Corporate Governance, the Social Responsibility of Business and its Impact on Corporate Reputation

Corporate governance is about what boards of directors do and how they do it within a framework of law and social responsibility. Social responsibility is integral to corporate governance. The key purpose of corporate governance is to enhance the socially responsible reputation of a company.

Most large companies have as their prime objective - the maximisation of shareholder value. This re-emphasis of the primacy of the shareholder raises the issue of where to place the wider social responsibility towards other stakeholders, such as customers, employees, suppliers and the local community. Explicit regard to the company's reputation as a business asset might be a useful way of resolving the apparent contradiction. In fact, reputation is more directly linked to shareholder value than is often thought.

The Pressure for Performance

A recent OECD report (*Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets*, April 1998) states that "**Corporate governance tends to gain public attention when performance problems are apparent**." When performance is poor, people look for somebody to blame. In the US, corporate governance became an issue for public debate in the early 1990s, after a series of dramatic company failures. Shareholders became concerned about the loss of shareholder value particularly among some of the major companies, notably Westinghouse, IBM and General Motors and took corrective action by getting rid of the CEOs of some large companies. In the UK, corporate governance was linked not only with poor performance but also with instances of outright fraud and company failure. All instances where the corporate reputation is at stake.

The second reaction was to look at what had gone wrong and how to plug the gaps. People looked at corporate governance, and focussed their attention on where boards of directors had gone wrong and what should they be doing right. What they discovered was that there was no accepted body of knowledge or accepted practice of what boards of directors should actually be doing, leave alone doing right. Committees and codes were quickly established to put something into the "black box" of corporate governance.

The response to public attention was a plethora of inquiries and reports around the world, well documented in the OECD report. These highlighted the need for greater accountability of the boards of directors in their stewardship of companies, leading to greater controls in the way they conduct their business. It has resulted in a separation of executive and non-executive powers, and the emergence of the independent director. These directors, who are not engaged in the day-to-day management of the business, monitor performance and assist (where possible) the performance of the executive team. Greater responsibilities have been given to these independent/non-executive directors. They have to ensure that there are appropriate checks and balances on the way in which executive directors run their businesses;

and especially that a company's exposure to business and other risks is not excessive. This is difficult technically; a risky business for the independent directors themselves. For it leads them to put their individual reputations on the line; and for very little reward. There is also the emergence of the belief that the chairman who runs the board should be different from the chief executive who runs the business.

The result has been that non-executive directors are now empowered to an extent that was never before. Boardrooms have in the last few years thus seen a revolution in the UK and to a lesser extent in the US. There are few companies amongst the top 300 in the UK where the chairman and the CEO are not separate. The number of non-executives has also grown.

Pressure on companies to improve their performance is coming from another source as the market for finance has become increasingly global and dynamic in nature. The pressure is inevitably being experienced worldwide. Institutional investors have accumulated immense power, and they have begun to flex their muscles through so called "shareholder activism". They insist that directors of a business give them their prime attention and stress that the board must run the company in their interests to maximise shareholder value. This makes the goal of the company very clear for directors. They have little choice but to concur, given that power over their jobs is predominantly in the hands of these shareholders.

Such a clear goal and performance measure is not really resisted by directors. It makes their life simpler when they are trying to cope under the intense pressure, complexity and general hurly-burly of international competition. The drive for increased performance, combined with greater transparency and accountability.

Social Fallout

The OECD report goes further in recognising how the above trends may be mutually reinforcing to the detriment of wider societal interests. It says: "In the new competitive environment the corporate need to quickly shift activities to new or improved products and technologies may be inconsistent with a company's long-term commitments to certain resource providers. Pressures for efficient capital allocation and corporate performance may reduce investments in programmes and enterprises that are perceived as having high social but low economic returns." In short, some of the other "stakeholders" – apart from shareholders - may lose out.

These are concerns that occupy Indian businesses, too. There seems to be no doubt that the economy needs to open up and become more competitive. The issue is when and how gradually, and what this means for the larger social responsibilities of the company, and for the country at large. The social fall-out from the turbulence in Russia and Southeast Asia has strengthened the hand of those who seek greater controls, not through corporate governance but through the very visible hand of the state. Castro recently talked about the "evils of global liberalism" and referred to help from the IMF as the "kiss of the devil". People and the environment have to suffer because of the "blind laws of the market". There is a dichotomy here. On the one hand you have

corporate governance, the independent directors and the active shareholder - those cracking the whip over them. On the other hand, you have capitalism and its impact on the performance of the emerging economies.

These tensions are also found in companies. The debate concerning 'shareholder value' versus stakeholders has been ringing round conference halls and seminar rooms the world over. The usual attempt at resolving the matter is to say that there is no conflict between the two in the longer term. The problem is that we live in a series of short terms. This fact is often reinforced by the imperatives thrust on companies by financial analysts acting on behalf of institutions, who are themselves under pressure for short-term performance.

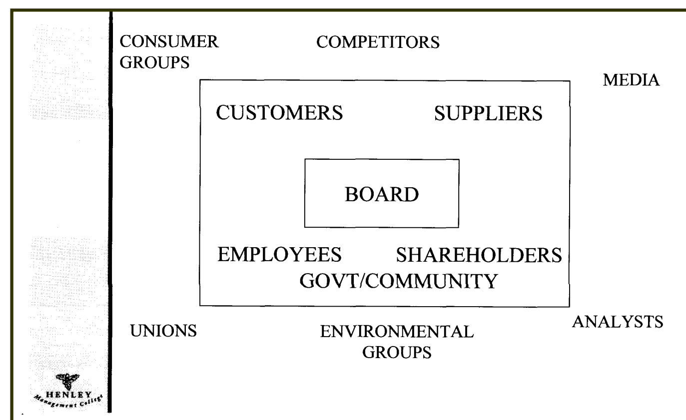
In Eastern philosophy it is axiomatic that the recognition of a contradiction is a good first step to gaining wisdom. How then can the extreme ends of the argument be reconciled? It is here that you introduce the concept of reputation. Reputation is defined as the perception of a character and corporate reputation is therefore the perception of the character of an enterprise, through the eyes of all its stakeholders.

Reputation

A company's reputation can be an asset or a liability. The argument to be presented here is that a company's reputation is directly linked to its shareholder value. If all were to focus on the main corporate purpose - enhancing the company's reputation, the apparent dichotomy between shareholder value and other stakeholder interests would disappear.

What is meant by shareholder value? It is rapidly becoming the standard measure of company performance, but how is it measured? There is a lot of mystique around the term, which is reinforced by consulting firms, usually attached to accounting firms, who trade in this opacity. Conceptually it is not so difficult and can be seen as the market capitalisation of the company, inclusive of dividends.

It has to do with cash flows, rather than with profits, because shareholders know that it is easy for companies to manipulate the calculation of profit. The finance director of one of the most successful companies in the UK, explained: "Shareholder value is essentially discounted cash flow writ large. If one imagines a company to be a bundle of projects each of which has a discounted cash flow value, then shareholder value is the sum of these." This may be a bit of an oversimplification, but it captures the essence of the idea.



Cash flows are derived from monetary exchanges with stakeholders. In each exchange, cash travels one way in exchange for goods and services that go the other way. Cash will flow in different directions depending on the stakeholder; for example, it comes from customers and goes out to employees, suppliers, etc. Cash flow is thus dependent on the exchange relationships a business has with its stakeholders.

In the centre is the board representing the company, and inside the box are the groups with which the company has exchange relationships. Cash flows one way, something else flows the other way. The board is in competition with the people outside the box for the loyalty, attention and support of the people inside the box.

Relationship Management

It is clear that the better the relationship a company has with its customers or suppliers, the more likely it is that cash will flow appropriately and securely into the future. This may seem like common business sense, but it often gets left out of boardroom calculations. In marketing literature there is increasing emphasis on "relationship marketing," which stresses that trust and commitment are at the heart of profitable relationships with customers. TQM recognises the benefit of retaining customer loyalty and satisfaction. Many of the latest ideas in strategic management see sustainable competitive advantage as being dependent on the quality of exchange relationships with customers, suppliers, employees, etc. The better these relationships are, the more give and take there will be, and the more likely people will be willing to tolerate short-term problems, and to cooperate in experiments and innovation.

Goodwill and Reputation

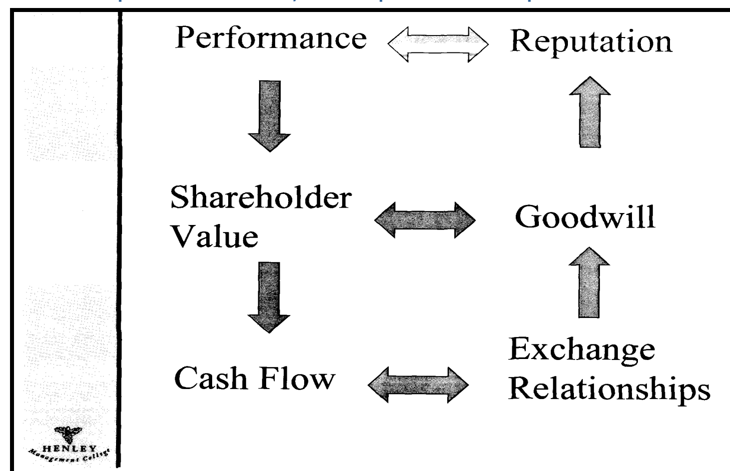
At the heart of strong relationships with stakeholders are trust and commitment to the firm. This means that stakeholders will

- feel they are getting a good deal from the firm;
- want to assist;
- wish the firm well; and
- be inclined to acquiesce voluntarily to the firm's wishes.

Many of these sentiments in a dictionary are grouped under the term "goodwill" – alongside the accounting term of the same name. The argument is that it is no accident that all these meanings are the same. **Market capitalisation is a function of two things: net assets and goodwill.** Goodwill is the extra value that is ascribed to a business that is living and enduring, over what value there would be if the business was dead and its assets were sold off. A business is alive only through the value of its relationships with its customers, suppliers, employees and shareholders. Goodwill, therefore, tends to constitute most of the value of a successful business.

Some dictionaries actually define goodwill as "*the value of a firm's reputation*". The other definition of reputation, which is often found in a dictionary, is "perception of a character"; Corporate Reputation is thus the perception of the character of an enterprise through the eyes of all its stakeholders. This brings the argument to its conclusion: the financial performance of a company - its shareholder value - is directly linked to how it is perceived by its stakeholders – its Reputation. In many businesses, these would be almost identical.

Essentially if you start from the left-hand side go down, through, performance, shareholder value and cash flow, relate these to the right-hand side, where you get your cash flow through exchange relationships, good will and reputation, establishing the rungs in the ladder along the way. It is, therefore, clear that the purpose of Corporate Governance is to generate socially responsible performance, or reputational performance.



Unfortunately, governance has been hijacked by the shareholders, and accountants - especially in India have hijacked much of management. In boardroom discourse, the left-hand side tends to be accentuated, and the right hand side tends to be forgotten, or treated as 'soft'.

This helps to explain a number of events. When companies hit a major public crisis, share prices often plummet. Shareholder value is destroyed and goodwill is lost. Some companies weather the storm better than others do, probably because their reputations are stronger and more enduring. Their stakeholders are willing to give them the benefit of doubt. Sometimes this trust and goodwill proves correct; but sometimes management and directors do not do what is expected of them and goodwill and reputation whither away over time. In rare cases it may be lost altogether and the company ceases to exist.

Companies have paid dearly for not attending sufficiently to their reputation - Union Carbide in Bhopal, and Turner & Newall with asbestos. On the other hand companies have demonstrated that they can withstand shocks to their reputation - Body Shop, British Midland and Johnson and Johnson, with Tylenol.

The following case study illustrates the reputational issue related to shareholder value in more detail.

Case study: RTZ

In the late eighties, RTZ acquired the mineral rights of British Petroleum for £3.7 billion. Their market capitalisation at the time was £3.3 billion. They financed the purchase with a rights issue of £486 million and debt of over £4 billion. Some of the assets were good, some were a bit risky. The deal was fraught with risk: There was a price risk as the Russian market had just opened up and there was a big 'splurge' of copper in the market. There was also environmental risk, as green groups had become increasingly active and one of the assets RTZ acquired in the deal was the Bingham Canyon Mine in Utah, which is over 2 miles wide. The mine was listed by US environmental agencies as one of the riskiest environmental areas in the country.

RTZ set up a system of managing this risk to take care of its reputation, its future success and the individual reputations of the directors. It put in place a formidable group of non-executive directors to manage the risk. The board included some of the most eminent people in the UK: Lord Alexander, Chairman of Natwest Securities Investment Board, Lord Armstrong, former secretary to the British Cabinet, Dick Giordano, Chairman of British Gas, Henderson, Chairman of ICI, and Sir Martin Jacob, Chairman of the Prudential and Director of the Bank of England.

The board environment committee was entirely non-executive. It had reporting to it a working group, a technical group and an advisory group. It had access to external independent experts and to internal experts. An environmental policy was set up for the operating boards of the company around the world, environmental audits were carried out and fed back to the board through the environment committee. Interestingly the operating company boards around the world also had non-executives on them. RTZ had set in place all the features of good Corporate Governance to manage the risk to their reputation:

- a separate committee
- strong independent directors
- independent advisors and
- a separate chairman and chief executive.

The result was that market capitalisation went from £3.3 billion to £9.4 billion between 1989 and 1994, so shareholder value increased tremendously. RTZ's example illustrates how important it is put strong independent non-executives at the heart of governance to manage the Reputation of the company and the risk to that Reputation. Choosing tough, critically minded and able non-executive directors helps a chief executive run the company.

Good governance is thus as much about building goodwill and reputation as it is about maximising shareholder value. In fact, it is the same. Unfortunately, the rhetoric of the boardroom does not recognise this explicitly enough. The public pronouncements of business leaders would have a far better public reception if they did. Moreover, if it were seen that this was the primary

purpose of business, there would be less distrust of the power of big business and more tolerance of the well-earned, high remuneration of its directors.

Most of the financial institutions would be surprised – perhaps even shocked – if the rhetoric of business leaders changed in this way. However, in the future this may not be as shocking. Some expect the next wave of developments in Corporate Governance to be directed at the governance of financial institutions. Pensioners could be likely to become less docile about the investment policy of the funds from which they derive their pensions. Pension funds may thus come under pressure from their own pensioners, who may want to see new values apparent in the performance criteria sought by their trustees.

Similar performance criteria are used by the growing ethical and "green funds". They seek to invest in companies that put their reputations ahead of short-term performance. This should not come as a surprise. Pensioners are not only interested in receiving an income, they also want to retire to a safe, clean world that is good to live in.

These are the views expressed by Professor Keith MacMillan, Dean of Academics, Deputy Principal and Professor of Management Studies, The Henley Management College in his address at The Second Chief Executive Officers' Roundtable in Jaipur in November 1998.

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