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978-0-521-19210-1 - Building Respected Companies: Rethinking Business Leadership and the Purpose of the Firm

Jordi Canals

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Building Respected Companies

The current financial crisis has clear macroeconomic roots, but the dominant view of the firm has made the crisis deeper and more devastating. Over the past few decades, maximizing shareholder value has become the firm's main objective. Chief executives have been keen on this because their economic incentives have been clearly associated with stock market performance. Unfortunately, this has driven many CEOs to make terrible decisions based on short-termism and greed. In this way, the firm has become the object of anger, criticism and cynicism. In *Building Respected Companies*, Jordi Canals argues that we must address this problem by developing companies that truly serve society, not just their shareholders in the short term. This requires a new perspective of what a firm is, what the purpose of the firm in society should be and what the role of the board of directors and senior executives should be.

JORDI CANALS is the Dean and Professor of General Management at IESE Business School. His areas of interest are corporate governance, globalization and corporate strategy. He is the author of several books, including *Universal Banks* (1996) and *Managing Corporate Growth* (2000). A Fulbright Fellow, he was a research fellow at Harvard Business School and a guest scholar at The Brookings Institution and the World Bank. He was also a member of the task force on corporate governance in Spain (2002–3).

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Endorsements

"Leadership must raise the aspirations of organizations and nurture their teams to deliver extraordinary performance. This must be achieved with the vision of building a globally respected corporation as recognized by all its stakeholders. Dean Canals brings out the essence of building a globally respected corporation and the role of leadership and governance in nurturing it." Dr. Narayana N.R. Murthy, Chairman, Infosys Technologies.

"A solid corporate reputation offers firms better growth and performance perspectives, and helps manage better current and future risks. This book offers a rich perspective on the role of chief executives in leading and developing corporate legitimacy, respect and admiration in society". César Alierta, Chairman, Telefonica.

"The current financial crisis hopefully acts as a catalyst not only for structural reforms but for mindset changes of business leaders. Jordi Canals' book articulates that only "values create value" and good leaders need to act accordingly. We need leaders with a long term view who help companies make a positive contribution to the common good of society and who clearly put character as the main criteria in the selection of good leaders. May the readers of this book contribute with their behaviour to positively change the business world." Franz Haniel, Chairman, The Haniel Group and Metro Group.

"This thoughtful book is no opportunistic response to recent events. Jordi Canals has been asking profound questions for many years: What exactly are companies for? How should CEOs be judged? Can short-term and long-term objectives be reconciled? What is the commercial value of something called respect? Here he suggests sage and workable answers to these and other highly topical issues." Sir Martin Sorrell, CEO, WPP.

"The global financial crisis and related corporate turmoil provide a compelling case for rethinking the purpose of companies. Using the crisis as a launching point, Jordi Canals presents a new vision of the company which is responsive to all its stakeholders while fulfilling its role as a responsible member of society. His work integrates diverse issues of corporate history, economics, corporate governance, and management practice, in a straightforward manner. This book will be useful not just for leaders on the verge of a crisis, but more importantly, for any business leader in search of inspiration on how to create respected, enduring enterprises." Victor Fung, Chairman, Li&Fung Group.

"As a CEO of a consumer goods company whose mission is 'bring health through food to as many people as possible', I am totally aligned with Jordi Canals' opinion that beyond profit, firms have a role to play in society. I welcome this book because it explores the notion of corporate reputation and leadership both in a visionary and pragmatic manner. This is not just a theoretical issue: we all sometimes wonder what purpose we have and why we get up and go to work every morning." Franck Riboud, Chairman and CEO, Danone.

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Preface

The current debate around corporate governance, leadership and corporate reputation has its roots in the business scandals in the United States and Europe during the last technology bubble at the turn of the century. The current financial crisis introduces new dimensions to this debate and is spreading the conviction that some corporate policies and individual behaviours must change in the business world.

Today, several influential voices support the thesis that capitalism must be reinvented. The G-20 summits in Washington in November 2008 and London in April 2009; the proposals for a new international financial architecture; the current redesign of financial regulation in the United States and the European Union; the scandals around executive compensation systems in Europe and the United States; and the increasing government intervention in the financial system and other industries around the world are examples of relevant voices and policy actions that point to a new direction in the balance between governments and the private sector. Most of those actions focus their attention on the government's role in the economy. This is an important reflection. Nevertheless, the effort to rethink what went wrong with the Western economies over the past few years needs to take into account the notion and purpose of the firm and the role of business leadership.

Beyond the usual explanations for the current financial crisis – the credit boom, the savings glut and the collapse of real estate – there is abundant evidence to suggest that many firms have lost their sense of mission and purpose in society. Moreover, the financial crisis reveals the poor quality of business leadership. Leadership is not an exact science, but it appears that many business decisions focused exclusively on the short term and were not made in the

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most professional way; the financial leverage in many firms went beyond prudent advice; compensation systems went out of control; and sound ethical principles were replaced by sheer opportunism and self-interest. As a result, some companies have gone bankrupt or are on the brink of collapse. A key question is what their boards and senior managers did or did not do to drive their firms to this desperate state. There is a widespread belief that the quality of business leadership can and should be improved, and that corporate reputation must be restored. How should this challenge be tackled?

This book wishes to offer some new perspectives on what a firm is, what business leadership is about and how good corporate governance and leadership can help develop better companies.

THE CURRENT CORPORATE GOVERNANCE DEBATE

In Western countries, many governments would like to make corporate governance rules mandatory, thus intensifying the degree of government intervention in business. The Sarbanes-Oxley Act of 2002 is a case in point. It was passed by the US Congress following a spate of corporate scandals during the technology bubble in the late 1990s and introduced a system of corporate governance mechanisms, including inflexible rules that did not help prevent the current economic crisis. The intention was good, but the final outcome rather mediocre. The current debate over executive compensation in the United States and Europe is suffering from the same weaknesses: a strong appetite for government intervention and some proposals to limit compensation which have been designed without considering the wider context of corporate governance, and the duties and responsibilities of board members and senior executives.

This debate makes chief executives and senior managers unhappy. They feel that its implicit aim is to curb management's power in favour of shareholders. They argue that this approach may not be desirable because neither shareholders nor even directors themselves have a sufficiently thorough knowledge of the company's situation and challenges, as there is a limit to the amount of time

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they can devote to the firm. Giving shareholders and board directors more decision-making power to the detriment of senior management may stifle entrepreneurship, and regulators may be taking a step in the wrong direction.

It is very unlikely that these discussions about governance will help firms escape the current crisis or minimize the risks and costs of a new one. The reason is that though those issues are important, they do not get to the root of the problem. Moreover, the nature of the current financial crisis points toward other, deeper roots, such as a poor understanding of the firm's operations, deficient internal control mechanisms, mediocre risk management systems, the combination of ambitious financial goals and leverage with risky compensation incentives and, more importantly, poor leadership at the top. An indispensable first step toward improving the firm's governance is rethinking what a firm is, what its purpose is, what society expects from firms, and what roles and responsibilities board directors and senior executives should have.

THE FIRM'S PURPOSE

This book aims to rethink the firm's purpose, and explore how firms can become respected institutions through better leadership and governance. We consider firms to be vital institutions for society and believe we cannot afford to see them and their reputation crumble. Better regulation can help. But what drives corporate performance – beyond good luck – is the quality of leadership and management displayed by the board of directors and the senior management team: the goals they set, the strategy they adopt, the speed and effectiveness of its execution and, more importantly, the quality of the people they work with and how they engage them.

By redefining the purpose of firms and business leadership, this book aims to shift the debate over corporate reputation and governance from the regulatory perspective toward the firm's mission and purpose. It also examines how companies can become respected institutions and how the senior management team – and not only

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the board of directors – can play a key role in this process. Though external control mechanisms, including product markets, capital markets and government regulation, have an influence in improving corporate governance and performance, we view these forces as insufficient on their own. Just as a train cannot move without a locomotive, long-term corporate performance will not improve through regulation alone. It needs good leadership: an effective board of directors and a competent CEO.

Companies have a purpose and a role in society, and today firms are more important and relevant to society than ever. They are social institutions that must be profitable and efficient, but short-term profits are not their only final goal. Firms exist to offer goods and services that customers want to buy. Society grants firms a licence to operate as such because they make a contribution to the common good in this specific way. If firms do a good job, they will not only generate profits in the process, but also will invest in people development, physical capital and technology. It is imperative that we rethink the notion of the firm, what its purpose is and what role it should have in society. Unless we reframe this notion, opportunism and short-term views will dominate any debate about the firm.

BUSINESS LEADERSHIP

Good leadership and governance are the engines that drive the development of successful firms that fulfil their role in society. But governance goes well beyond regulation; it requires a more comprehensive approach. The company's CEO and the senior management team play a key role and must assume certain responsibilities in the governance process. In reality, the board of directors and the executive committee are like the company's lungs: a company cannot operate effectively in the long run if one of its two lungs is not working at full capacity. That is why the design of good corporate governance mechanisms cannot be limited to the structure and functions of the board of directors, or the measures taken to ensure that the shareholders' meeting works properly. Good governance mechanisms should also

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consider the leadership that the chief executive and senior executives provide. Leadership requires professionalism, innovation, initiative, integrity, team building and a shared culture and values, all of which come from the character and experience of CEOs and senior managers, not from external regulation.

FIRMS AS RESPECTED INSTITUTIONS

A more solid understanding of the firm and good business leadership will contribute to transforming the firm into a respected institution. Traditionally, a firm's reputation was based on its products, technology, brand or corporate culture. Today, we know that those qualities and attributes help a great deal. Respected firms develop many of those dimensions, integrate them and take them to a new level. By adopting this integrative perspective, companies may become more respected institutions in society, not only because they solve economic problems but also because they think in the long term, create sustainable human environments, invest in human capital and professional development, foster innovation and meet other challenges that are crucially important to society. Companies can and should be respected institutions. They are organizations with a distinctive economic mission, but they also have a purpose in society that is not confined to the economic goals.

The assumptions outlined above also provide potential answers to today's financial crisis. The current economic turmoil has been partially fuelled by an idea of firms as pure profit maximizers in the short term, on many occasions without connection with the firms' long-term performance, as well as by the notion of business leaders as agents focused only on delivering such results. The design of some economic incentives that link pay to performance in some risky ways for the company's long-term success was considered to be the key factor for senior managers to deliver the expected short-term results. The current crisis has proven those wrong, with the effect of putting the firm's reputation in jeopardy. This is very unfortunate, because firms are vital institutions in a dynamic, prosperous

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and fair society. For this reason, it is necessary that we make sure that companies could be perceived as respected institutions. This is why it is more important than ever to rethink what firms are, what purpose they have, what society expects from them, and what business leaders should do to effectively address this huge challenge that firms and society face.

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The roots of this book lie in courses and programmes on general management and corporate governance for MBA students and senior executives that have been taught at the IESE business school over the past ten years. Discussions with students and executives both inside and outside the classroom were extremely helpful in shaping the concepts presented in this book. My deepest gratitude goes to each one of them. Over the years, the work and interaction with senior managers and boards of directors added new perspectives to the ideas discussed in this book on some of the toughest challenges boards and senior leaders must face. The experience of serving on the task force on corporate governance set up by the Spanish government (2002–3) and the interaction with regulators also helped shape some of this book's ideas from the viewpoint of public policy.

This book is based on a previous one that I initially wrote in Spanish, *En busca del equilibrio* (Prentice Hall, Madrid, 2008), although it includes new sections, concepts and cases. I deeply appreciate IESE professors Antonio Argandoña, Jose M. Campa, Joan E. Ricart and Juan C. Vázquez-Dodero for their help and guidance in reviewing the manuscript partially or totally. Their suggestions greatly improved the book. Three referees made extremely useful comments on how to improve the book and make some arguments stronger and clearer. I am very grateful to them. Paula Parish, Cambridge University Press Management Editor, did a terrific job in guiding me through the process of improving the draft. Any remaining mistakes are mine only.

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