a₹tha

E - JOURNAL OF FRTL @ IIM CALCUTTA

May 2023, Volume 11, Issue 1

INDIAN INSTITUTE OF MANAGEMENT
CALCUTTA

INDIAN INSTITUTE OF MANAGEMENT CALCUTTA

FRTl
Financial Research & Trading Laboratory

Going back to Managerial Capitalism – Not a Retrograde Step

Asish K Bhattacharyya

ABSTRACT

Monitoring boards are ineffective in monitoring the CEO. In the 21st century, monitoring efficiency is abysmal due to the widening information asymmetry between the CEO and the board constituted of independent directors. The monitoring board has lived its life, and it is time to go back to managerial capitalism and the advisory board system.

INTRODUCTION

It is almost fifty years since the term corporate governance emerged in the U.S.A. The Federal Securities and Exchange Commission (SEC) first brought corporate governance onto the official reform agenda in the mid-1970s.[1] In the U.S.A., the monitoring board, with independent directors, replaced the advisory board after the collapse of some large corporations (like Penn Central Railroad) and the detection of many fraudulent transactions. The objective was to strengthen the internal constraints on managerial discretion. The concept of a monitoring board emerged in other countries after the Cadbury Committee[2] submitted its report in 1992.

Although the business ecosystem has changed fundamentally, the corporate governance system has not evolved.

In this essay, I discuss the changes in the business environment in the 21ST century and present a modest proposal for changes necessary in the corporate governance structure.

1 Brian R. Cheffins, The History of Corporate Governance in Wright, Mike. The Oxford Handbook of Corporate Governance (Oxford Handbooks) (p. 47). OUP Oxford. Kindle Edition.

2 The Committee was set up in May 1991 by the Financial Reporting Council, the London Stock Exchange, and the accountancy profession in U.K..

BUSINESS ENVIRONMENT IN THE 21st CENTURY

Cheffins (2015) identifies important factors that transformed the corporate structure in the U.S.A. Those are the decline (almost demise) of the corporate control market, which was considered a robust external mechanism for strengthening corporate governance; corporate scandals such as Enron and WorldCom that prompted a federal regulatory response (Sarbanes Oxley Act); change in the ownership structure (significant ownership by institutional investors); and change in institutional investors' approach, from selling out shares promptly when a company is underperforming to take corrective actions, as the increased prevalence of share ownership stakes sufficiently large to preclude exercising the "Wall Street Rule."[3]

In the 21st century, five fundamental changes occurred in the business environment - rapid technological innovations, globalisation, business purpose and governance, knowledge economy and competition.

Technological environment

Birkinshaw (2018) observes that the digital revolution will profoundly impact a corporation's scale, scope and organisation. The digital age has blurred firms' boundaries. The firm's scope is changing as the cost of transacting in the market has fallen relative to transacting within the firm's boundary. Collaboration between individuals and firms has improved with the efficient use of information. This facilitates greater modularisation of work. Technological innovations have resulted in virtually unlimited economies of scale. Examples are network economies and platforms.

Globalisation

The globalisation of supply chains and geographic expansion are becoming norms rather than an exception. Globalisation has reduced physical transportation, communications, data storage and analysis costs. New-age transnational organisations, global value chains, and "born global" entrepreneurial ventures pose challenges to traditional multinational firms. Although the recent geo-political tensions and the COVID-19 pandemic have disrupted the global value chains, they have not reversed the globalisation trend. The globalisation trend is likely to continue.

Business purpose and ESG

For so long, managers single-mindedly pursued the objective of creating shareholder value. Initially, they resorted to short-term profitability. Later, at the dawn of the 21st century, they focused on preserving and creating long-term firm value. Focus on shareholder value distracted managers' attention from the company's purpose and led them to ignore sustainability issues. The triple bottom line (planet, people, and profit) received

[3] Dumping of large volume of shares in the market results in sudden dip in the share price.

only lip service. Companies consumed natural resources recklessly, polluted the environment by dumping wastes and emitting carbons and contributed to climate change, and ignored the impact of their success on society. They never considered internalising the costs of negative externalities caused by their products and processes.

In the 21st century, managers cannot remain oblivious to the impact of their operations on the natural environment and society. Managers now realise that they must place purpose before profit.

The members of Generation Z[4], now customers and employees of companies, are asking companies what their purpose is and what they are doing to address the issues like climate change and degradation of natural resources, which they have inherited because of the way businesses operated starting from the first industrial revolution. In the 21st century, companies will find attracting and retaining talent challenging unless they focus on their environmental and social responsibilities while preserving and creating the company's value. More and more customers are now ready to pay a premium for environment-friendly products and products produced through an environmentally friendly process. They shun companies that demonstrate socially irresponsible and unethical behaviour.

The commitment of countries to the UN's Global Sustainability Goals[5] has created an awareness among companies that their survival would be at stake unless they wisely use and regenerate the limited natural resources and support the government in containing and reducing social and economic inequalities. They are adopting the circular economy principle to minimise the use of natural resources. Governments are framing rules to accelerate the adoption of the circular economy principle. Widening inequality would make it difficult for companies to build a trusting relationship with society. Businesses will find it challenging to scale up their activities due to a lack of purchasing power with most of the population. Similarly, they will find it challenging to find the skills necessary to use new technologies unless the current and future generations are healthy and skillful.

Investors (asset management companies) are asking questions about how the company is dealing with environmental, social, and governance (ESG) issues. For example, In January 2018, Larry Fink, the CEO of BlackRock, the world's largest financial asset manager (with an AUM of $ 8,594,485 million as of December 31, 2022), sent a letter to the CEOs of all the firms in his portfolio saying[6]: "Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must deliver financial performance and show how it contributes positively to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate."

[4] Generation Z refers to those born between 1994 and 2010.
[5] The 2030 Agenda for Sustainable Development, adopted by all United Nations Member States in 2015, provides a shared blueprint for peace and prosperity for people and the planet, now and into the future.
[6] Larry Fink, "A Sense of Purpose," BlackRock, www.blackrock.com/hk/en/insights/larry-fink-ceo-letter.

Henderson observes, "For Fink to suggest that "companies must serve a social purpose" is the rough equivalent of Martin Luther nailing his ninety-five theses to Wittenberg Castle's church door[7].

Knowledge economy

The companies post the first Industrial Revolution till the 20th century were a bunch of tangible assets. They created value using tangible assets (like property, plant and machinery) supported by complementary assets (like product brands and patents). Twenty-first-century corporations are a hive of ideas. In an HBR article, Davenport[8] wrote that 21st-century corporations are driven by data and fueled by knowledge work. Those corporations create value by using knowledge assets[9]. Firms can extend their scope by utilisation of data and information technology. Examples of platform businesses are Facebook, Uber, WhatsApp, Amazon, JioMart, and Twitter. Those businesses revolutionised the economy and generated significant employment.

Competition

Aveni et al. (2010) observe that competitive advantage is not sustainable or enduring but more temporary. This situation has arisen due to fast-paced competitive actions and counter-responses among rivals, disruptions caused by new firms with innovative business models challenging the incumbent players, incumbent players expanding their scope rapidly, and discontinuities in the business environment. For example, Tata Motors sells electric buses through Gross Cost Contract (GCC). The public authority (like the Delhi government) pays the Original Equipment Manufacturers (OEMs) on a per-kilometre basis and supervises their functioning. The OEMs bear all the operation and maintenance costs. This eliminates the need for third-party services for maintaining the buses.

Ideation, innovation and resilience are the mantras for the survival and growth of corporations in the 21st century.

CHALLENGES BEFORE THE TWENTY-FIRST CENTURY CORPORATION

In the twenty-first century, companies are facing new challenges that were never faced by companies earlier. Companies need to address those challenges collectively.

Acquisition and retention of talent

[7] The legend is that on October 31, 1517, Martin Luther, the priest and scholar, approaches the door of the Castle Church in Wittenberg, Germany, and nails a piece of paper to it containing the 95 revolutionary opinions that would begin the Protestant Reformation. However, historians now believe that Martin Luther did not act that dramatically.

[8] Davenport, Thomas H. Google-the 21st century company. Available at: https://hbr.org/2008/04/googlethe-21st-century-company. Extracted on May 18, 2023

[9] Knowledge assets are talent, skills, know-how, know-why, relationships, and machines and networks that embody them)

The new generation of employees' priority is not job security. They look to contribute to a well-defined purpose in an intellectual climate that provides learning opportunities and opportunities to work independently. They look for a brand and reputation that help them to enhance their self-esteem and arrange resources from the external environment. They are loyal not to the company but to the team, communities of practice, and groups of one's occupation. Only those companies that meet the above needs can attract and retain talent.

Davenport (2023) observes that a true 21st-century corporation (like Google) gets new ideas and products from smart and connected employees (millennials and Generation Z). They strongly encourage employees to spend a specified chunk of time on innovation and ensure that there are few barriers to getting innovation into the marketplace. They provide excellent technology and physical environments and create a stimulating intellectual environment at work.

Ethics, equity, and inclusiveness

Companies share the value created by them based on the relative bargaining powers of different stakeholder groups. For example, many Indian companies shy away from paying minimum wages decided by the government to unskilled workers, primarily migrant workers. In some industrial sectors, companies violate the principle of 'equal pay for equal work' while deciding compensation to contract workers who are not on the company's payroll. In the 21st century, stakeholders expect companies to distribute value based on ethics, equity, and inclusiveness. Therefore, 21st-century corporations need to redefine the pathway of value created through the cooperation and coordination between owners of different factors of production. They cannot ignore the issue, as stakeholders expect companies to behave ethically and adopt the principles of equity and inclusiveness.

Data privacy presents an ethical challenge. Companies have access to big data and use data analytics to get relevant information for strategic and tactical decisions. Similarly, they use AI to their benefit. Regulations regarding data privacy lag the pace with which data analytics and AI progress. Therefore, managers often face the ethical dilemma of whether they should use the data in a way that benefits the company but might violate the data privacy norms while complying with the related regulations. It is a serious challenge to managers of the 21st -century corporations.

Till now, companies managed stakeholders based on their power and interest in the company. They ignored the interest of those stakeholders who cannot impact the company's successes but get impacted by that. 21st-century corporations face challenges in identifying stakeholders impacted by the corporation's success (but cannot impact the success) and dealing with them fairly.

Companies must collaborate with archetypes who use similar resources as inputs, including competitors, to fulfil environmental and social responsibilities. This is a challenge for the managers of 21st-century corporations.

REIMAGING CORPORATE GOVERNANCE

It is well established that the CEO is much better informed than the board, as most of the directors in monitoring boards are part-time independent directors. Therefore, the board cannot perform its oversight function effectively. Over the past fifty years, many corporate governance failures (like Enron, WorldCom, Satyam and the global financial crisis of 2008) vindicate the same. Independent directors jump the boat when they detect a signal that the board might capsize shortly. Bar-Hava et al. (2021), observe that the likelihood of resignation increases with a director's reputation and weak future firm performance. They report that results suggest that independent directors' personal reputation concerns might conflict with the shareholders' interests, although the public perception is that they protect non-controlling shareholders' interests. This research result corroborates earlier research findings. Regulators are conscious of the weaknesses of the institution of independent directors. Therefore, worldwide, regulators continuously bring incremental changes to strengthen the institution. However, they so far failed to address the motivation and independence issues.

In reality, the monitoring board is a façade that gives the illusion that the board monitors the CEO. Most boards function as advisory boards in the garb of a monitoring board. Regulators and courts seldom penalise independent directors for corporate governance failures.

In the 21st century, information asymmetry between the CEO and the Board has widened due to the pace of changes in the ecosystem and fleeting competitive advantage resulting in frequent changes in strategies and the business model. Therefore, it is time to consider whether the monitoring board has lived its life.

In a complex business environment, when stakeholders expect the managers to own up the responsibility for the environmental and social impact of their company's success, the CEO needs a capable board to use as a sounding board to validate its assumptions and decisions and seek advice on critical issues. CEO should be allowed to choose her board members whom she can trust. Even now, research shows that individuals nominated by the board for appointment on the board are selected from the network of directors and senior management, as no CEO (controlling shareholder or a professional CEO) would like to have unknown devils (or angels) on the board. Independent directors on the board fulfil the stipulated criteria established by law but are often sympathetic to the incumbent management for right or wrong reasons.

Regulators' initiatives have improved the financial audit quality and enhanced transparency (like sustainability reporting and disclosures under the International Financial Reporting Standards), and the speed with which information is disseminated by stakeholders using social media has given impetus to shareholders and social activism. Investors, employees (millennials and Generation Z), customers and social activists are asking tough questions. The passive monitoring by credit rating agencies and players in the capital market has improved.

It is time that regulators should consider going back to managerial capitalism with an advisory board model. Incremental improvements in the monitoring board system would not work.

References

Bar-Hava, Keren, Sterling Huang, Benjamin Segal, and Dan Segal. "Do independent directors tell the truth, the whole truth, and nothing but the truth when they resign?." Journal of Accounting, Auditing & Finance 36, no. 1 (2021): 3-29.

Birkinshaw, Julian. "How is technological change affecting the nature of the corporation?." Journal of the British Academy 6, no. s1 (2018): 185-214.

Cheffins, Brian R. "Delaware and the transformation of corporate governance." Del. J. Corp. L. 40 (2015): 1.

Henderson, Rebecca. Reimagining Capitalism (p. 10). Penguin Books Ltd. Kindle Edition.

Davenport, Thomas H. Google-the 21st century company. Available at: https://hbr.org/2008/04/googlethe-21st-century-company. Extracted on May 18, 2023

D'Aveni, Richard A., Giovanni Battista Dagnino, and Ken G. Smith. "The age of temporary advantage." Strategic management journal 31, no. 13 (2010): 1371-1385.

****