

**THE 2006 COMPANIES ACT:
UK COMPANY LAW CATCHES UP WITH THE EFQM EXCELLENCE MODEL!
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One of Europe's leading Excellence assessors looks at how the EFQM Excellence Model aligns with, and might support organisations as they address, new UK company legislation

INTRODUCTION

Section 172 of the UK's Companies Act 2006, implemented in October 2007, enshrined in law the duty for directors' decision making to consider the interests of employees, suppliers, customers, the community and the environment. As the legislation was being drafted, it was probably the most contentious section.

The full effect will only be really tested as case law emerges, but it seems that UK company law is now catching up with the EFQM [European Foundation for Quality Management] Excellence Model^a. This management framework has been in use for nearly 20 years, and has focused on the very stakeholders that Section 172 now includes. Research in both Europe and USA has shown that effective use of such models can pay off, so the new law may not be a leap of faith after all.

This table shows the close similarities between the factors that Section 172 identifies and the relevant Fundamental Concepts underlying the Excellence Model (updated for the 2010 refreshed Model).

Section 172 factors to consider	Fundamental Concepts of Excellence
a) the likely consequences of any decision in the long term	<ul style="list-style-type: none"> ➤ Achieving balanced results ➤ Leading with vision, inspiration and integrity
b) the interests of the company's employees	<ul style="list-style-type: none"> ➤ Succeeding through people ➤ Achieving balanced results ➤ Taking responsibility for a sustainable future
c) the need to foster the company's business relationships with suppliers, customers and others	<ul style="list-style-type: none"> ➤ Building partnerships ➤ Adding value for customers ➤ Taking responsibility for a sustainable future
d) the impact of the company's operations on the community and the environment	<ul style="list-style-type: none"> ➤ Taking responsibility for a sustainable future
e) the desirability of the company maintaining a reputation for high standards of business conduct	<ul style="list-style-type: none"> ➤ Leading with vision, inspiration and integrity ➤ Taking responsibility for a sustainable future ➤ Managing by processes ➤ Nurturing creativity and innovation <p>and of course genuinely pursuing Excellence should mean all-round high standards.</p>
f) the need to act fairly as between members of the company.	<ul style="list-style-type: none"> ➤ Achieving balanced results ➤ Leadership and constancy of purpose ➤ Taking responsibility for a sustainable future.

If you want to follow the *spirit* of the legislation, the Model could be useful. I do not believe the Model is a legal panacea for Section 172, so if your only wish is for the lowest legal level of compliance, I doubt you will gain anything from reading further: just check the views of your accounting and legal advisers and

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follow their guidance. But if you think the law may be onto something, this note may give some food for thought.

I am not giving a legal opinion (I am neither accountant nor lawyer), just considering some implications and opportunities based on my considerable work with the EFQM Excellence Model since 1993.

THE LEGISLATION

In essence, **Section 172** requires directors to direct their efforts towards achieving success for the company - and its shareholders – by paying attention to a number of factors and stakeholders. This approach is termed Enlightened Shareholder Value.

Although not an exhaustive list, relevant factors to consider include: employees; customers, suppliers and others; the community and environment; the long term effect of decisions; the benefit of maintaining a good reputation; and acting fairly towards all members of the company.

The wording of Section 172 says that directors must 'have regard to' the various factors, and this means 'give proper consideration to'.¹ It does not appear that the legislation is expecting all directors to be superheroes, but paying lip service is not enough.²

There is also a requirement (except for companies subject to the small companies' regime) in **Section 417** of the Act to include in the annual report a business review to allow members of the company to assess how directors have performed against the needs of Section 172. So overall it looks as if Enlightened Shareholder Value is not something the government is intending can be swept under the carpet.

More information about these Sections of the Act is in Appendix 1.

Spirit of the law

Behind the letter of the law is the spirit – the legislators' underlying aims. The spirit behind Section 172 is that Enlightened Shareholder Value is an effective way to manage a company.

I do believe the Excellence Model can help a company and its directors understand how well their policies towards the factors have been embedded in the organisation – and so support the spirit of the law. Section 172 only talks about directors' responsibilities, but fine words at board level are one thing - implementation throughout the organisation can be another.

So what will be the position if directors make a strategic decision that appears to bear in mind other stakeholders, but then do not support that with the means to implement it? I don't the answer know yet, this is probably one of the things that will emerge from case law. But are you interested in managing according to the spirit of the law – or just minimum compliance to 'keep your nose clean'?

Directors' judgement (and misjudgement)

The new Act is not seen as a panacea, mistakes will still be made just as in the past. And legislators recognise that sometimes actions may have to be taken, for the long term success of the company that will not be good for all stakeholders.

The intention is not for courts to be involved where company directors have acted in their best judgement and good faith, including on the stakeholder requirements. Honest misjudgements and failures in strategy and tactics are not intended to be cause for negligence claims.

THE EFQM EXCELLENCE MODEL

The thinking behind the Model is that excellence in overall organisational results is driven by excellence in customer, people and society results. This seems to be what UK law now recognises – as Enlightened Shareholder Value. And of course there is research in Europe and USA showing that use of frameworks like the Excellence Model can deliver through to the bottom line - and to the share price for quoted companies.³ The table on page 1 has already highlighted relevant links in the concepts. So how might the Model help?

Could the Excellence Model give a compliance test with Section 172?

My immediate view is “no”, at least not in the sense of legal compliance.

Currently an assessment against the framework of the Model is 'best endeavour' and 'good faith' in nature – it is not a guarantee, nor a formal 'legally binding' certification. To give it legal standing would need numerous issues to be overcome, and I believe heading down that route would risk eliminating the overwhelmingly positive aspects of working with the Model and creating instead a feared inspection regime.

An aide memoire for directors and managers?

The numerous, but still not exhaustive, guidance points of the Model could give directors (and managers implementing approaches resulting from board decisions) a reminder of some potential areas that they may need to consider in their dealings with the Section 172 factors. This may help demonstrate the reasonable care, skill and diligence that is expected of them.

The Excellence Model does not tell directors exactly how they should carry out such things as *how* they trade off the needs of various stakeholders, or balance short and long term issues, etc, because the Model is not prescriptive and different ways may be appropriate for different organisations. But could the Model be a starting point for some more detailed thinking?

Those looking for a tick list of how they must do things will, of course, not find it in the Model, but it can help others think about their organisations.

Testing implementation with the Excellence Model?

Self-assessment against the Model could help to confirm how well the company's strategic approaches to, amongst other things, Section 172 related issues are embedded throughout the organisation. For example:

- is a policy saying “our staff are our greatest assets” (a cliché in itself) supported by approaches that really do treat staff as valuable assets, or by initiatives that actually treat staff as 'cannon fodder'?
- is a high level policy of being “customer focussed” supported by approaches that demonstrate that, or by activities that really just seek to separate customers from their money?
- is a declared policy of working in partnership with suppliers betrayed by dilatory terms of payment?

A comprehensive audit would be needed to cover every eventuality conclusively, but in practice D&D Excellence usually finds that a facilitated self-assessment involving a cross section of an organisation's people can give a fairly reliable picture of the real operations and culture. And I think that the spirit of Section 172 is as much to do with the prevailing culture of an organisation as with the detail of its procedures.

So a self-assessment might improve understanding of the how well the company's objectives are supported by well-deployed activities in relevant areas of the organisation. As well as highlighting where it is doing well and also potential areas for improvement in implementing the objectives, it may influence

the reporting requirements of Section 417 – supporting more substantive comments and moving away from platitudes.

The spirit of the law is the important thing

I have said that the Model is not a panacea: it really is not a magic wand. I have made the point that I see the Model as one way of addressing the spirit of the law, not its use as a formal audit tool to police Section 172 compliance.

It is unlikely that carrying out a self-assessment(s) would give directors formal legal protection in the event of a legal claim against them by the company, ie, by shareholders. It does occur to me, however, that if directors are supporting a self-assessment as a means of testing how well their high level decisions have been put into practice, there will be an added incentive for them to stress that they want a completely honest view. Why risk a view through ‘rose tinted specs’ and potentially missing a problem that is holding back their aims?

There are practical issues if a self-assessment is used in a very large or multi-unit organisation. Should it cover the whole organisation, just the board, each division, or some combination? It really does need to ensure that different levels/divisions of the company are operating consistently, aligned with the directors’ intentions. This, however, can have significant logistical implications for such organisations, so needs careful thought before action.

POSTSCRIPT

When I wrote this article originally, the economic problems of 2007-2008 were all around us in the UK. But these arose, at least in part I believe, from the extreme form of capitalism practised in Anglo-Saxon financial markets. I was fairly sure they did not result from company directors having to think about factors other than their shareholders!

When updated in early 2010, the economic problems in the UK generally persist, and a number of UK financial services organisations have even had to be taken into whole or part public ownership. It is still not obvious to me that these problems have been caused by company directors being forced to consider factors other than their shareholders.

So if that old way doesn’t always work too well, why not consider an alternative such as making use of the EFQM Excellence Model and its alignment to Enlightened Shareholder Value?

The update of this paper was prompted by the update of the EFQM Excellence Model to its 2010 incarnation. The only changes made in this paper are to the Section 172 : Fundamental Concept comparison table on page 1. The eight underlying Fundamental Concepts of Excellence in effect remained the same for the 2010 Model as for the previous version, although they descriptions were changed slightly and their meanings clarified, including some updating to reflect current thinking and practice. If anything, these changes made the alignment even easier to identify than before.

Company success

Section 172 covers directors' duty to 'promote the success of the company' for the benefit of members as a whole (ie, all shareholders)⁴.

- ❖ Success means what the owners collectively want the company to achieve.⁵ Promote, in this sense, means to further the success of the company. So the directors must direct their efforts to achieving the objectives that the company's members have decided represent success. (A corollary seems to be that a company must have some clear objectives.)

The Act and its notes appear to use 'owners' 'shareholders' and 'members' synonymously. There is no distinction reflecting, for example, the case where pension funds may be the shareholders in public companies, but the owners may be said to be the pension fund members. Whether this is something that will also be defined/refined in the courts remains to be seen.

Enlightened Shareholder Value

Section 172 also enshrines in statute a principle that the Company Law Review termed Enlightened Shareholder Value ("ESV").

- ❖ ESV is a concept that says that sustainable shareholder benefit accrues from companies' considering a broad range of factors.⁶

Success from Enlightened Shareholder Value

To 'promote the success of the company', Section 172 requires directors to 'have regard to' (amongst other matters):

- a) *the likely consequences of any decision in the long term*
- b) *the interests of the company's employees*
- c) *the need to foster the company's business relationships with suppliers, customers and others*
- d) *the impact of the company's operations on the community and the environment*
- e) *the desirability of the company maintaining a reputation for high standards of business conduct*
- f) *the need to act fairly as between members of the company.*⁷

The explanatory notes to the Act say that this list is not intended to be exhaustive, but reflect areas of particular importance in responsible business behaviour.

Directors' obligation to shareholders

Directors' ultimate legal obligation in running the company is still to the company's shareholders. Section 172 has not introduced new legal liability to other stakeholders.

- ❖ The new requirement is that directors should 'have regard to' the interests of other stakeholders, to the longer term benefit of the company. Government believes that this aligns with the way businesses operate now.⁸

- ❖ For most responsible companies, this does not mean a major change in practice. Typically they already have paid attention to many factors that would influence the longer term success of their company. And existing case law already supported consideration of some of these factors, eg, Lord Goldsmith has said that:

*"...the need to have regard to the interests of employees as part of the main duty to promote the success of the company...was part of case law before becoming statute."*⁹

Company report and accounts: the business review

Section 417 of the Act states that unless a company is subject to the small companies regime, the directors' report must contain a business review.

- ❖ It gives specific details on the content, but the overarching aim is to inform members of the company and help them assess how directors have performed against Section 172.¹⁰

This requirement suggests that Enlightened Shareholder Value cannot really just be swept under the carpet. To a greater or lesser extent, often dependent upon the size of the company, information will have to be provided. It will be interesting to see how this reporting requirement plays out, and the quantity and quality of information that is provided.

Specific references

- 1 Margaret Hodge, Commons Report, 17 October 2006, column 789, quoted in Ministerial Statements about the Companies Act 2006, Duties of Company Directors, published by DTI, June 2007.
- 2 Companies Act 2006 Explanatory Notes, Note 328:
"In having regard to the factors listed, the duty to exercise reasonable care, skill and diligence (section 174) will apply. It will not be sufficient to pay lip service to the factors, and, in many cases the directors will need to take action to comply with this aspect of the duty. At the same time, the duty does not require a director to do more than good faith and the duty to exercise reasonable care, skill and diligence would require ..."
- 3 'Quality Award Winners also Improve Financial Performance, by Dr. Vinod Singhal and Dr. Kevin Hendricks, 2001; Organisational excellence strategies & improved financial performance, by Centre of Quality Excellence, University of Leicester, Copyright 2005. Short reports of both are, with the copyright holders' permission, on the 'Does it work' section of D&D Excellence Ltd website, www.ddexcellence.com/
- 4 Companies Act 2006, Section 172 (1):
"A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole..."
- 5 Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 255, quoted in Ministerial Statements about the Companies Act 2006, Duties of Company Directors, published by DTI, June 2007:
"The starting point is that it is essentially for the members of the company to define the objective they wish to achieve. Success means what the members collectively want the company to achieve. For a commercial company, success will usually mean long-term increase in value. For certain companies, such as charities and community interest companies, it will mean the attainment of the objectives for which the company has been established."
- 6 Alistair Darling, Commons Second Reading, 6 June 2006, column 125, quoted in Ministerial Statements about the Companies Act 2006, Duties of Company Directors, published by DTI, June 2007:
"It [Enlightened Shareholder Value] recognises that directors will be more likely to achieve long term sustainable success for the benefit of their shareholders if their companies pay attention to a wider range of matters...Directors will be required to promote the success of the company in the collective best interest of the shareholders, but in doing so they will have to have regard to a wider range of factors, including the interests of employees and the environment."
- 7 Companies Act 2006, Section 172 (1).
- 8 Margaret Hodge, introduction to Ministerial Statements about the Companies Act 2006, Duties of Company Directors, published by DTI, June 2007:
"I strongly believe that businesses perform better, and are more sustainable in the long term, when they have regard to a wider group of issues in pursuing success. That is a common-sense approach that reflects a modern view of the way in which businesses operate in their community: they interact with customers and suppliers; they make sure that employees are motivated and properly rewarded; and they think about their impact on communities and the environment. They do so at least partly because it makes good business sense."

9 Lord Goldsmith, Lords Grand Committee, 6 February 2006, column 243 , quoted in Ministerial Statements about the Companies Act 2006, Duties of Company Directors, published by DTI, June 2007.

10 Companies Act 2006, Section 417 (2):

“The purpose of the business review is to inform members of the company and help them assess how the directors have performed their duty under section 172 (duty to promote the success of the company).”

Other acknowledgements

This note is not intended as an academic paper, but the specific references above may be helpful in identifying specific comments in the legislation and supporting government documentation. The following references relate to some of the other sources of specialist information that I used in formulating my thinking. This list of sources is for information only.

- ❖ A guide to directors’ responsibilities under the Companies Act 2006; John Davies, Head of Business Law, Association of Chartered Certified Accountants. Downloaded from <http://www.accaglobal.com/>
- ❖ Burges Salmon Briefing. The Companies Act 2006. What does it mean for Directors? February 2007. Downloaded from <http://www.burges-salmon.com/>
- ❖ Addleshaw Goddard, Company Law Reform Series – Issue 5, Directors' duties - Best practice evolves. Downloaded from <http://www.addleshawgoddard.co.uk/>

I have not quoted directly from their publications and the organisations named have not been contacted. Any mis-interpretations are mine alone. For specialist accounting and legal advice on this subject you should refer to your own advisers.

For more information about the EFQM Excellence Model, the website of D&D Excellence Ltd at www.ddexcellence.com is very popular.