questions & answers

with WILLIAM FRATER

Corporate governance

Do the failures of WorldCom, Enron and Tyco in the United States display a massive weakness in American-style capitalism?

During the 1990s, the US market saw unprecedented growth. Blurred by greed and the possibilities of enormous returns and remuneration packages, a fragile system based on short-term viewpoints flourished. Asset managers work on short-term contracts with the institutional funds. They, in turn, pressurised companies through the movement of money. Companies thus had a huge pressure placed on them to continually improve on their quarterly earnings. Chief executives and directors were also working on two-to-three year appointment periods, with their remuneration packages in terms of stock options tied to earnings growth.

The net result of this problematic system was that company executives embraced short-term strategies to show strong earnings growth – these included acquisition accounting, hiding of liabilities and misreporting of earnings. Executive remuneration packages went through the ceiling. But, in the words of J K Galbraith, one of the most eminent economists of the century, "recessions catch what the auditors miss". The market slowdown and the deflation of the technology bubble, all of the greed and excess of executives and associated mismanagement and dishonest accounting got exposed. The exposure has not ended. The markets continue to reel on the next bit of bad news and shareholders continue to lose their life savings.

Companies are no longer controlled by their owners, or the shareholders, but by management and the individuals/firms that are recruited by management. If management has a short-term time horizon, this is reflected in the strategic direction that the company takes. Most shareholders, through either mutual or retirement funds, have long-term time horizons, but they have delegated their powers to asset managers on the basis of short-term renewable contracts. Such managers either base their strategies on a 'rent a stock' principle, and thus sell the stock if they perceive there to be a problem, or they buy across the whole market (index funds), hoping that risks will be minimised through general exposure.

While this has been the case in the US, with its diverse and relatively provocative financial media, and institutions and shareholders that attend and raise issues at company meetings, shareholders are less active in South Africa. There are relatively few instances where shareholders in South Africa have actively challenged corporate management, voted out directors, or passed resolutions to facilitate changes in company policy. For that matter, shareholder meetings in South Africa are comparatively lonely events, with the main participants and voters being the company directors.

The corporate disasters in the US have heralded a mass of legislation that puts substantial reporting requirements on companies and – in the name of shareholder protection – controls on self-regulating professional bodies such as auditors. Corporate governance and accountability have become the new buzzwords. Public opinion is moving away from those ever pervasive views of 'business for business sake', expounded by economists such as Milton Freidman who have played a massive role in establishing the economic psyche of twentieth century America.

Do you envisage a dramatic change in corporate behaviour, with companies putting more emphasis on sustainable, transparent and accountable practices?

The change in dimension from the short to the long term brings with it many of the arguments surrounding corporate sustainability. Corporations interact with a range of different stakeholders. These include their shareholders and workforce, the environment, society, customers, suppliers and government. The relationships with these stakeholders are increasingly being seen as an attribute of long-term business success. Following massive stakeholder-based problems, some of the leading global companies have now started to establish communication channels with their key stakeholders. A frequently sited example is Shell, which faced massive consumer pressure in its historical markets as a result of human rights abuses in Nigeria and its intention to sink the Brent Spar oil platform. These pressures resulted in boycotts and eventually shareholder pressure. Shell management has been moving to incorporate 'triple bottom line' reporting, which aims to account for economic, social and environmental performance.

Similar pressure from stakeholder groups, and the move from the 'trust me' to the 'tell me' to the 'show me' attitude of stakeholders, has resulted in many companies changing their corporate strategies from oligarchic secrecy to consultative openness. Corporate Governance codes such as *King II* encourage greater company disclosure, accountability of its leadership and the adoption of better internal controls and risk management procedures. Company adherence to such codes, while still a matter of relative performance, is becoming a mainstream requirement from stock exchanges (the JSE will require reporting in terms of *King II* from March 2003), but also for investors. This is illustrated by the findings of the McKinsey & Co survey, which draw attention to the substantial premiums that institutional investors are prepared to pay for shares in well-governed companies. It is also likely that corporate governance and more sustainable business practices will not only be confined to the large, listed companies, but will spread to their suppliers. For instance, a situation could develop where building contractors are only eligible for state tenders if they have sub-contractor charters, which effectively force sub-contractors to apply fair labour, health and safety standards.

How will companies gain from improving their practices?

There are positive aspects, such as:

- Brand value and reputational value are key to a company's long-term survival. Good brand value improves the company's position relative to its competitors.
- Worker health and safety is also an area where companies can gain from improving their practices. This has become particularly evident in the recent surge in asbestosis cases.
- Poor environmental performance will lead to the company facing clean–up costs and fines. Good long-term environmental performance will save the company in terms of lower waste, energy and water consumption costs.
- Proactive social involvement by a company not only adds to its brand value, but also contributes to the long-term good of the society in which the company is operating.

These are all areas that a long-term owner or shareholder has to consider. A well managed company with a strong and accountable leadership that embraces sustainability and openness and is prepared to constructively engage with its stakeholders is likely to perform better in a world of increasing resource depletion and inequality. Investors want to invest in companies where the returns outweigh the risks.

There has been a growing movement towards socially responsible investment (SRI), whereby investors participate in the ownership of companies that have good practices (or do not have bad practices), or take ownership responsibility for the company that they invest in. The growth of this movement has meant that companies that have good practices have attracted higher levels of investment, not only from the SRI community, but also from managers who understand that their long-term risk profiles are better than their peers. A company's share price and rating determines its cost of capital. Companies with better ratings than their peers are able raise money cheaper, giving them a significant competitive advantage.

What role can the labour movement and civil society play in encouraging companies to change?

Members of the labour movement and civil society are shareholders through their participation in savings schemes such as pension and provident funds. In South Africa in particular, these funds own a very large slice of listed companies. However, they remain largely silent regarding the behaviour and practices of the companies that they own shares in – effectively leaving control to a self-replicating and, in many instances, self-serving group of executives. The asset managers who they employ are appointed with absolute returns in mind and frequently do not play an active role in promoting better corporate governance and long-term sustainability. The net result of this system is passive ownership, which is dependent on regulations to prevent the corporate disasters and the massive losses in savings that have happened in the US.

The labour movement and civil society can be major agents for change. Companies remain accountable to their shareholders. These shareholders should start to raise their voices and encourage corporate transformation. The shareholder's right is a legal right as well as an asset. Should the labour movement and organised civil society not use these rights, they reinforce the current system through their apathy. Long-term savers are also long-term shareholders and people who want their children and grandchildren to grow up in a better and more caring world. It would be a shame to think that we currently have the power to change things in this direction, but we are simply not using it.

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