

## The 3 TenorRS: Yali, Clarkson & Drucker Changing the Definition of Total Returns to Shareholders

David R. Beatty O.B.E. , MA (Cantab), CFA, Professor of Strategic Management & Director of Clarkson Centre for Business Ethics Rotman School of Business University of Toronto Canadian Centre for Ethics & Corporate Policy The Canadian Institute of Chartered Accountants May 22nd, 2001

Each of these three men are thrilling performers. Audiences have delighted in their accomplishment, learned from their experience and wisdom. They have changed the way the world works. Today I am delighted to welcome Madelaine Clarkson to our lunch. Madelaine's husband Max founded the Clarkson Centre for Business Ethics at the Rotman School after Max was Dean of the School from 1975-1980. Madelaine and Max always insisted that social responsibility was an integral part of being in business.

Most of you will know Peter Drucker the father of modern management. Like Max Peter is an icon in the business community. If Max was builder Peter was and remains the observer. But who was Yali ?

### Introduction

Yali is a Papua New Guinean who was the genesis of Jared Diamond's remarkable book: "Guns, Germs and Steel – The Fates of Human Societies". Jared Diamond was a biologist who studied the magnificent Birds of Paradise in PNG. Jared Diamond was walking on a beach on the New Guinea coast with a prominent 'big man' named Yali .....Yali asked Jared the following question:

"Why is it that your people have developed so much cargo while my people have so little cargo?" 'Cargo' being the pidgin word for material goods of any kind.

Jared Diamond launches into an incredible sweep of biology, climatology and geography to answer the question of how material goods arose in some parts of the world and not others.

### Yali's question

Yali's question was a simple question yet disturbingly profound for if Yali had observed the social impact of our material success he might well have asked:

"When you get richer with cargo do you get poorer in community?"

Papua New Guinea society was and is tribal. Everything revolves around the tribe. What we would call civic responsibility is the cornerstone of existence. Tribe first, everyone else later. So, did we get the material goods? Yes, in incredible abundance and variety. Have we lost our civic sense of belonging to a broader community? Oftentimes it would seem we have.

### **Are there forces changing the balance we have between material abundance and community responsibility?**

My answer:

YES. There are powerful forces at work which will change the balance and which will offer rich opportunities to those companies that have the insight to respond to these forces.

Corporate strategy based on Total Returns to Shareholders (TRS) and corporate accountability to broader social goals are merging to give a new meaning to Total Returns. The pressures from consumers, from shareholders and from employees are forcing top management and Boards of Directors to look at their enterprises from a much more holistic viewpoint.

Background: Corporate Social Responsibility Today

Most of America's 500 largest corporations boast a code of ethics and 80% of the FTSE 350 in Europe do as well. Ethics Officers Associations and Compliance Officers Associations abound.

Max Clarkson working with Richard Leblanc, Andrew Stark, Michael Deck and Len Brooks sponsored a number of initiatives including the Redefining the Corporation series of books and conferences. In addition, under Max's guidance the codes of over 200 firms were collated and a handbook on Codes of Ethics was published by the Society of Management Accountants of Canada.

Thomas Donaldson, a partner with Max in this endeavour and a distinguished Professor at Wharton, recently wrote:

Corporate ethics programs were like hummingbirds in the 1950s. You didn't see one often and when you did it seemed too delicate to survive....now we have the equivalent of a Brazilian aviary."

So we have a place to start: where are we headed?

The Gathering Storm:

Pressures To Transform are Growing Relentlessly

External forces are mounting a relentless pressure on all companies, and hence on all Boards, to transform paper driven codes into people driven practises and to broaden the scope and scale of those codes. There are 3 major forces:

1. Consumer action
2. Shareholder & market pressures
3. Knowledge worker preference

Let me review each of these in more detail.

## 1. The internet has enabled massive consumer power to judge and act upon corporate social behaviour

On Max's 75th birthday, the 10th anniversary of the Clarkson Centre, he listed the celebrated global catastrophes of Union Carbide and Bhopal; Exxon and Valdez, Shell and Nigeria, Johns Manville, Dow Corning.... each disaster resulted in consumer boycotts and profound reputational damage to the companies involved.

Celebrated incidents continue to occur. In Canada, the RoB, over the last 6 months, has yielded a cornucopia of egregious behaviour in the financial services industry. These transgressions are not buried on the bottom of page 6 but trumpeted in the headlines. Yet beyond the isolated incidents something systemic is occurring. There is a new and powerful convergence of forces that seek out, illuminate and punish deviant behaviour. To the investigative reporter and the pressure group we have added the internet and global reporting through CNN, Fox, Time Warner/AOL ... the convergence revolution.

The result is a hugely powerful fusion of interests capable of promoting socially responsible behaviour and punishing socially irresponsible behavior. As the risks of being caught out rise so do the costs. It takes decades to build a brand and a reputation; it takes but days to reduce that reputation to rubble when the world finds out at once. For example, Nike's line: "JUST DO IT" projected the image that its customers were:

- ? respectful of self
- ? achievement oriented
- ? responsible members of the planet
- ? with it

while, at the same time, it used sweatshops to make its products. Consumers flailed the company. Monsanto thought it stood for 'food-health-hope' and ended up in the pillory for its Genetically Modified seeds which sowed only fearful prospects. From a Board and top management point of view the nature and extent of the risks to any company franchise are increasing as are the costs of a failure increasing.

In Value-At-Risk terms, the banking based language of risk management, the maximum expected losses are increasing while the possibility of a major financial catastrophe (the stress test on the tail of the probability distribution) is becoming terrifyingly large.

## 2. The owners of company shares are vigorously expanding the pressure for socially responsible behaviour

The owners of common stocks are increasingly institutional investors, the pension funds and mutual funds of our lives. In Canada, these institutions have been increasing their pressure on Boards of Directors in a number of areas via their proxy power and the powers of moral suasion.

Potent forces on the 'buy' side include the behaviour of these funds, the growth of socially screened fund, and the Dow Jones Sustainability Group Index which provides core data and investment alternatives to individuals and groups. If you measure it and publicize it you can influence it!

In the UK the Pensions Act of 1995 has a new Statutory Instrument that requires all Pensions schemes from July 2000 to include a Statement on Socially Responsible Investment as part of their publicly proclaimed Statement of Investment Principles.

Every fund manager is instructed in writing to consider the following when selecting shares:

"A company run in the long-term interests of its shareholders will need to manage effectively relationships with its employees, suppliers and customers, to behave ethically and to have regard for the environment and society as a whole."

As pension funds control a huge and growing percentage of equity markets in the UK it will be a foolish Board indeed that ignores its social responsibilities. And it won't be long, I trust, before the Caisse de Depot, Teachers, OMERS and others begin to flex their muscles in this direction. Anticipating the coming boom in increased social reporting and corporate transparency Robert Herz, David Phillips and Mary Keegan of PriceWaterhouseCoopers among others have written *The Value Reporting Revolution: Moving Beyond the Earnings Game*. (ISBN: 0471398799 Wiley, 2001).

Shareholders are demanding to know more and more things about the company's operations and intangible assets and liabilities. From a Board and top management point of view the shareholder is getting more discriminating in the returns he/she wants so that Total Returns to Shareholders is taking on an entirely new meaning... not just profit but planet as well.

### 3. The knowledge workers who form the core of the modern corporation are increasingly demanding high standards of ethical performance

Let's return to our third tenor Peter Drucker: "When I ask my students why they volunteer, far too many give the same answer: "Because in my job there isn't much challenge, not enough achievement, not enough responsibility; and there is no mission, there is only expediency."

"Within 15 years you can be certain to expect a shift from creating shareholder wealth as the first priority of business to creating an environment that attracts, retains and motivates knowledge workers."

From a Board and top management point of view the rise of the knowledge worker as the great productive force in our society will force all corporate enterprise to think, talk, work and act in accordance with a broader view of society.

Consumer action, shareholder pressure and the preferences of knowledge workers will transform the meaning of Total Returns to Shareholders.

The Hinge of Fate:

Boards Will Determine The Route To Be Taken

Companies are living shorter lives. In a new book by Richard Foster and Sarah Kaplan called *Creative Destruction* the authors state that in 1920 a company on the S&P index (some 90 companies) would survive 68 years. Looking forward from today's S&P 500 they estimate 10 years as an average life.

CEOs have shorter tenures. One estimate is that the average CEO of a North American public company survives but 4 years in office. Directors, on the other hand, average over 11 years experience. Therefore, Boards alone have the perspective, the mandate, the interest and the possibility to respond to these relentless pressures. Boards will work with top management to determine the policies for the socially responsible behaviour of the company and the Board will seek assurance that these policies are the basis of all corporate behaviours.

There are really only two basic strategic responses of a company to the gathering impacts of socially responsible behaviour:

1. Follow the leaders
2. Create the future

Ignoring the challenges from consumer, investor and employee is not an option. Boards that ignore those challenges will see their companies fail.

#### 1. Follow the Leaders

Boards can follow leaders. There are many celebrated companies such as J&J, P&G, New York Life, Mountain Equipment Co-op and The Body Shop which have always been vision led and socially responsible. There are now many 'born again' companies many from the extractive industries -Royal Dutch/Shell, BP Amoco, BHP and Texaco, but many from consumer goods industry like Philip Morris and Nike ... which have used the burning platform of their public humiliation (and plummeting market cap) to change their entire set of policies with respect to their social responsibilities.

There are new coalitions such as the CAUX roundtable (Max was a delegate), and CERES with the Global Reporting Initiative (GRI). Professional firms are at the front lines of the "war for talent". We need look no further than McKinsey,

Monitor, BCG, PriceWaterhouseCoopers to see the scale and scope of change in attracting, retaining and motivating gifted talent.

Rajat Gupta, the McKinsey boss, opined at a recent conference of the firm's partners:

"I believe strongly that we must constantly talk about our values to sustain their vitality, and that these stories help to instill a deeper understanding of our values as much more than abstract concepts."

PriceWaterhouseCoopers now boasts the tag line: "Join us. Together we can change the world."

So, by following the leaders with incrementally adaptive policies Boards may yet weather the storm and be able to attract the knowledge workers that are the core of their future and avoid the catastrophe of ethical failure.

## 2. Create The Future

The truly innovative company will turn the challenge of ethical risk and corporate social responsibility into an opportunity. There are many definitions of strategy today but the one I like best is Michael Porter's:

"Strategy is the creation of sustainable, long term, differentiated competitive advantage"

One problem with this definition is that in today's world, long-term advantage might be a week long! So, a lot of academic thought on strategy has poured into the notion that the long term competitive advantage all firms so desperately seek lies in people. Markets change, products change, competition changes .... it will be the skill sets of the dedicated employees that will lengthen the odds of survival. That's where Foster and Kaplan land.

Why not have a more comprehensive humanistic value system at the core of your company's strategy?

If Elsie Maio is right the consuming public will move to products and services that come from companies with high ethical reputations. Elsie Maio is writing a book on how to do this... that will be called: Soulbranding; Riding the Coming Tsunami of Corporate Accountability. Elsie is a hard headed ex-McKinsey consultant who has worked for Lou Gerstner at IBM and recently at Rio Algom here in Toronto. If Peter Drucker is right such a company will be able to attract, retain and motivate the best knowledge workers available.

Drucker + Maio = long term sustainable, strategic differentiation

The Clarkson Centre for Business Ethics Will Continue at the Rotman School of Business to do 3 things: Build our relationships with the ethical thought leaders of our times – that's all of you here today – to continue to work with you to celebrate the leaders, direct the confused and to illuminate the dimensions of the future.

1. Teach business ethics at Rotman, an integral part of all the MBA programs, and an emerging opportunity in executive education.

2. Expand into Board effectiveness where the new leverage lies ... in this way we can become the Clarkson Centre for Business Ethics and Board Effectiveness ... CC(BE)2 ....

Yali, Clarkson and Drucker ... three wise voices. Three profound observers. Three who together give us insight, hope and guidance in building a more integrated and healthy communities. Corporate accountability and corporate strategy merged!

Let's make it happen.