelines, the Indicator Protocols, Technical Protocols and the Sector Supplements.
- Group of 77 and China, or G77/China:** An international organization established in 1964 by 77 developing countries; membership has now increased to 133 countries. The group acts as a major negotiating bloc on some issues including climate change.
- HGWP (high global warming potential):** Some industrially produced gases such as sulphur hexafluoride (SF<sub>6</sub>), perfluorocarbons (PFCs) and hydrofluorocarbons (HFCs) have extremely high GWPs.
- Hot air:** A situation in which emissions (of a country, sector, company or facility) are well below a target due to the target being above emissions that materialised under the normal course of events (i.e. without deliberate emission reduction efforts). Hot air can result from overoptimistic projections of growth.
- Human capital:** The set of skills which employees acquire on the job, through training and experience, and which increase their value in the marketplace.
- Human resources:** This refers to the individuals within the firm, and to the portion of the firm's organization that deals with hiring, firing, training and other personnel issues.
- Human rights:** UN Norms definition is: 'human rights' and 'international human rights' include civil, cultural, economic, political and social rights, as set forth in the International Bill of Human Rights and other human rights treaties, as well as the right to development and rights recognised by international humanitarian law, international refugee law, international labour law, and other relevant instruments adopted within the United Nations system.



- Human rights, internal:** The extent to which the organization follows codes and legislation with relevance to traditional human resources regulations as well as discrimination, harassment and employee privacy.
- Human Rights Act:** A piece of legislation that sets out individual rights and freedoms under law, this can be applicable to members of an organization's workforce. Many countries have similar rights enshrined into law.
- Hydrofluorocarbons (HFCs):** HFCs are synthetic industrial gases, primarily used in refrigeration and semiconductor manufacturing as commercial substitutes for chlorofluorocarbons (CFCs). There are no natural sources of HFCs.
- Incentive-based regulation:** A regulation that uses the economic behaviour of firms and households to attain desired environmental goals. Incentive-based programmes involve taxes on emissions or tradable emission permits. The primary strength of incentive-based regulation is the flexibility it provides the polluter to find the least costly way to reduce emissions.
- Income statement:** A statement showing the revenues, expenses and income (the difference between revenues and expenses) of a corporation over some period of time.
- Independent board member:** Definitions for 'independent' can vary greatly but usually implies that the member has no financial interest in the organization or other potential benefits that could create a conflict of interest.
- Institutional investor:** An investor that is not an individual and may be a foundation, endowment, pension fund or the like.
- Intangible asset:** A non-monetary asset, including people, ideas, networks and processes, which is not traditionally accounted for on the balance sheet.
- Integration:** The explicit inclusion by asset managers of CG/SEE-risk into traditional financial analysis.
- Intellectual capital:** Knowledge that can be exploited for some money-making or other useful purpose, including the skills and knowledge that a company has developed about how to make its goods or services.
- Intergenerational equity:** The fairness of the distribution of the costs and benefits of a policy when costs and benefits are borne by different generations. In the case of a climate change policy the impacts of inaction in the present will be felt in future generations.
- Intergovernmental Panel on Climate Change (IPCC):** The IPCC was established in 1988 by the World Meteorological Organization and the UN Environment Programme. The IPCC is responsible for providing the scientific and technical foundation for the United Nations Framework Convention on Climate Change (UNFCCC), primarily through the publication of periodic assessment reports (see 'Second Assessment Report' and 'Third Assessment Report').
- Internal fraud:** Loss due to acts of a type intended to defraud, misappropriate property or circumvent regulations, the law or company policy, excluding diversity, discrimination events, which involve at least one internal party.
- Investor relations (IR):** A strategic corporate marketing activity, combining the disciplines of communications and finance, which provides present and

potential investors with an accurate portrayal of a company's performance and prospects.

**Joint implementation (JI):** One of the three market mechanisms established by the Kyoto Protocol.

**Kyoto mechanisms:** The Kyoto Protocol creates three market-based mechanisms that have the potential to help countries reduce the cost of meeting their emissions reduction targets. These mechanisms are Joint Implementation (Article 6), the Clean Development Mechanisms (Article 12) and Emissions Trading (Article 17).

**Kyoto Protocol:** An international agreement adopted in December 1997 in Kyoto, Japan. The Protocol sets binding emission targets for developed countries that would reduce their emissions on average 5.2% below 1990 levels.

**Land use, land-use change and forestry (LULUCF):** Land uses and land-use changes can act either as sinks or as emission sources. It is estimated that approximately one-fifth of global emissions result from LULUCF activities.

**Leading indicator:** A predictive indicator of anticipated performance that can be observed prior to the period of performance.

**Liability:** A financial obligation, or the cash outlay that must be made at a specific time to satisfy the contractual terms of such an obligation.

**Licence to operate:** The ability of a corporation or business to continue operations based on ongoing acceptance by external stakeholder groups.

**Market benefits:** Benefits of a climate policy that can be measured in terms of avoided market impacts such as changes in resource productivity (e.g. lower agricultural yields, scarcer water resources) and damages to human-built environment (e.g. coastal flooding due to sea-level rise).

**Market value:** (1) The price at which a security is trading and could be purchased or sold. (2) The value investors believe a firm is worth; calculated by multiplying the number of shares outstanding by the current market price of a firm's shares.

**Methane (CH<sub>4</sub>):** CH<sub>4</sub> is among the six greenhouse gases to be curbed under the Kyoto Protocol. Atmospheric CH<sub>4</sub> is produced by natural processes, but there are also substantial emissions from human activities such as landfills, livestock and livestock wastes, natural gas and petroleum systems, coalmines, rice fields and wastewater treatment. CH<sub>4</sub> has a relatively short atmospheric lifetime of approximately 10 years, but its 100-year GWP is currently estimated to be approximately 23 times that of CO<sub>2</sub>.

**Montreal Protocol on Substances that Deplete the Ozone Layer:** An international agreement that entered into force in January 1989 to phase out the use of ozone-depleting compounds such as methyl chloroform, carbon tetrachloride and CFCs.

**National action plans:** Plans submitted to the Conference of the Parties (COP) by all Parties outlining the steps that they have adopted to limit their anthropogenic GHG emissions.

**Negative feedback:** A process that results in a reduction in the response of a system to an external influence. For example, increased plant productivity in response to global warming would be a negative feedback on warming,

because the additional growth would act as a sink for CO<sub>2</sub>, reducing the atmospheric CO<sub>2</sub> concentration.

**Net present value:** The amount of cash today that is equivalent in value to a payment, or to a stream of future cash flows minus the cost.

**Nitrous oxide (N<sub>2</sub>O):** N<sub>2</sub>O is among the six greenhouse gases to be curbed under the Kyoto Protocol. N<sub>2</sub>O is produced by natural processes, but there are also substantial emissions from human activities such as agriculture and fossil fuel combustion.

**Non-Annex I Parties:** Countries that have ratified or acceded to the UNFCCC that are listed in Annex I of the UNFCCC.

**Non-Annex B Parties:** Countries that are not listed in Annex B of the Kyoto Protocol.

**Non-financial performance:** Also known as extra-financial performance. The performance of a business measured in terms of non-financial aspects such as environmental and social responsibility.

**Non-market benefits:** Benefits of a climate policy that can be measured in terms of avoided non-market impacts such as human-health impacts (e.g. increased incidence of tropical diseases) and damages to ecosystems (e.g. loss of biodiversity).

**Non-party:** A state that has not ratified the UNFCCC. Non-parties may attend talks as observers.

**Norms-based screening:** Negative screening of companies according to their compliance with international standards and norms such as issued by OECD, ILO, UN, UNICEF.

**Operational risk management (ORM):** The oversight of many forms of day-to-day operational risk including the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. Operational risk does not include market risk or credit risk.

**Perfluorocarbons (PFCs):** PFCs are among the six types of greenhouse gases to be curbed under the Kyoto Protocol. PFCs are synthetic industrial gases generated as a by-product of aluminium smelting and uranium enrichment. They also are used as substitutes for CFCs in the manufacture of semiconductors. There are no natural sources of PFCs. PFCs have atmospheric lifetimes of thousands to tens of thousands of years and 100-year GWPs thousands of times that of CO<sub>2</sub>, depending on the gas.

**Performance:** The percentage change in a portfolio's value over a specified period.

**Performance indicator:** Qualitative or quantitative information about results or outcomes associated with the organization that is comparable and demonstrates change over time.

**Pioneer screening/Thematic investment propositions:** Thematic investment funds are based on environmental, social and governance (ESG) issues such as the transition to sustainable development towards a low carbon economy.

**Polluter pays principle (PPP):** The principle that countries should in some way compensate others for the effects of pollution that they (or their citizens) generate or have generated.

- Poor human resources management:** Extent to which the company's HR policies and practices are found wanting in terms of generating stress, discrimination, harassment, impact on employee privacy.
- ppm or ppb:** Abbreviations for 'parts per million' and 'parts per billion,' respectively – the units in which concentrations of greenhouse gases are commonly presented.
- Positive feedback:** A process that results in an amplification of the response of a system to an external influence. For example, increased atmospheric water vapour in response to global warming would be a positive feedback on warming, because water vapour is a GHG and thus increases in water vapour in association with increases in greenhouse gases would cause greater warming than would occur if water vapour remained constant.
- Positive screening:** Seeking to invest in companies with a commitment to responsible business practices, or that produce positive products and/or services. Includes best-in-class and pioneer screening.
- Price elasticity:** A measure of price sensitivity in the marketplace: the percentage change in the quantity of a product divided by the percentage change in the price.
- Price-to-earnings ratio (P/E):** The multiple of earnings at which a stock sells, determined by dividing current stock price by current earnings per share (adjusted for stock splits).
- Proxy:** Document intended to provide shareholders with information necessary to vote in an informed manner on matters to be brought up at a stockholders' meeting.
- Radiative forcing:** The term radiative forcing refers to changes in the energy balance of the earth/atmosphere system in response to a change in factors such as greenhouse gas emissions, land-use change, or solar radiation.
- Ratification:** After signing the UNFCCC or the Kyoto Protocol, a country must ratify it, often with the approval of its parliament or other legislature. In the case of the Kyoto Protocol, a Party must deposit its instrument of ratification with the UN Secretary General in New York.
- Reforestation:** Replanting of forests on lands that have recently been harvested.
- Regional groups:** The five regional groups meet privately to discuss issues and nominate bureau members and other officials. They are Africa, Asia, Central and Eastern Europe (CEE), Latin America and the Caribbean (GRULAC), and the Western Europe and Others Group (WEOG).
- Renewable energy:** Energy obtained from sources such as geothermal, wind, photovoltaic, solar and biomass.
- Return on investment (ROI):** A measure of a corporation's profitability, equal to a fiscal year's income divided by common stock and preferred stock equity plus long-term debt. ROI measures how effectively the firm uses its capital to generate profit.
- Risk:** (1) The possibility of losing rather than gaining. (2) A measure of price fluctuation relative to a broad market gauge. (3) The possibility of an adverse incident due to the presence of hazards or uncertainties.

**Screened portfolio investing:** The application of social criteria to conventional investments, such as stocks, bonds and mutual funds.

**Second Assessment Report (SAR):** The Second Assessment Report, prepared by the Intergovernmental Panel on Climate Change, reviewed the existing scientific literature on climate change.

**Secretariat of the UN Framework Convention on Climate Change:** The United Nations staff assigned the responsibility of conducting the affairs of the UNFCCC. In 1996 the Secretariat moved from Geneva, Switzerland, to Bonn, Germany.

**Sell side analyst:** A financial analyst who works for a brokerage firm and whose recommendations are passed on to the brokerage firm's customers.

**Sequestration:** Opportunities to remove atmospheric CO<sub>2</sub>, either through biological processes (e.g. plants and trees), or geological processes through storage of CO<sub>2</sub> in underground reservoirs.

**Shareholder resolution:** A recommendation or requirement, proposed by a shareholder, that a company and/or its board of directors take action presented for a vote at the company's general shareholders' meeting.

**Sinks:** Any process, activity or mechanism that results in the net removal of greenhouse gases, aerosols, or precursors of greenhouse gases from the atmosphere.

**Socially responsible investing (SRI):** The incorporation of an investor's social, ethical, or religious criteria into the investment decision-making process.

**Source:** Any process or activity that results in the net release of greenhouse gases, aerosols, or precursors of greenhouse gases into the atmosphere.

**Stakeholder:** Any party that has an interest, financial or otherwise, in a firm – stockholders, creditors, bondholders, employees, customers, management, the community and the government. Stakeholders are defined broadly by the Global Reporting Initiative as those groups or individuals: (a) that can reasonably be expected to be significantly affected by the organisation's activities, products, and/or services; or (b) whose actions can reasonably be expected to affect the ability of the organisation to successfully implement its strategies and achieve its objectives.

The term 'stakeholder' includes stockholders, other owners, workers and their representatives, as well as any other individual or group that is affected by the activities of the organisation. The term 'stakeholder' includes indirect stakeholders when their interests are or will be substantially affected by the activities of the organisation, such as: consumer groups, customers, governments, neighbouring communities, indigenous peoples and communities, non-governmental organisations, public and private lending institutions, suppliers, trade associations and others.

**Stratosphere:** The region of the earth's atmosphere 10–50 km above the surface of the planet.

**Substitution:** The economic process of trading off inputs and consumption due to changes in prices arising from a constraint on greenhouse gas emissions. How the extremely flexible US economy adapts to available substitutes and/or finds new methods of production under a greenhouse gas constraint will be critical in minimising overall costs of reducing emissions.

- Sulphate aerosols:** Sulphur-based particles derived from emissions of sulphur dioxide (SO<sub>2</sub>) from the burning of fossil fuels (particularly coal). Sulphate aerosols reflect incoming light from the sun, shading and cooling the earth's surface (see 'Radiative forcing') and thus offset some of the warming historically caused by greenhouse gases.
- Sulphur hexafluoride (SF<sub>6</sub>):** SF<sub>6</sub> is among the six types of greenhouse gases to be curbed under the Kyoto Protocol. SF<sub>6</sub> is a synthetic industrial gas largely used in heavy industry to insulate high-voltage equipment and to assist in the manufacturing of cable-cooling systems. There are no natural sources of SF<sub>6</sub>. SF<sub>6</sub> has an atmospheric lifetime of 3200 years. Its 100-year GWP is currently estimated to be 22 200 times that of CO<sub>2</sub>.
- Supplementarity:** The Protocol does not allow Annex I Parties to meet their emission targets entirely through use of emissions trading and the other Kyoto mechanisms; use of the mechanisms must be supplemental to domestic actions to limit or reduce their emissions.
- Supply chain:** A sequence of suppliers and customers that add value in the form of materials, components, or services, ultimately resulting in a final product.
- Sustainable Mobility:** World Business Council on Sustainable Development defines Sustainable Mobility as 'the ability to meet the needs of society to move freely, gain access, communicate, trade and establish relationships without sacrificing other essential human or ecological values today and in the future'.
- Sustainability:** Conditions or characteristics supportive of sustainable development, encompassing the environmental, social and economic aspects of a corporation.
- Sustainability report:** Sustainability reporting is the practice of measuring, disclosing and being accountable for organisational performance while working towards the goal of sustainable development. A sustainability report provides a balanced and reasonable representation of the sustainability performance of the reporting organisation, including both positive and negative contributions.
- Tangible asset:** An asset, whose value depends on particular physical properties, including reproducible assets such as buildings and non-reproducible assets such as land.
- Targets and timetables:** Targets refer to the emission levels or emission rates set as goals for countries, sectors, companies, or facilities. When these goals are to be reached by specified years, the years at which goals are to be met are referred to as the timetables.
- Technological change:** How much technological change will be additionally induced by climate policies is a crucial, but not well-quantified, factor in assessing the costs of long-term mitigation of greenhouse gas emissions.
- Thermal expansion:** Expansion of a substance as a result of the addition of heat. In the context of climate change, thermal expansion of the world's oceans in response to global warming is considered the predominant driver of current and future sea-level rise.

- Trace gas:** A term used to refer to gases found in the earth's atmosphere other than nitrogen, oxygen, argon and water vapour. When this terminology is used, carbon dioxide, methane and nitrous oxide are classified as trace gases.
- Transnational corporation (TNC):** The term refers to an economic entity operating in more than one country or a cluster of economic entities operating in two or more countries – whatever their legal form, whether in their home country or country of activity, and whether taken individually or collectively.
- Transparency:** Openness of an organisation with regard to sharing information about how it operates. Transparency is enhanced by using a process of two-way, responsive dialogue.
- Triple bottom line:** A framework for sustainable development that defines three fundamental aspects of corporate performance – economic, environmental and social.
- Troposphere:** The region of the earth's atmosphere 0–10 km above the planet's surface.
- Uncertainty:** Uncertainty is a prominent feature of the benefits and costs of climate change. Decision makers need to compare risk of premature or unnecessary actions with risk of failing to take actions that subsequently prove to be warranted. This is complicated by potential irreversibilities in climate impacts and long-term investments.
- United Nations Framework Convention on Climate Change (UNFCCC):** A treaty signed at the 1992 Earth Summit in Rio de Janeiro that calls for the 'stabilisation of greenhouse gas concentrations in the atmosphere at a level that would prevent dangerous anthropogenic interference with the climate system'.
- Upstream:** The term 'upstream' relates to a production chain activity that extends from the extraction of raw materials to the use of a good or service by an end-user. 'Upstream' refers to those organisations that play a role in the supply chain of the reporting organisation or, more generally, play a role in an earlier step in the production chain than the organisation itself.
- Urban heat island (UHI):** The tendency for urban areas to have warmer air temperatures than the surrounding rural landscape, due to the low albedo of streets, pavements, car parks and buildings.
- Value creation:** Activities that generate shareholder value for a company, e.g. value-based management.
- Vector-borne disease:** Disease that results from an infection transmitted to humans and other animals by blood-feeding arthropods, such as mosquitoes, ticks and fleas. Examples include Dengue fever, viral encephalitis, Lyme disease and malaria.
- Water vapour (H<sub>2</sub>O):** Water vapour is the primary gas responsible for the greenhouse effect. It is believed that increases in temperature caused by anthropogenic emissions of greenhouse gases will increase the amount of water vapour in the atmosphere, resulting in additional warming (see 'Positive feedback').
- Weather:** The short-term (i.e. hourly and daily) state of the atmosphere. Weather is not the same as climate.



**APPENDIX  
A**

About SERM





## About SERM

The Safety and Environmental Risk Management (SERM) project began in 1993 with support from the London insurance industry, the United Nations (UNEP) and European Community (ESF Funds).

SERM became an independent UK-based rating agency in 1996. It specialises in identifying well-managed companies through measuring their extra-financial risks, also known as corporate social responsibility risk.

Over the past 10 years SERM has conducted extensive research and development and has established a unique algorithm to allow the risks to be measured and comparisons to be drawn between companies and sectors. An advisory panel of experts oversees this work.

The input data from SERM's in-house research is combined with SERM's rating algorithm, which takes into consideration the total cost (both tangible and intangible) of any potential incident and the likely effectiveness of risk management in avoiding or mitigating any such incident. The key rating outputs are a 'net risk to capital' figure – based on market value – and a point on a 31-point scale from AAA+ to E.

Our customers can access a unique set of reports, rating social, health and safety and environmental risks for a rapidly increasing range of companies, including all trading companies in the FTSE 350 and the Eurotop 100 indices. These will shortly be available to access online for downloading.

The reports include:

- The SERM risk rating, quantifying inherent and residual risk to market capital along 25 different social and environmental risk factors;
- Comparison of an individual company's risk profile with its sector, or a defined peer group; and
- A portfolio tool to calculate the risk to capital both overall and by factor for any variety of stocks.

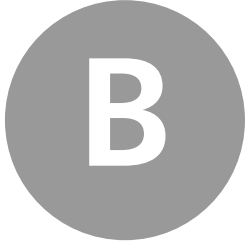
Contact details:

Post: Trafalgar House, 11 Waterloo Place, London, SW1Y 4AU  
Telephone: +44 (0) 20 7863 8850  
Direct Line: +44 (0) 1206 768430  
Internet: [www.serm.co.uk](http://www.serm.co.uk)  
Email: [adamrose@serm.co.uk](mailto:adamrose@serm.co.uk)



**APPENDIX  
B**

SERM rating model definitions



# SERM rating model definitions

## Health and safety risk

Health and safety concerns relate to current adverse health issues, both acute (short term) and chronic (long term), as they impact on the workforce. Also looking at current adverse health issues, both acute (short term) and chronic (long term), as they impact on users of the company's products/services and the public. Internal safety issues as measured by the extent of major/cumulative incidents causing injury/death to the workforce/contractors, as a result of equipment malfunction/human error. External safety issues concerning exposure to major/cumulative incidents causing injury/death to customers/suppliers and the public, as a result of equipment malfunction/human error. Health and safety liabilities in terms of magnitude of historical chronic ill-health issues that can be attributed to the company's operations (asbestosis, 'black lung', RSI, etc.), including those continuing beyond cessation of operations. New health issues are coming to the fore with potential large class actions, for instance against the long haul airlines in relation to deep vein thrombosis (DVT).

1. **Health internal:** current adverse health issues, both acute (short term) and chronic (long term), as they impact on the workforce.
2. **Health external:** current adverse health issues, both acute (short term) and chronic (long term), as they impact on users of the company's products/services and the public.
3. **Health and safety liabilities:** magnitude of historical chronic ill-health issues that can be attributed to the company's operations (asbestosis, 'black lung', RSI, etc.), including those continuing beyond cessation of operations.
4. **Safety internal:** as measured by the extent of major/cumulative incidents causing injury/death to the workforce/contractors, as a result of equipment malfunction/human error.
5. **Safety external:** exposure to major/cumulative incidents causing injury/death to customers/suppliers and the public, as a result of equipment malfunction/human error.

New health issues are coming to the fore with potential large class actions, for instance against the long haul airlines in relation to Deep Vein Thrombosis (DVT).

## Social/ethical risk

1. **Poor corporate governance:** extent to which a company's overall management is perceived not to reflect the perception of acceptable individual and business behaviour.
2. **Unrestrained corporate power:** perception of excessive unrestrained power held by corporate management manifesting itself by: e.g. the ability to dominate an industry by imposing standards that competitors must match, gaining concessions on major investment conditions, being the major employer in a location: related to size and international reach.
3. **Lack of corporate community involvement:** extent to which an organisation neglects taking a participative community role and shows little concern with its general problems/needs.
4. **Adverse marketing practices:** extent to which marketing/advertising of products/services is misleading/morally dubious: e.g. marketing to children, cartels, price fixing, incorrect labelling, potential environmental damage, offensive to particular social groups.
5. **Adverse business practices:** extent to which company's business practices are exposed in terms of: e.g. not paying suppliers, exerting heavy pressure on franchisees, pressuring agents to sell, stealing intellectual property and other 'sharp practice'.
6. **Engagement in bribery and corruption:** extent to which dubious practices are used to gain business advantage: e.g. paying bribes, excessive corporate entertainment/gifts, money laundering, complicity in smuggling.
7. **Poor human resources management:** extent to which the company's HR policies and practices are found wanting in terms of generating stress, discrimination, harassment, impact on employee privacy.
8. **Abuse of human rights:** extent to which an organisation's business practices are found wanting on issues such as working conditions, pay and hours, child labour, right of trade union recognition and dealing with oppressive regimes, use of local security forces.
9. **Negative impacts of technology:** extent of perception that adoption of new technologies leads to effects on business practices and/or society (e.g. teleworking), or carry unknown degrees of risk for present and future generations (e.g. GMOs).
10. **Other:** e.g. animal rights, high social dependence, cultural clash of different value systems, etc.

## Environmental risk

Environmental risk looks at the extent to which the following risk factors are perceived as being principal environmental 'aspects' of a company, in terms of significance of their impact. Environmental incidents (net of insurance claims) relate to risk of emissions releases to air/land/water that causes a pollution incident and meets with severe regulatory/public reaction – net of insurance claims. Not only is public perception playing an increasing role to an institution's

operational risk but is also resulting in regulatory pressure on environmental risks that can have serious consequences. The US government's decision to order General Electric to remove toxic waste is the most recent example.

Energy consumption provides a 'footprint' throughout a company's operations; both in-process and support services (e.g. office, business travel). The degree of greenhouse gas (production), e.g. CO<sub>2</sub>, SO<sub>2</sub>, N<sub>2</sub>O, emissions generated throughout the company's operations as a result of production output is also of concern, especially given the recent ratification of the Kyoto Protocol.

Water consumption, which also leaves a 'footprint' throughout the production operations, both in-process and support services (e.g. office, truck cleaning, etc.); wastewater generation in terms of volume/severity of wastewater, industrial, wash water, municipal sewage, etc. Raw materials looking at the extent (volume/type) of natural resources materials (excluding water) constituting inputs into the company's production operations; waste generation such as solid waste 'footprint' generated throughout the production process – both off-spec product output and waste by-products of the production process; historical liabilities in terms of magnitude of historical legacies of contamination/pollution, usually site specific: e.g. contaminated land, redundant/derelict structures, spoil heaps, etc.; amenity issues and the extent of nuisance caused by any aspect of the company's operations, both internal (to workforce) and external (to public off-site); others may include other controlled/uncontrolled emissions/releases (VOCs, radiation, dioxins, etc.).

Environmental risk looks at the extent to which the following risk factors are perceived as being principal environmental 'aspects' of a company, in terms of significance of their impact.

1. **Environmental incidents:** risk of emissions releases to air/land/water that causes a pollution incident and meets with severe regulatory/public reaction.
2. **Energy use:** energy consumption 'footprint' throughout a company's operations, both in-process and support services (e.g. office, business travel). GHG (production) – degree of GHG (e.g. CO<sub>2</sub>, SO<sub>2</sub>, N<sub>2</sub>O) emissions generated throughout the company's operations as a result of production output.
3. **Air emissions including GHG (production):** degree of air pollution and greenhouse gas emissions generated during production (whether internal or outsourced) of an organisation's products and services output.
4. **Air emissions including GHG (transport):** degree of air pollution and greenhouse gas emissions generated during transportation (whether internal or outsourced) of an organisation's products and services output.
5. **Water use:** water consumption 'footprint' throughout the production operations, both in-process and support services (e.g. office, truck cleaning, etc.).
6. **Wastewater generation:** volume/severity of wastewater generated as a result of the company's operations – industrial, wash water, municipal sewage, etc.
7. **Raw materials:** extent (volume/type) of natural resources materials (excluding water) constituting inputs into the company's production operations.
8. **Waste generation:** solid waste 'footprint' generated throughout the production process – both off-spec products output and waste by-products of the production process.

9. **Historical liabilities:** magnitude of historical legacies of contamination/pollution, usually site specific: e.g. contaminated land, redundant/derelict structures, spoil heaps, etc.
10. **Peripheral pollution and amenity issues:** extent of nuisance caused by any aspect of the company's operations, both internal (to workforce) and external (to public off-site).
11. **Natural resources degradation:** attitudes to the extent to which the company's licensed operations disturb and/or degrade both environmental (land, air, water) and ecological resources.

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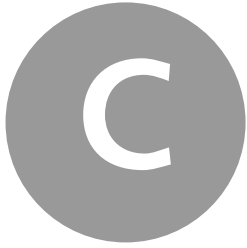


# APPENDIX

## C

SERM risk analysis methodology  
in brief





# SERM risk analysis methodology in brief

## Methodology overview

The SERM Rating Agency has developed a sustainable risk rating model. It is a tool to assist in the measurement of non-financial risk issues, also known as 'extra financial risks', or corporate social responsibility (CSR) risks. The model seeks to find if an organisation is 'sustainable' and has a functioning SERM system in place. An overview is as follows.

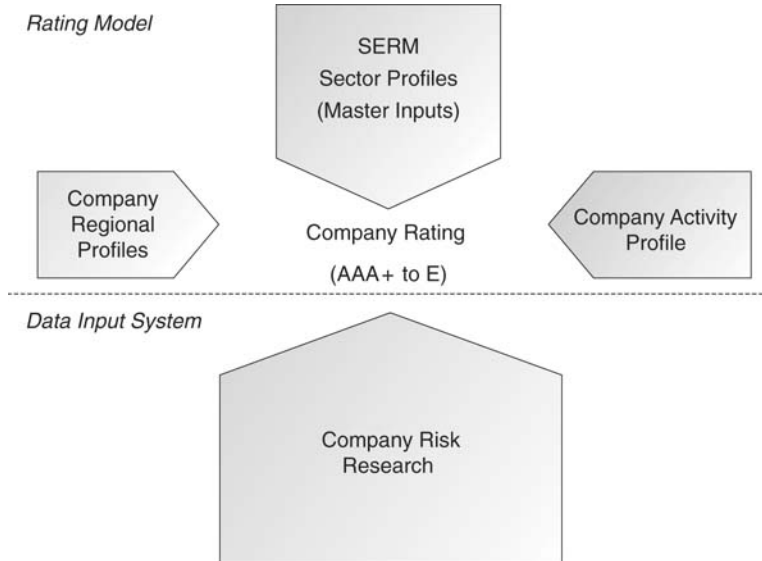
SERM provides a consistent, quantitative assessment of how successfully a company manages its risks in the following areas:

- Economic indicators, including corporate governance;
- Health and safety;
- Social and ethical;
- Environmental; and
- Stakeholder risk issues.

The risk categories above are researched in detail, and are then assessed on a positive and negative scoring system. The consistency comes from only using public domain information for the SERM rating agencies' public ratings.

The methodology has been tested and refined over 10 years, developed in partnership with: the insurance industry, the United Nations Environment Programmes (UNEP), the Association of Chartered Certified Accountants (ACCA), the Association of British Insurers (ABI) and the Centre for the Study of Financial Innovation (CSFI), among many others. It can be used to assess any size of organisation.

The rating process combines a wide variety of research, including: direct and indirect risks of the company, its sector and subsectors of activity, the countries of operation, stakeholders views and comments, the key CSR issues of concern, as well as company specific risk management techniques.



## Researching companies

The SERM Rating Agency uses approximately 34 000 public information sources, including all publicly reported company information, to compile companies' risk reports. This research informs our stakeholder-based view of their extra financial risks, or so-called 'sustainability risks' which can be described as the uncertainty surrounding events and their outcomes, which may have a significant effect, either enhancing or inhibiting:

- Operational performance (direct risks as they are directly manageable);
- Achievement of aims and objectives; or
- Meeting the expectations of stakeholders (including shareholders), or damaging the reputation of the organisation (indirect risks).

### *Research is conducted on the following extra-financial indicators of operational performance:*

- Economic and corporate governance issues (Book Part B);
- Social and ethical risks (Book Part C):
  - Business and marketing practices, including involvement in bribery and corruption;
  - Human rights of the workforce (equal opportunities, etc.) and the general public;
  - Community investment, involvement and complaints; and
  - The use of (or not) of corporate power.
- Health and safety risks (Book Part C):
  - Workforce health and safety issues; and

- General public and customer health and safety issues, including the level of product recalls and product liabilities issues.
- Environmental issues (Book Part D):
  - Environmental damage caused and resulting fines and clean-up costs;
  - Resource, energy, water and material usage and costs; and
  - Historical liabilities of land, processes and products.

*Further analysis of all published data on stakeholders' view of the organisation and an analysis of the companies' corporate reputation, brand and shareholder value are added to our reports*

- *Corporate reputation* – the organisation's reputation. This reflects key stakeholders' perception of the company's strength and corporate governance. It includes the credibility, reliability, trustworthiness and responsibility of the organisation;
- *Individual brand values* – the product's reputation. This reflects the relevant customer's perception of brand name and resultant loss of sales/increases in returned goods/inventory costs; related to visibility; and
- *Stakeholder value* and the potential for damage to an organisation's reputation:
  - Academic and research organisations;
  - Business partners and suppliers;
  - Customers and their representatives;
  - Direct action and NGO interest;
  - Employees and their representatives – employee morale and industrial;
  - Financial viewpoints – investor, lender and insurer's confidence;
  - Government and the regulatory regime – changes to a company's operating environment beyond its control;
  - Local government;
  - International governments and regulatory regimes;
  - Journalist and media interest; and
  - Key competitors and the competitive environment.

## The rating methodology outlined

The research is quantified and analysed by the SERM model, our starting point is the development of a measurement of the 'gross' or 'inherent' risk borne by these companies, by virtue of the nature of their subsectors of activity, geography of operations, and potential for damage to their reputations. This 'gross' risk is measured as a percentage of the total market value of the companies, if these risks were left unattended. For the regulated companies this is measured at 33.8% of the total capital of the companies, if these risks were left unattended.

Of course, there is active management of a lot of operationally important areas of business; examples include: the promotion of workforce health and safety; as well as good labour relations as standard norms of running a successful business.

SERM then evaluates the quality of the management across a range of issues, the people in place, policies, processes, performance indicators and programmes for improvement. This is translated into a risk reduction factor (RRF), a proxy for the quality of the management of extra financial risk issues. These risk reducing activities by the companies (the RRF) reduce their ‘gross’ risk to leave a company with a ‘net’ risk level, which is the potential financial exposure of the company to these risks.

The resultant risk figure is the ‘net’ risk to market value, and this includes direct and indirect costs and loss of assets due to fines and non-compliance with regulations. The resultant risk scores are provided in the next section of this report, with an overview in Table 1.

In effect the risk rating is an analysis of the potential for damage to ‘tangible’ and ‘intangible’ assets, and potential goodwill (viewed by SERM as the value of an organisation’s reputation) the three components of companies’ value.

Market value = tangible assets (less debt) + goodwill + intangible value

The extent to which both tangible and intangible risk factors influence share price is vital information. These risk factors include: corporate reputation and individual brand values; regulatory regime and government reaction to public pressure; media and NGO interest; employee morale; and investor, lender and insurer confidence.

This research is then turned into a net risk level, which corresponds to the ratings, which cover a scale from AAA+ to E.

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#### SERM rating scale

As a percentage of combined net (residual) risk

Up to 3.9% <b>AAA+</b>	12.0%–12.9% <b>BBB+</b>	21.0%–21.9% <b>CCC+</b>	30.0%–30.9% <b>DDD</b>
4.0%–4.9% <b>AAA</b>	13.0%–13.9% <b>BBB</b>	22.0%–22.9% <b>CCC</b>	33.0%–33.9% <b>DD</b>
5.0%–5.9% <b>AAA–</b>	14.0%–14.9% <b>BBB–</b>	23.0%–23.9% <b>CCC–</b>	36.0%–38.9% <b>D</b>
6.0%–6.9% <b>AA+</b>	15.0%–15.9% <b>BB+</b>	24.0%–24.9% <b>CC+</b>	39.0%–75.0% <b>E</b>
7.0%–7.9% <b>AA</b>	16.0%–16.9% <b>BB</b>	25.0%–25.9% <b>CC</b>	
8.0%–8.9% <b>AA–</b>	17.0%–17.9% <b>BB–</b>	26.0%–26.9% <b>CC–</b>	
9.0%–9.9% <b>A+</b>	18.0%–18.9% <b>B+</b>	27.0%–27.9% <b>C+</b>	
10.0%–10.9% <b>A</b>	19.0%–19.9% <b>B</b>	28.0%–28.9% <b>C</b>	
11.0%–11.9% <b>A–</b>	20.0%–20.9% <b>B–</b>	29.0%–29.9% <b>C–</b>	

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## Rating analysts’ scoring system

### Scoring methodology

A SERM rating process requires different types of inputs:

1. *Company overview* information;
2. *Company performance information* – collected by researchers: information that is published by the company. Look for evidence of how well or badly a

company is at managing its risk within the SERM categories. Usually positive news;

3. *Company performance information* – collected by researchers: articles from around the world on the company. Usually negative news;
4. *Sector information*: inherent risks associated with the company's subsectors and sectors of activity;
5. *Regional information*: Inherent risks associated with the countries' the company is operating in. It is important to check on: specific national laws; emerging policies; natural hazards and risk associated with human rights interest as examples of particular areas for attention.

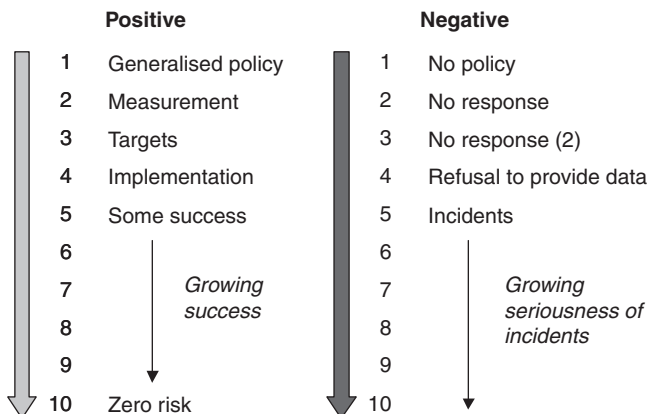
The rating analysts take all these information and data sources and create a risk report of the company with scoring of different risk categories for environmental, safety and social risks. These are:

- Economic indicators, including corporate governance;
- Health and safety;
- Social and Ethical;
- Environmental; and
- Stakeholder risk issues.

Each of these main categories has at least five subcategories. For example, Environment is made up of GHG production, Waste Water, Historic Liabilities and more. In total, there are 38 subcategories. On each of the subcategories, it is possible for a company to perform well (Positive) or badly (Negative) – or a combination of the two.

The SERM analyst allocates a positive and a negative score for each subcategory of the company they are analysing – and to justify their score with written evidence.

## Positive and negative scoring: general patterns



A more detailed scoring example is as follows, in this instance for external human rights risk scoring.

**Table 1**

<b>Positive</b>	
<b>0</b>	No data available
<b>1</b>	General policy statement has been made
<b>2</b>	Positive statements and detailed policy on protection of human rights
<b>3</b>	Detailed policy statement with evidence of some improvement programmes and/or people have responsibility
<b>4</b>	Evidence of management systems and procedures to counter human rights abuse. This includes policy, people and processes in place
<b>5</b>	Evidence of management systems and procedures to counter human rights abuse, as above, with additional programmes of improvement
<b>6</b>	As above with additional evidence of action being taken against human rights abuse
<b>7</b>	The above with extensive evidence of action being taken against human rights abuse and support for enforcement programmes
<b>8</b>	Significant historical evidence (more than two cases) demonstrating that action is taken against offenders in a consistent and severe manner
<b>9</b>	As 8 with the addition over 2 years of proof of improvements
<b>10</b>	As 9 above with the 3 years' evidence of improvements. Recognised as leader in this field by external bodies
<b>Negative</b>	
<b>0</b>	No data available
<b>1</b>	Minor health and safety hazard/land contamination; no damage or injuries at present
<b>2</b>	Denial of responsibility or existence for the above
<b>3</b>	Major health and safety hazard/contamination; no damage or injuries involving death of wildlife
<b>4</b>	Denial of responsibility or existence for the above
<b>5</b>	Minor human illness and/or injury resulting from incidents/contamination, including products
<b>6</b>	Denial of responsibility for above
<b>7</b>	Major human illness resulting from contamination
<b>8</b>	Denial of responsibility for above
<b>9</b>	Human death/s or terminal illness resulting from contamination
<b>10</b>	Denial of responsibility for above

## Evidence for the scores

Naturally, each score must be supported by evidence, so SERM's clients can understand our reasons for scoring each company.

Analysts are required to record detailed references to support the ratings that have been issued to companies. In the online database, there is a text box provided for this purpose.

The text box should be a short summary of the reasons for the score, either in prose or in bullet points. The source, and date of source, should be provided

and underlined. The page of the source and, if appropriate, relevant section of the report should also be included.

***Example 1:***

Environmental incidents (positive score)

- +6 There is evidence that the company actively seeks to manage and mitigate or clean up environmentally damaging incidents. Examples are provided by the analyst to support this rating statement.

OilCo's open and proactive approach to an oil spill in Australia near Sydney Harbour won public support. OilCo accepted responsibility for the clean-up, even though they were not directly liable, a third party shipping company was.

Greenpeace have publicly congratulated OilCo on their efforts to clear up the site: 'We accept that the Shell management have done everything in their power to mitigate the harm of this incident ...' (p. 18, 'quotes title', source documents name, date of source)

***Example 2:***

Environmental incidents (negative score)

There is evidence that the company has been directly and indirectly involved with the causing of environmentally damaging incidents.

- 5 For our sample company, OilCo was involved in over 34 spillages to water and 7 to groundwater, causing the death of wildlife and some minor disruptions to communities' water supplies. These count as a cumulative number of minor incidents of polluting land and water, which together count as a major incident well managed, and therefore mitigated in part. Specific incidents are then described for the rating reviewer to decide if they are considered minor, major, mitigated and correctly scored. A serious incident well mishandled would be –7, numerous major incidents –8, numerous major incidents mishandled –9, and numerous incidents involving the loss of human life –10.

For example, the Sydney harbour oil spill was a minor incident, for which OilCo was only indirectly responsible. Furthermore, due to OilCo's rapid response, little damage was done to wildlife. (Source name, source date, source year)

## Rating the company

There will be numerous stories within each risk category; these are in either a positive and negative section of the risk analysis. Once each of these has been attributed a score all the wide ranges of scores are computed through the SERM risk analysis model, with the addition of sector and subsector influences. The algorithm for factoring each category's risk exports this into a template which shows each risk's threat to the market value of the organisation. This research is then turned into a net risk level, which corresponds to the ratings, which cover a scale from AAA+ to E, as explained above.



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**APPENDIX  
D**

SERM sample report methodology



# SERM sample report methodology

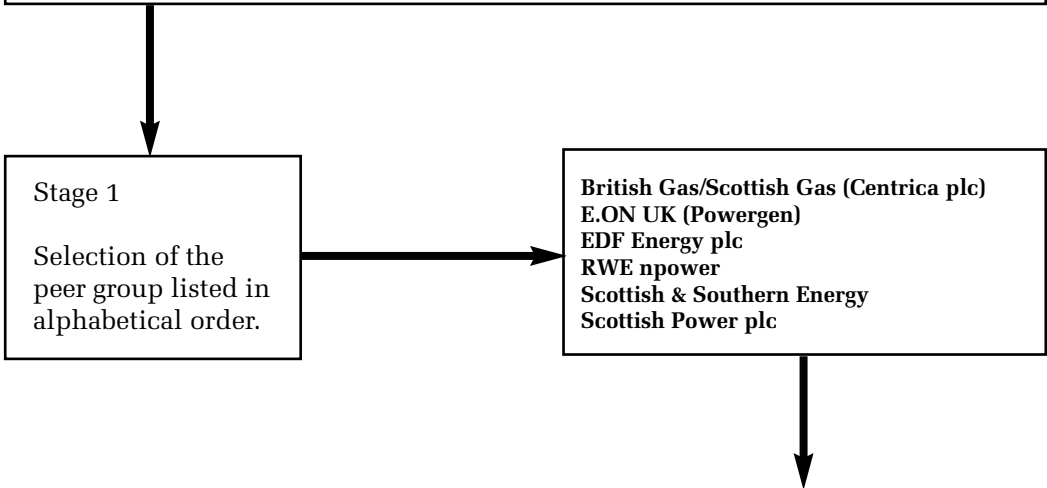
This appendix demonstrates how the summary tables and graphs are achieved.

The SERM rating system has been developed to compare companies' risk exposure and performance across selected peer groups and/or constituents of an investment portfolio.

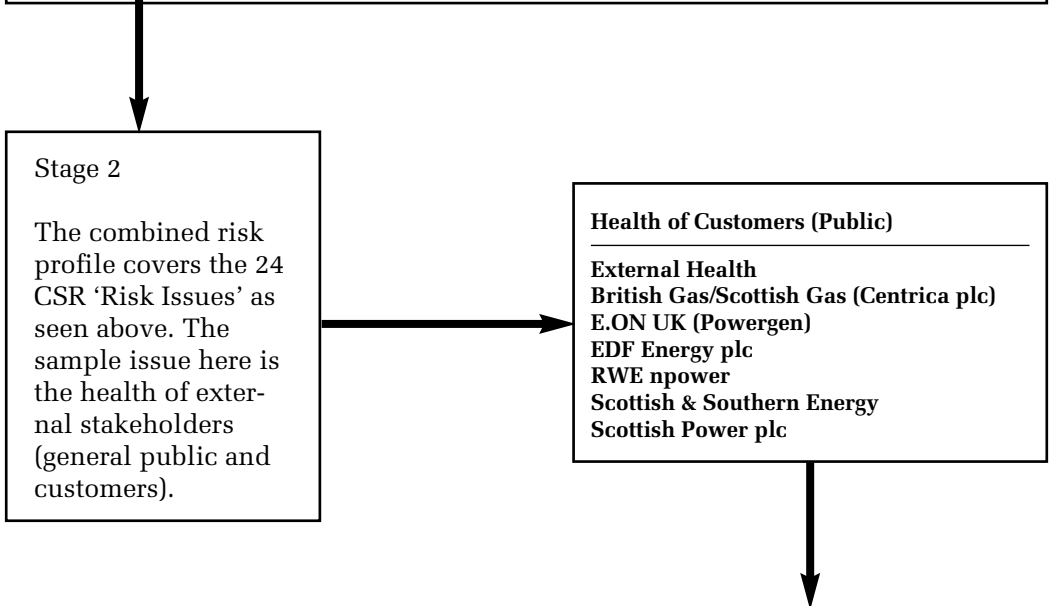
The SERM ratings are constructed from a wide range of subsector/regional operations and any selected group of companies can be analysed under the system.

SERM conducts extensive research from over 37 000 journals, government, non-government organisations (NGOs), prosecution records and any other pertinent publicly available information sources. SERM does not rely on interaction with the selected companies and the completion of lengthy questionnaires/interviews.

SERM's in-depth desk-based research is designed to provide an informed and consistent external perspective of how a company is managing its corporate social responsibility (CSR) issues and associated 'reputational risk'.



<b>Combined</b>		
<b>Environment</b>	<b>Health &amp; safety</b>	<b>Social &amp; ethical</b>
1 Environmental activities/ incidents	11 Health internal (workforce)	16 Use of corporate power
2 Air/GHG emissions from production	12 Health external (public)	17 Community investment
3 Air/GHG emissions from transport	13 Historic liabilities (health)	18 Marketing practices
4 Water use	14 Safety internal (workforce)	19 Business practices
5 Waste water generation	15 Safety external (public)	20 Bribery & corruption
6 Energy use		21 Human rights/resources (internal)
7 Raw materials		22 Human rights (external)
8 Waste generation		23 Natural resources usage
9 Historical liabilities		24 New technology
10 Peripheral pollution (noise, light, visual)		



## Stage 2

The combined risk profile covers the 24 CSR 'Risk Issues' as seen above. The sample issue here is the health of external stakeholders (general public and customers).

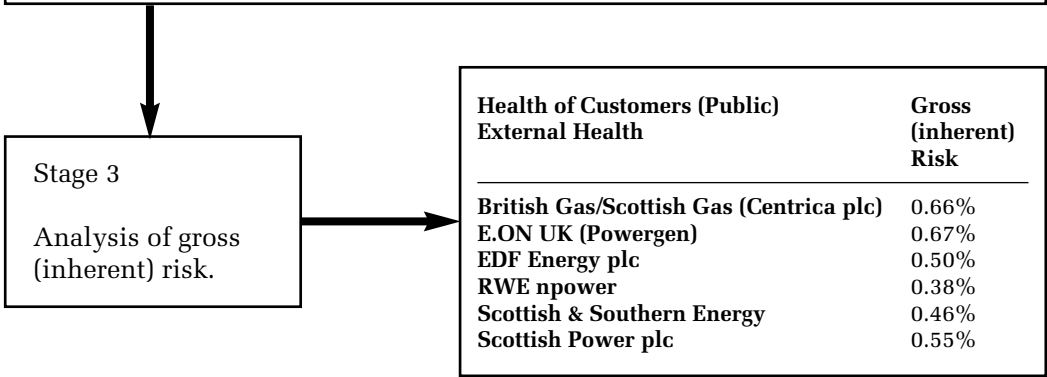
## Health of Customers (Public)

**External Health**  
 British Gas/Scottish Gas (Centrica plc)  
 E.ON UK (Powergen)  
 EDF Energy plc  
 RWE npower  
 Scottish & Southern Energy  
 Scottish Power plc

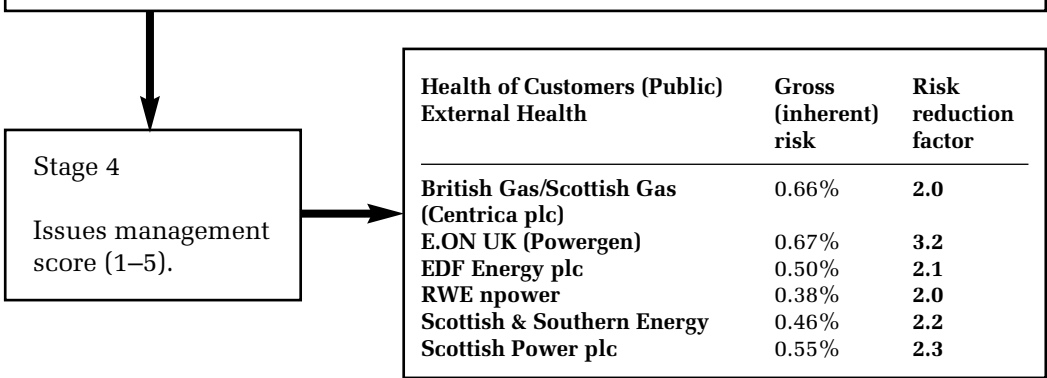
Based on SERM’s analysis of a company’s subsector activity profile and the ‘Master Inputs’ that the Advisory Panel have assigned to the various subsectors; SERM is able to assess the risk profile against each CSR ‘Issue’.

SERM then conducts extensive research from over 34 000 journals, government, non-government organisations (NGOs), prosecution records and any other pertinent publicly available information sources to define a ‘negative score’ which combined with the risk profile determines the gross (inherent) risk.

The gross (inherent) risk represents an estimate of risk to market value; prior to taking account the company’s performance in mitigating/managing the CSR ‘Issue’.



Based on researched information, SERM assess the company’s ability to address these issues and meet the expectations of its stakeholders. Using a defined set of criteria SERM’s senior analysts then assign a ‘positive score’. This is entered into SERM’s model and is translated to form the issues management score that ranges from 1 (poor) to 5 (excellent).



The issues management score is then applied as a risk reduction factor to calculate the net (residual) risk.

SERM’s balanced approach to assessing risk means that materiality and performance are both taken into account in the analysis.

**Stage 5**

Gross (inherent) risk is divided by the issues management score (RRF) = net (residual) risk.

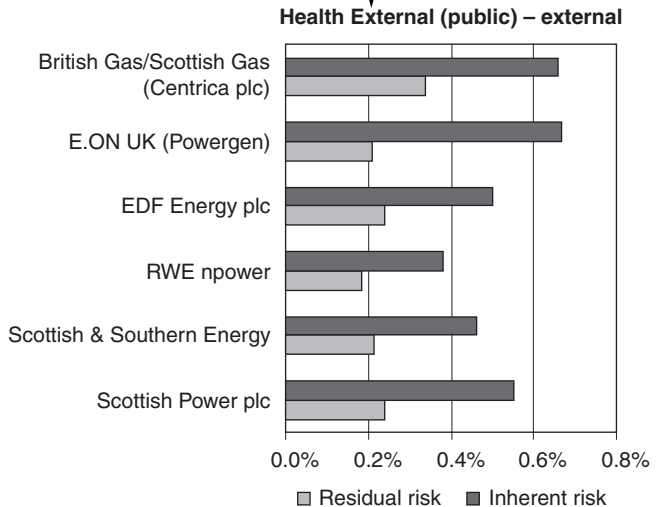
Health of Customers (Public) External Health	Gross (inherent) risk	Risk reduction factor	Net (residual) risk
<b>British Gas/Scottish Gas (Centrica plc)</b>	0.66%	<b>2.0</b>	0.34%
<b>E.ON UK (Powergen)</b>	0.67%	<b>3.2</b>	0.21%
<b>EDF Energy plc</b>	0.50%	<b>2.1</b>	0.24%
<b>RWE npower</b>	0.38%	<b>2.0</b>	0.19%
<b>Scottish &amp; Southern Energy</b>	0.46%	<b>2.2</b>	0.21%
<b>Scottish Power plc</b>	0.55%	<b>2.3</b>	0.24%

The companies can then be ranked in order of net (residual) risk.

The lower the net (residual) risk the higher the ranking.

**Stage 6**

The results are then graphed.



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**APPENDIX  
E**

Sectors ranked by risk





## Sectors ranked by risk

Sectors	Risk level	Ranking
Industrial Metals	High	1
Mining	High	2
Tobacco	High	3
Industrial Transportation	High	4
Aerospace & Defence	High	5
Pharmaceuticals & Biotechnology	High	6
Oil & Gas Producers	High	7
Banks	High	8
Oil Equipment, Services & Distribution	High	9
Food Producers	High	10
Beverages	High	11
Forestry & Paper	High	12
Chemicals	High	13
Mobile Telecommunications	High	14
Gas, Water & Multi-utilities	High	15
Construction & Materials	Medium	16
General Industrials	Medium	17
Food & Drug Retailers	Medium	18
Electricity	Medium	19
Travel & Leisure	Medium	20
Household Goods	Medium	21
Automobiles & Parts	Medium	22
General Retailers	Medium	23
Electronic & Electrical Equipment	Medium	24
Health Care Equipment & Services	Medium	25
Leisure Goods	Medium	26
Personal Goods	Medium	27
Fixed Line Telecommunications	Medium	28
Industrial Engineering	Low	29
Real Estate	Low	30
Technology Hardware & Equipment	Low	31
Support Services	Low	32
Equity Investment Instruments	Low	33
Media	Low	34
Non-equity Investment Instruments	Low	35
Software & Computer Services	Low	36
Life Insurance	Low	37
General Financial	Low	38
Non-life Insurance	Low	39



**APPENDIX  
F**

Institute of Risk Management –  
Business Continuity and Crisis  
Management syllabus



# Institute of Risk Management – Business Continuity and Crisis Management syllabus

## **Understanding the risks**

- Track the development of risk management and business continuity from its roots of origin to modern practice;
- Provide risk and continuity-related definitions;
- Provide a link between risk management and business continuity management as part of a risk management framework; and
- Develop the theme of risk management and business continuity management as part of good governance and business management.

## **Stakeholders and their role**

- Begin the process of understanding the operational risks to the organisation and above all the potentially destructive impact of some risks;
- Recognise the wide range of stakeholders in the organisation; and understand their importance, roles and needs;
- Ensure a sensitivity to these stakeholders' roles when undertaking risk assessments, business impact assessments and any subsequent risk management activity;
- Understand both the role of the stakeholder who plays a part before an incident; and the potential additional impact of new stakeholders' who emerge as an incident is unfolding; and
- Set the wider scene for risk assessments, the business impact analyses and the recovery planning subjects.

## **Governance, good practice, standards, regulation and the law**

- Consider the position of governance, good practice, standards, regulation and the law in the risk management framework;
- Examine the relationship between governance, good practice, standards, regulation and the law;
- Explore each subject heading in sufficient detail to appreciate the position of these in terms of business continuity management; and

- Analyse the global response of organisations to business continuity management regarding each of the governance and standards issues.

## **Culture, strategy, performance, risk and business continuity**

- Explore how risk management and business continuity management can be embedded as part of good management practice;
- Consider the position of risk management and business continuity management in the strategic and operational planning process;
- Review the risk environment in the context of what is at risk and what impact discontinuity might have on an organisation and its vision, values, culture and risk tolerance;
- Consider business continuity at all levels both internally and externally to the business environment, in context of enterprise risk management and enterprise business continuity management; and
- Examine how the board is engaged and attention sustained through demonstrating how value can be added to the organisation.

## **The business continuity management cycle**

- Consider how to engage the board in appreciating the need for business continuity management;
- Discuss the communication and embedding of business continuity management throughout an organisation;
- Recognise the wide range of stakeholders in the organisation; and understand their importance, roles, needs and engagement;
- Introduce the business continuity management cycle; and
- Compare and contrast the business continuity cycle and the risk management cycle.

## **The business impact analysis (BIA)**

- Understand the role and the values of a business impact analysis (BIA) within the business continuity management process;
- Understand the BIA framework, its needs, its players and its ownership;
- Enable consistency and clarity of objectives;
- Enable a consistent, clear and measured communication of risk issues;
- Access and evaluate sources of information; and
- Consider the opportunities for decision making around information evolving from the BIA.

## **The business impact analysis: a hitch hikers guide**

- Understand practical considerations when delivering a BIA;
- Be aware of some of the options to obtain information and gain trust in the balanced picture being developed; and

- Consider options for tools to be able to present risk concepts in a clear and concise way ready for decision making.

## **Application and uses of BIA information**

- Illustrate the wider role and the practicalities of the BIA by reference to individual risks;
- Consider individual risks to intellectual assets, physical damage to workstations and production lines, and outsourcing and the value chain; and
- Illustrate the differing values of the BIA including the creation of tools and information that lead directly into business recovery plans.

## **Technology exposures and continuity**

- Consider the special dependencies and the exposures around the technological services to an organisation;
- Identify the dependencies and interdependencies of centralised computer services, distributed systems, communications and end-user equipment. Furthermore identify the exposures around laptops and other remote equipment;
- Identify the risks within both in-house and also outsourced services and dependencies;
- Bring together and match the crucial, urgent operational needs and opportunities available from the technology suppliers;
- Consider the special expectations, exposures and dependencies of e-commerce.
- Ensure the risk management and continuity of computerised systems embrace the mutual dependencies between technical services and the 'old technologies' and people are clearly recognised;
- Encourage the organisation, once the dependencies and opportunities are clear, to develop technological continuity plans that will precisely meet those urgent crucial needs;
- Ensure as best as possible a credibility in technology risk management and continuity planning; and
- Establish ground rules and checklists in establishing technology continuity plans.

## **Dependency management: supplier management, outsourcing and business support**

- Provide definitional language for supplier management, outsourcing and insourcing;
- Explore the implications of supplier management and lead times for replacement following loss or disruption;
- Examine the issues involved and the planning required in managing the exit from an outsourcing agreement;

- Examine with the use of case studies the implications of single-source and critical components in production and supply-chain processes;
- Investigate the issues associated with production-line management techniques including just-in-time;
- Consider the services provided to support business continuity management and the issues of dependency associated with these; and
- Discuss an approach for dovetailing business continuity with supplier and outsourcing management.

## **Other applications for business continuity tools and principles**

- Recognise where the business continuity principles and tools can be used elsewhere in the organisation;
- Make as much additional use as possible out of the business continuity tools, information and resources that have been created;
- By maximising all such values, improve the business case further for the resources and time applied; and any monetary investment made in business continuity management; and
- Illustrate these additional values by considering individual exposures.

## **The role of people**

- To gain an appreciation of the issues associated with people and business continuity management;
- To gain an understanding of why some people excel following an incident while others falter and what makes the difference;
- Examine the dynamics of team performance, the team players and issues associated with plan invocation and recovery;
- Consider the people success factors of an invocation;
- Examine post-trauma considerations and management;
- Consider supply-chain, outsourcing and off-shoring people-related issues; and
- Consider business continuity management training and education needs and the options for delivery.

## **The values of insurance products in a crisis situation**

- To consider insurance products from the viewpoint of the critical or catastrophic risks carried by an organisation;
- To understand whether and where insurers' products and the insureds' needs interface;
- To assess the value of conventional insurance products to organisations facing potentially catastrophic damage; and
- To identify in particular where these insurance products do not provide protection for the continuity needs of an organisation.

## Communications in a crisis

- Examine the role of communication;
- Consider aspects of reputation;
- Consider communication by stakeholder and the options available;
- Gain an appreciation that building resilience applies to communication too;
- Consider communication as part of the planning process;
- Consider communication as part of the notification, invocation and recovery processes;
- Evaluate the opportunities and threats associated specifically with the media; and
- Review the communications issues associated with team training, rehearsal and exercising.

## Relationships with emergency and governmental services

- To consider the role that emergency services and other governmental departments play in business continuity;
- To consider the role that emergency services and other governmental departments play in crisis management;
- Explore the value in understanding those roles and in cooperation when undertaking a process of continuity management; and
- Recognise the opportunities and challenges brought by public authorities throughout the management of a business-threatening incident that has occurred.

## Rehearsals and exercising of plans and risk decision making

- Discuss the importance of ensuring as much credibility as is possible in catastrophic risk management and continuity planning;
- Consider the values of rehearsal training and exercising of people and the resources that are expected to be used;
- Understand the use of exercising and rehearsal training as a quality measuring tool for decision making around risk;
- Understand the importance of exercising plans as a vital check that these plans are still up to date;
- Consider the different types of exercises that are available to the risk manager and where different styles best meet different requirements;
- Consider guides and standards that are available on exercising; and their use as benchmarking tools; and
- Understand the limitations as well as the values of exercising.

## Maintenance, benchmarking, assurance and audit

- Review the drivers and options for plan review and maintenance;
- Consider the role of benchmarking tools;

- Discuss quality assurance and compliance in the context of business continuity management; and
- Explore the validation of business continuity plans through the processes of internal and external audit.

## **The continuity plan and its role**

- Examine the purpose of a plan;
- Explain the plan components;
- Outline the stages of an incident and how plan design can address these;
- Consider the differing needs of the small, medium and large organisation;
- Review specialist plans' needs from call centre to board level crisis;
- Examine team characteristics at various positions within an organisation's plan framework;
- Review support services and suppliers;
- Evaluate the role of software; and
- Consider where business continuity management heading fits as a discipline both independently and as part of risk management.



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**APPENDIX  
G**

CBC framework for corporate  
governance for SMEs



# CBC framework for corporate governance for SMEs

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Elements of corporate governance	What should be in place
<b>Commitment to Business Principles</b>	<p><i>A set of Business Principles adopted by the board and fully communicated inside and outside the company.</i></p> <p>Comments on application for small SMEs: <b>The 'CBC Business Principles' apply equally to small SMEs as to large companies.</b></p>
<b>Policies and practices</b>	<p><i>* Written policies and supporting practices addressing the key elements of corporate governance. This could be a document of a few pages that summarises the elements that follow.</i></p> <p>Comments on application for small SMEs: <b>Small SMEs should document policies and supporting practices, albeit in very concise form.</b></p>
<b>Health, safety, security and environment</b>	<p><i>A commitment by the board or owner to proper standards of HSSE. Demonstrated action for a healthy, safe and secure working environment.</i></p> <p><i>Full compliance with HSSE laws and regulations.</i></p> <p><i>Demonstrated actions to avoid environmental damage.</i></p>
<b>Leadership and structure</b>	<p>Leadership exercised in a transparent manner for the benefit of the whole entity.</p> <p>A distinction between the owner and the enterprise as a separate entity, avoiding conflicts of interest.</p> <p>* A 'board of directors' (or equivalent) with:</p> <ul style="list-style-type: none"><li>• A director selection and appointment process.</li><li>• <b>Agreed and understood roles and responsibilities.</b></li><li>• <b>Separate roles of chairperson and chief executive, if practical.</b></li><li>• <b>Responsibility for cohesion in the board resting with the chairperson.</b></li><li>• <b>A number of independent non-executive directors.</b></li><li>• <b>A balance of skills among the members of the board.</b></li><li>• <b>An audit committee composed of independent directors.</b></li><li>• <b>Board meetings on not less than a quarterly basis.</b></li><li>• Pre-circulated board papers and record minutes of board meetings and of decisions made in permanent form.</li></ul>

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Comments on application for small SMEs:

**Small SMEs should aim at an early stage of evolution to have the following (less formal) mechanisms in place:**

- **Availability to the enterprise of skills and experience, of objectivity and independence of thought; and**
- **Appointment of a company mentor or independent advisor.**

**Small SMEs may not have a board with independent directors. Nonetheless external advice should be considered.**

**Strategy, planning and monitoring**

A written strategy capable of being communicated to stakeholders.

\* A business/financial plan:

- Setting out how the strategy will be achieved
- Containing a financial plan

Containing plans for key resources such as human resources, systems, assets and intellectual capital:

- Setting key goals and plans for monitoring and (self-)assessment.
- Management succession planning.

A safe record of key decisions made and reasons why (especially for acquisition or disposal of assets).

Comments on application for small SMEs:

**A small SME might not have the above steps in a detailed form. Nonetheless a written financial plan should exist.**

**Risk management**

Awareness of risks to the business:

- Identification of risks (as part of the business plan).
  - Assessment of likelihood of the risk eventuating and the impact if it did.
  - Risk mitigation measures.
  - A ‘Whistleblowing’ system, with encouragement of open communication and feedback.

Comments on application for small SMEs:

**Being sensitive to the risks the enterprise is facing both short and long term is essential even if formal processes do not exist.**

**People strategy**

*Future requirements for people:*

- *A leadership succession plan.*
- *Plans for key skill groups.*
- *A people plan linked to the business plan.*

\* *Individual goal setting, appraisal and development planning:*

- *Regular personal performance coaching between leaders and key staff.*
- *Feedback from employees (or by company mentor) to head of company.*
- *Distinct review of directors by their (internal) peers.*

\* *Basic training:*

- *Induction and formal training courses.*
- *Training courses, both interpersonal and skills based.*

Comments on application for small SMEs:

**In very small companies the acquisition of skills may be less formal. External providers may be used for specific skills training.**

<b>Communication and engagement</b>	<ul style="list-style-type: none"> <li>* Identification of stakeholders: Recognising those parties – other than the owners of the business – that have a legitimate interest in an enterprise such as employees, suppliers, customers of funding, tax and regulatory authorities and local communities.</li> <li>* Timely communication and provision of appropriate information to investors and stakeholder groups. Interaction with stakeholders on a basis that involves genuine and proactive dialogue.</li> </ul>
<b>Conflicts of interest</b>	<p><b><i>Recognition by management of their duties to the owners of the business.</i></b></p> <p><b><i>Avoidance of conflicts of interest.</i></b></p> <p><b><i>Maintenance of a register of business and financial interests of directors and senior staff and their immediate family.</i></b></p>
<b>Compliance</b>	<p><b><i>Compliance with all relevant laws, regulations and codes of best practice. These include both local and international markets.</i></b></p>
<b>Control environment and processes</b>	<p>Adequate internal control systems.</p> <ul style="list-style-type: none"> <li>* Periodically reviewed by independent (external) auditors.</li> <li>* Open disclosure of internal control weaknesses or failures, with formal remedial action.</li> </ul> <p><b><i>Comments on application for small SMEs:</i></b> All but the smallest, non incorporated entities should be subject to independent external audit.</p>
<b>Transparency and disclosure</b>	<ul style="list-style-type: none"> <li>* Quarterly financial reports prepared by internal accounting and approved by the Board.</li> <li>* Annual financial statements audited by independent external auditors and approved by Shareholders' Meeting.</li> </ul> <p><b><i>Comments on application for small SMEs:</i></b> For very small companies the financial statements may be very simple in nature and largely cash flow based.</p>
<b>Business partners and Contractors</b>	<p>Encouragement and promotion of good standards of corporate governance among partners, suppliers, contractors and customers. As progress is made, subcontractors should also be considered.</p>

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APPENDIX  
H

OECD policy framework for  
investment



# OECD policy framework for investment

The OECD in setting out a 'Policy framework for investment' (2006) has defined a set of questions concerning what needs to be in place to support good corporate governance and to promote responsible business conduct. These questions are reproduced below.

Corporate governance:

1. What steps have been taken to ensure the basis for a corporate governance framework that promotes overall economic performance and transparent and efficient markets? Has this been translated into a coherent and consistent regulatory framework, backed by effective enforcement?
2. How does the corporate governance framework ensure the equitable treatment of shareholders?
3. What are the procedures and institutional structures for legal redress in cases of violation of shareholder rights? Do they function as a credible deterrent to such violations? What measures are in place to monitor and prevent corporate insiders and controlling owners from extracting private benefits?
4. What procedures and institutions are in place to ensure that shareholders have the ability to influence significantly the company?
5. By what standards and procedures do companies meet the market demand for timely, reliable and relevant disclosure, including information about the company's ownership and control structure?
6. How does the corporate governance framework ensure the board plays a central role in the strategic guidance of the company, the effective monitoring of management, and that the board is accountable to the company and its shareholders? Does the framework also recognise the rights of stakeholders established by law or through mutual agreements and encourage active cooperation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises?
7. What has been done, and what more should be done in terms of voluntary initiatives and training, to encourage and develop a good corporate governance culture in the private sector?
8. Has a review been undertaken of the national corporate governance system against the OECD Principles of Corporate Governance? Has the result of that review been made public?

9. How is the ownership function of state-owned enterprises (SOEs) structured to ensure a level playing field, competitive market conditions and independent regulation? What are the processes in place to ensure the state does not interfere in day-to-day management of SOEs and that board members may effectively carry out their role of strategic oversight, rather than to serve as a conduit for undue political pressure? How are SOEs effectively held accountable to the government, the public and to other shareholders (if any)?



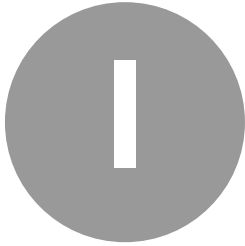
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# APPENDIX

## I

Transaction due diligence  
documentation



# Transaction due diligence documentation

## Types of documents

In a transaction such as the sale of a business the materials and main documents will typically include some of the following documentation:

### Pre-exchange

- Due diligence preliminary enquiries, further enquiries and the seller's responses to them;
- Heads of agreement;
- Due diligence terms of reference – engagement letter – accountants;
- Instructions for accountants' short and long form report;
- Due diligence terms of reference – engagement letter – lawyers;
- Environmental audit – engagement letter;
- Exclusivity agreement;
- Confidentiality agreement;
- Data room letter;
- Due diligence rules of engagement;
- Funding comfort letter;
- Environmental comfort letter;
- Due diligence reports;
- Report on title; and
- Legal opinion of foreign lawyers.

### Exchange of contracts

- Disclosure letter;
- Sale and purchase agreement;
- Guarantees;
- Tax indemnity;
- Service agreements;
- Intellectual property assignments and licences;
- Real property transfers;
- Assignment of contracts; and
- Directors' meeting minutes;

## Closing

- Shareholders' resolutions and circular;
- Announcements;
- Letters to customers;
- Stamp duty and company registry forms;
- Governmental consents;
- Release of charges, guarantees; and
- Closing agenda.

## Ongoing action for the due diligence teams regarding the transaction documentation

Throughout the transaction, the legal due diligence team leader for both the seller and the buyer needs to peruse any transaction documentation which might affect the due diligence exercise. Each draft of the documentation should be checked for any amendments made affecting the due diligence. One document that the legal due diligence teams on both sides are usually responsible for is the disclosure letter. As will be seen from the discussion below, following the initial meeting with the client, the buyer or seller and its lawyers will have a number of tasks to undertake, including:

- Selecting and instructing other advisors;
- The preparation of legal due diligence enquiries;
- Agreeing terms of engagement and reference with them and any in-house due diligence teams;
- Planning the campaign;
- Agreeing various preliminary documents with the other side, including:
  - Heads of agreement;
  - A confidentiality agreement;
  - A lock-out agreement; and
  - Rules of engagement;
- Project and data management; and
- Starting the data acquisition/disclosure process.

## Typical transaction procedures

Comment has already been made regarding the usual due diligence process. However, the due diligence process may vary according to the following situations:

- Sale by auction; or
- Sale by treaty.

In the case of both a sale by auction and a sale by treaty, a number of preliminary steps may be taken:

- The seller will obtain a valuation of the target and possibly instruct a corporate financier to find a buyer;

- The seller will:
  - Instruct its corporate financier (if any), accountants and lawyers to do some analysis of the target to identify any major issues to be addressed (such as subsidiaries to be hived out);
  - Analyse the taxation ramifications of the sale for the seller; and
  - Commence the grooming of the target for sale;
- The seller may prepare an information memorandum regarding the target for potential interested parties;
- The seller will require any interested parties to execute a confidentiality agreement before issuing the information memorandum to them;
- The buyer may undertake some basic due diligence into markets, political risk, compatibility of organisational cultures; and
- The buyer may also involve its accountants in some preliminary analysis of the seller's financial accounts.

## Sale by auction or tender

It is evident that the seller can improve the terms of its sale by creating a competitive environment where a number of bidders are given access to the due diligence data and make bids for the target. In many cases the sale is not strictly an auction in that the seller is not obliged to accept the highest bid. The typical sequence of events in a sale by auction is as follows:

- With the issue of the information memorandum the seller may request that bidders respond by a specified date with an indication of the price to be offered and the assets desired;
- The seller is likely to issue a data room agreement to each bidder;
- Each bidder will be allotted a certain amount of access to the data room and possibly to target personnel for additional information;
- The bidders may submit requisitions for further information which the seller may respond to;
- The buyer's in-house due diligence team, if any, prepares their due diligence reports;
- The buyer's accountants prepare their draft due diligence report. Often, this is sent to the seller for comment on any inaccuracies;
- The buyer's lawyers may provide a due diligence report, which is not usually provided to the seller;
- The bidders submit their bids;
- The seller will select one or more bidders with whom to continue negotiations unless a bidder persuades the seller to enter into an exclusivity agreement whereby the seller agrees not to negotiate with any other party for a period of time or not to conclude a sale with any other party;
- The buyer may negotiate basic heads of terms with the seller;
- The buyer may be permitted additional time to undertake due diligence;
- The negotiations concerning the warranties, which have been ongoing for some time, are finalised close to exchange of the sale and purchase agreement; and

- The seller's lawyers produce a draft disclosure letter, exempting facts and documents from the warranties.

It should be appreciated that this is a basic structure for the process of conducting a sale by auction or tender. All of these should, of course, be amended to reflect the individual circumstances of the transaction. Similar comment applies to the discussion of sale by treaty below.

## Sale by treaty

The typical sequence of events in a sale by treaty is as follows:

- The buyer may negotiate basic heads of terms with the seller;
- The buyer may insist that the seller enters into an exclusivity agreement whereby the seller agrees not to negotiate with any other party for a period of time or not to conclude a sale with any other party;
- The seller nominates either a member of its own staff or of the target to handle the due diligence enquiries from the buyer and its professional teams;
- The buyer sends its in-house due diligence team to the target's offices where it is usually given a room or a data room is set up by the buyer (where the seller wishes to keep the buyer away from its offices). Alternatively, the data may all be sent to the buyer for it and its advisors to analyse at their own offices;
- The buyer instructs its accountants to commence due diligence. They will also usually be based at the target's offices;
- The buyer and seller instruct their lawyers;
- In addition to the commencement of preparation of documentation, the buyer's lawyers forward a set of preliminary enquiries to the seller's lawyers. Normally, the seller will warrant the accuracy and completeness of the written responses;
- The buyer's lawyers are rarely based at the target's offices;
- At the same time as the due diligence teams commence work, the parties and their lawyers start to negotiate the various agreements. These activities will continue in parallel during the due diligence exercise, with the agreements and their terms being amended to reflect the results of the due diligence exercise;
- The seller's lawyers pass the preliminary enquiries to the seller's nominee for handling enquiries, who will arrange for the collation of requested documentation and for answers to the buyer's questions;
- The seller's lawyers will vet, filter and qualify the representative's responses and, where appropriate, restate them in their own terminology before sending them to the buyer's lawyers;
- The documents the seller has collected will usually be indexed and sorted into separate sets of folders known as the disclosure bundle. The written responses will refer to the appropriate documents by their index number in the disclosure bundle;

- The seller's lawyers prepare further enquiries from time to time, based on the answers to the preliminary enquiries and earlier further enquiries and results of its independent information collection activities;
- Omissions in the disclosure bundle and any gaps in the written responses by the seller's lawyers are made good during the negotiations with additional written responses and deliveries of documents;
- The buyer's in-house due diligence team, if any, prepares their due diligence reports;
- The buyer's accountants prepare their draft due diligence report. Often, this is sent to the seller for comment on any inaccuracies;
- The buyer's lawyers may provide a due diligence report, which is not usually provided to the seller; and
- The negotiations concerning the warranties, which have been ongoing for some time, are finalised close to exchange of the sale and purchase agreement;
- The seller's lawyers produce a draft disclosure letter, exempting facts and documents from the warranties.

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