Corporate social responsibility under the UK Corporate Governance system

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ABSTRACT

This essay explores how corporate social responsibility has a great impact to society and which measures have been taken by governments to protect social and environmental issues. Firstly, it shows the main problems of legislation to support CSR in the light of UK Corporate Governance Code. Then it compares merits and drawbacks of hard and soft law in order to identify the most way to support CSR. At the end it gives some recommendations to improve the interconnected frameworks

Keywords: Corporate social responsibility, Corporate Governance, sustainability

Introduction

Corporate social responsibility has a long history dating back to the nineteenth century. At the first time it was a movement for improving labour conditions. Today it gains broad prominence such as social and environmental problems. However, current corporate mechanisms struggle to promote CSR. In many cases legal frameworks do not fully adopt CSR in their requirements, and continues to support shareholder value maximization. This essay explores how corporate social responsibility has a great impact to society and which measures have been taken by governments to protect social and environmental issues. Firstly, it shows the main problems of legislation to support CSR in the light of UK Corporate Governance Code. Then it compares merits and drawbacks of hard and soft law in order to identify the most way to support CSR. At the end it gives some recommendations to improve the interconnected frameworks.

1. **The main problems of governments to support sustainable business.**

Global financial crisis showed that failure of corporate governance and short-term orientations affect wide-ranging economic and social welfare. Today governments as well as managers are more likely to give question how sustainability might contribute to their companies rather than how business might contribute to sustainability. Because, current regulatory frameworks for corporate social responsibility are not well adopted to support other stakeholders interest as shareholders one. Some scholars argued that CSR depends on the institutional context where shareholder primacy is strong there the role of sustainability goes weaker. Even well intended initiatives for CSR can support the interest of shareholders. For instance, sometimes companies may transfer wealth to stakeholders in order to achieve tax avoidance. There are some problems in corporate governance mechanisms to focus on CSR. For instance, existing regulations unduly promote stakeholders interests. Mostly they are well adopted for the benefit of shareholders. Most disclosure mechanisms are misguided to promote sustainability. That is why some scholars argued that current corporate governance mechanisms continue for shareholder value maximization.

Even if, UK corporate governance code operates "agency cost" thinking. Because the Code views that the mechanism of corporate governance should improve to manage the company effectively for the benefit of all shareholders. There is arisen one question that how to make corporate social responsibility to work for everyone. There are different suggestions to reach the point. Some scholars suggest using CSR as a complementary strategy rather than substitute one. For instance, using non-corporate governance regulatory measures to solve the shareholders.

Another problem is that most regulatory frameworks describe company as private institution despite its social and public impacts. It is believed that company works for the benefit of its shareholders.[1] However, company should not be considered as money making mechanism for its shareholders because it brings great deal of impact to society as well. The failure of global financial crises showed that how excessive risk taking of market can impact to the economic and social sphere. The consequences of these failures are the product of corporate governance gaps. Because of the deregulation of market by states led to devastate economy and society as well. That is why there should be law reform which effectively address to the CSR. These reforms should redefine the purpose of the company by putting clear duties and liabilities of directors in the consideration of sustainability on the decision making process.

2. The role of hard/ soft law to promote corporate social responsibility.

The corporate governance framework for CSR is divided two forms. 'Hard law' in the form of domestic legislations and 'soft law' in the form of recommendations and corporate governance codes. UK Companies Act 2006 is a significant legislation which regulates basic requirements of companies. Section 172 of Companies Act, gives to director to act he considers in good faith to promote the success of company. However, directors should take to account the interest of other stakeholders as well. Some scholars argue that this section of Companies Act has limitation to promote good governance. And hard law does not work well for the corporate social responsibility. Because this section gives to directors to impose subjective test in decision making process and does not permit anyone to interfere to internal activities of company. For instance, in the case of Re Smith & Fawcett Ltd[2], directors were required to act they consider, not what a court may consider. In other case, it is seen that directors must act for the benefit of stakeholders when the interest of shareholders would be taken as a whole.[3] As Bowen J has famously stated, "The law does not say that there are to be no cakes and ale, but there are to be no cakes and ale, except such as are required for the benefit of the company."

So there is a basic question arise from the case study that whose interest should be promoted to the company. Is the interest of shareholders more important than the interest of stakeholders? This question is quite difficult to explain because section 172 gives huge discretion to directors to act fairly between members of the company. According to the cases it is seen that case law for the enactment of enlightened theory remains unhelpful and section 172 of Companies Act simple codifies pre-existing law. However, as authors view, directors should reflect sustainable business needs for the long term success of company.

Also there is some confusion between the sections of Companies Act. For instance, according to the section 170 directors owes duties to the company however in section 172 directors should promote the success of company for the benefits of its members (shareholders). These two sections are misguided each other. There should be some clarification in the meaning of "benefits of the member"

Instead of hard law, soft law has a great impact to corporate decision making process. Soft law provisions create flexibility to companies in order to comply with them. Explanations of

[1] *Umarov, Bekzod, and Khamdambek Atajanov. "The Role Of Corporate Control In Protection Of The Rights And Interests Of Shareholders." The American Journal of Political Science Law and Criminology 3.12 (2021): 32-41.*

[2] *Re Smith v Fawcett Ltd [1942] Ch. 304 at 306*

[3] *Hutton v West Cork Railway [1883] 23 Ch D 654.*

Corporate Governance Codes are not obligatory for companies. All of the obligations are non-compliance rather than rigid rules. For instance, UK Corporate governance Code requires companies to report their activities by complying the provisions of Code. If companies cannot comply with those provisions, they should explain why they cannot. It is important to highlight that Code do not require compliance, encourages best practice of 'comply or explain' approach. However, UK corporate Code does not explicitly refer to corporate social responsibility. Its principles encourage making effective engagement with stakeholders. However, there is not any section which regulates relation with stakeholders. It is recommended that there should be special provisions and sections for the stakeholders to promote corporate social responsibility. Code should recognize the rights of stakeholders in creating wealth, jobs, and the sustainability. There should be a connection with stakeholders during the board`s decision making process. For instance, Dutch corporate governance code is a good example of engaging with stakeholders` interest which requires formulating a strategy for long term value creation. According to research, soft law measures can be seen as the guarantor of stakeholders and its provisions are more secure and flexible than hard law. However, some scholars argue that 'comply or explain' approach works for the benefit of shareholders because any disclosure which is not beneficial can be marginalized or refused by shareholders. It is seen that even if well-structured corporate governance code provides shareholder wealth maximization.

3. Accountability mechanisms to support corporate social responsibility

3.1. Examples of non-financial disclosure obligations.

In order to make business more beneficial for both public and private interest there should be some accountability standards in the corporate governance mechanisms. There are different types of accountability mechanisms to hold the balance between the interest of shareholders and stakeholders. For instance disclosure and transparence requirements are the main pillars of accountability. According to the section 414 C of Companies Act, companies should announce their strategic report to inform members of the company about the performance of directors to promote success of company. The strategic report must contain a review of companies business and description of uncertain risks which facing the company. The review must analyze development and performance of company. Additionally, there are some requirements for disclosing the number of women on boards. Diversity on board of directors promotes to create more equitable society. The opportunity and power can be equalized between majority and minorities. Thus promoting diversity on boards helps to governments to create more equitable society. Furthermore, section 414 CA requires non-financial information statement form the company which relates to trading, banking, and insurance sphere. The content non-financial information statement should contain environmental and social matters. In addition, according to the Corporate Governance Code, boards should provide '*Viability Statement*' in the Strategic Report to investors to lead the company to long-term success.

However, in many cases disclosure system is misguided. Because many companies follow "tick the box" method in order to show window-dressing approach. Sometimes negative information is not being disclosed. In such situation disclosure mechanisms do not focus on stakeholders' interest. Managers may use disclosure obligations as a public relation tool rather than an opportunity for changing corporate behavior for the sustainability purpose. Moreover, some companies use disclosure obligations as a window-dressing strategy. For instance, many companies raise corporate funds for impaired children to show that they are engaging with society, however in reality these funds does not inspire children. Because nobody monitors these initiatives. Charities do not want to give money to disabled people. There are no accountability mechanisms to monitor raised money. Corporate initiatives do not solve the bottom issues they do not understand the main point of charity funding. They think that charity is the way of encouraging children and taking some photos for memory. It is recommended that companies should incorporate corporate social responsibility to their strategy.

In US corporations are required to disclose the measures of due diligence to support chain of custody of conflict minerals. For instance, corporations which use conflict minerals originated in the Congo, should disclose a report about the measures taken to exercise due diligence. Additionally, Resource Extraction Payment Rule – which requires disclosure of payments made by corporations to governments for the commercial development of oil, natural gas, or minerals in order to combat global corruption.

3.2. Executive remuneration mechanisms which support or hinder corporate social responsibility.

One of the accountability mechanisms of CSR is regulating executive remuneration packages through different ways. Usually remuneration policies work as an accountability mechanism to hold the directors in the interest of shareholders. However, it does not only reduce agency costs but also it helps to reduce wealth inequality.

4. Recommendations for improving interconnected framework for CSR

It is important to create interconnection between company and its strategy. However, in most situations CSR struggles to gain attention from the pressure of shareholder primacy. Companies cannot simple adopt sustainability. Voluntary forms of CSR are not sufficient enough to protect company against short-term orientation. Because, voluntary approach leads to avoid from accountability. There are different suggestions to focus on interconnected framework. For instance, some scholars suggest focusing on shareholder values in order to make sustainable business. It is suggested that paying executive's equity rather than bonuses can bind directors for long term orientation. Because, bonuses lead directors to make short term profit. Long term equity incentives cause managers to increase innovation on company. Directors` remuneration encourages high share prices while declines investment to the sustainability. For instance, between 1992 and 2018 share price and share buybacks increased from 20% to 60 percent in European companies' business while investment in research and development has declined by 45% and 38% respectively. Short termism might lead to less investment and changes to business that are necessary for sustainable challenges. If directors take equity for five or ten years, they cannot sell them in some period of time. This mechanism binds directors with sustainable business. Furthermore, directors should be more accountable because less accountability could harm both shareholders and stakeholders as well. For instance, if directors become unaccountable, they will take corporate opportunity for their own interest rather than companies' interest. So directors should be always accountable to company. However, if shareholders do not make profit as much as possible they may sell their shares and leave the company. In this situation it is hard to hold long term sustainability without support of shareholders. If there any patient investors who want to stay company even if they do not make short profit, there should be some conditional loyalty schemes to encourage them with extra share and equities. For instance, Warren Buffet strategy allows company to build their brand for long term because he gives large stakes who has conditional loyalty to the company. Secondly, identifying and mitigating risks and supporting sustainability should be part of the directors` duty of care. Directors should take to account the interest of employees, customers, society and environment in the decision making process. However, enforcement of the directors' duties to act in the long term interest of the company is limited. Because current legal frameworks are not well adapted to put rigid responsibilities to directors to think about sustainability in the decision making process. The main problem is that director's duties tend to favour the short term maximization of shareholders` value. Separation ownership and control effected separation investment and CSR. Because short-term orientation in the market causes social and environmental destruction. For instance, global financial crises in 2008 showed that how excessive risk taking and failure to incorporate with social issues can devastate whole range of economy and society as well. To avoid from new GFC some scholars argue to facilitate corporate restructuring, innovations and social development. They suggest, improving the role of institutional investors in corporate governance can help align corporate behavior with social issues. For instance, pension funds whose beneficiaries are ordinary workers can demand transparency and corporate social responsibility in order to achieve long term sustainable development.

Another suggestion is given by some scholars argued that the role of non-executive directors on the board is important to sustainability. Because they have a strong power to lead the board engaging with environmental and social issues. Higher degree of board independence can help to promote CSR and provide more voluntary disclosures.

Conclusion.

To conclude, Global financial crisis showed that if the companies do not promote corporate social issues on their strategies, the impact of devastation would be harmful for not only economy but also society as well. Today governments and companies are trying to solve social and environmental problems by implementing new regulations. However, those frameworks unduly promote CSR. Mostly they are well adopted for the interest of shareholders. Hard law and soft law requirements aim to support shareholders interest rather than stakeholders' one. However, there are some recommendations which can help to promote corporate social responsibilities through corporate governance mechanisms.

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