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Auditing Ethics: Everything Else Shareholders Need to Know

by Rushworth M. Kidder

We take it for granted that public corporations must publish a financial audit. Should they also publish an ethical audit?

Surprising though it sounds, there's movement in this direction -- and for good reason. Audits have several purposes: They open a transparent shaft into the bowels of prior years' finances, and encourage good practice in the current year. But they're also predictive. Audits help investors answer the question that matters most: Is this company a good bet for the future?

In today's complex world, the answer to that risk-analysis question doesn't come through financial numbers alone. It requires a consideration of non-financial issues -- environmental impact, community relations, employment conditions, and a host of other topics related more to ethics than to finance. Get these wrong -- stonewall an environmental disaster, offend the local populace, blow off health or safety issues -- and the results can wreck your reputation and tank your stock just as surely as a financial mess-up.

How can investors tell whether a company is at risk in these areas? And how can they compare companies regarding non-financial matters? At the end of the 1990s, such questions helped launch the Global Reporting Initiative (GRI). Its goal: to bring consistency to corporate reporting on economic, environmental, and social issues.

In the last several months, two more initiatives out of Europe have helped elevate non-financial reporting on the corporate agenda:

- A listing of global companies has appeared that ranks the quality of their non-financial reporting. It was put together by the United Nations Environment Program and the London-based consulting firm SustainAbility, with the addition this year of Standard & Poor's, the credit-rating agency. The recently published listing ranks several of the largest European businesses in the top 20, including BP, Royal Dutch/Shell, and Unilever. But only two U.S. firms (Ford and HP) are in the top 20 -- perhaps reflecting the fact that U.S. companies have been forced to grapple with new financial-reporting strictures in the Sarbanes-Oxley Act, leaving little time for non-financial reporting.
- Britain's Department of Trade and Industry has released guidelines for corporations preparing their "Operating and Financial Review" statements. The new standards require corporate directors to include "information relating to their environmental, employment, and social and community policies to the extent necessary for shareholders to understand how these are impacting the business and wider community." The phrase "to the extent necessary" remains deliberately vague. It avoids the highly specific questions that characterize the GRI. Yet the new U.K. regulations are no mere fuzz: The act contemplates criminal penalties for "recklessly approving" a non-financial report.

How important is this trend? Rob Lake, who looks after corporate governance and social responsibility issues for the $150 billion portfolio of Henderson Global Investors in London, likes the GRI reporting structure but worries that it "sets out to be all things to all people." He feels comfortable with the new U.K. approach that, as he says, simply requires a board to "tell shareholders anything it thinks they should know about strategy."

Would this kind of reporting have warned the public of scandals brewing at Enron or Parmalat? Maybe not, although Mr. Lake notes that "regulation of this sort might create more space and create more comfort for [insiders] who are trying to screw up their moral courage to take a stand" against fraud and corruption.

But the important point here, as Mr. Lake emphasizes, is that "in this day and age, a whole host of things must be done well by companies that want to be successful for their shareholders." Among them are these "broad ethics-related issues," which he says are now "seen to have value in market terms."

If this trend holds, twenty-first-century directors will need to practice a new kind of moral futurism. Just as they now use sophisticated strategies to foresee financial risks, they must develop methodologies to look over the horizon and foresee ethical, social, and environmental risks that have not yet arisen. Needed now are innovative conceptual frameworks for creating reports so penetrating and far-seeing that no director or investor could be excused for allowing another Enron or Parmalat to happen. Non-financial reporting at least gets us started down that track.