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Governing through the lens of fairness

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Paul Lee

Risk, actions and behaviours (Part 1)

'Most stakeholders, from the factory floor to the company's owners, would see the purpose of a company as making a profit. It is hard to argue against the importance of profit, however, it is a bit like oxygen – a necessary but not sufficient reason for existing as an organisation.'

Carl Sjostrom and Hans-Kristian Bryn

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Governing through the lens of fairness

Paul Lee argues that businesses need to be governed using a lens of fairness in order to be fully effective in building long-term prosperity beyond the current dreadful, but temporary, circumstances.

Fairness is the issue of our times, and should be used by boards to assess their long-term way forward. People will accept some inequality because we believe that it can be justified as arising from differential work effort, greater frugality or other appropriate sources, but humankind cannot stand very much unfairness. Simply, it feels unjust. Perceived increases in unfairness over the last several years are, I believe, the reason why capitalism is running into disrepute.

In part in response to this questioning of capitalism, companies around the world are being asked to govern with their stakeholders more fully in mind. In the US, the Business Roundtable (BRT) has purported to rewrite the purpose of companies so that they direct value to stakeholders generally, not merely focus on value creation for shareholders. In the UK, companies have been coming to terms with new obligations to report regarding directors' duties to consider the interests of stakeholders under s 172 of the Companies Act 2006. European and Japanese companies would highlight that they have always recognised the need to consider stakeholder interests – particularly those of employees, who in many countries have a right to board representation. Investors too have pressed for a richer understanding of the role of companies in society.

And that was before the current crisis brought societal interests further to the forefront of people's minds.

However, whether companies actually rise to the challenge of delivering for stakeholders is yet to be seen. Certainly, some of those who signed the BRT statement show no sign of actually delivering on it. For example, Amazon's Jeff Bezos, believed to be the world's richest man, was a prominent signatory of the BRT statement. Yet within days, his organisation's Whole Foods Market was removing the right to healthcare of some part-time employees. More recently, rather than itself providing more flexibility, the firm has encouraged its staff to donate their right to paid time off to colleagues who become ill due to Covid-19. Neither action seems to deliver on the BRT commitment to 'Investing in our employees. This starts with compensating them fairly and providing important benefits'.

Indeed, how companies respond to the coronavirus crisis seems set to be a defining moment not just for each individual company but also for capitalism itself. It is also a moment when companies and their leaders can demonstrate real leadership and deliver on responsibilities to their stakeholders. Using the lens of fairness to decide how to do so should be the way forward. It's a demanding metric, it requires judgement and good sense to balance fairly the interests of multiple interested parties, but the role of boards is to apply judgement and good sense; this is an opportunity for boards to help identify the way forwards for their businesses.

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Some argue that the current crisis means companies can worry only about their finances and should ignore these broader societal issues. Certainly, every business will naturally be considering how it can survive financially. But every business will also need to be considering how it can prosper once we are beyond the current crisis. That will require the maintenance of good relations with all stakeholders, and so the retention of their goodwill in the near term. Consumers, employees and investors are already watching to see how companies respond.

It seems unlikely to be a coincidence that the two UK companies that have seemed most clumsy in their response to Covid-19 crisis, JD Wetherspoon and Frasers (the latter better known under its former and main trading name Sports Direct), are both led by founders – Tim Martin and Mike Ashley respectively – who are used to operating without first needing to account to their boards or being vigorously challenged by their non-executive directors. Following public and political criticism, both are now working to reverse their previous stances and apologise. Governance, it is clear, matters.

To be fully effective in building long-term prosperity, this challenge from directors and this effective governance needs to operate using a lens of fairness. What might this mean in practice? Here are some potential considerations for thoughtful, forward-looking boards:

Workforce
This term better captures the devolved and outsourced model of resourcing used by many companies. The obligation to fairness does not only apply to employees. Corporations are legal creations and can only operate through people. They therefore do themselves a disservice if they fail to treat their workforce as a whole fairly – such a workforce will not generate the value that a well-treated and well-motivated one would.

Feature

Fairness questions apply to workers within the corporate supply chain. There will always be practical limits to the depth of insight into supply chain businesses that company boards can have. Yet that does not mean questions of fairness can be wholly ignored; certainly, it is hard to justify ignorance of poor treatment of supply chain workers if a company does not pay its suppliers enough to facilitate good treatment.

Environment
Taking into consideration the externalised costs of business is only fair. Generating profit through imposing an unfair burden on others can make short-term economic sense but it is no long-term strategy. Costs cannot be externalised forever, and a business that is profitable only because of externalisation risks facing its profitability disappearing overnight when regulation changes. Companies would be much wiser to consider how to minimise their negative external impacts and build their business models and expected profitability appropriately. If they risk being outcompeted by businesses that are less environmentally aware then they should press for fair regulation that enables competition on a basis that does not incentivise systemic damage. These considerations are most immediate in respect of climate change and the need fairly to move towards a carbon-constrained world, but the concepts extend across broader environmental concerns.

> ‘There is a growing expectation that responsible businesses need to pay a fair level of taxation – though what is “fair” is still a matter of discussion.’

Suppliers
Suppliers of public companies are typically smaller and may often be dependent on the goodwill and business of the larger company. It is for this reason that the UK and other governments have required transparency about supplier payment terms. The requirement is that such terms should be limited to a few months, and the expectation is that disclosure should support enforcement. In spite of this, too many companies extend supplier terms, sometimes using esoteric supply chain finance structures to do so, flattering their own apparent working capital efficiency in some macho display for their financiers. Yet the simple truth is that the more stable larger company will tend to have a lower cost of capital than the smaller more dependent one, so by pushing financing costs onto suppliers, companies are acting in an uneconomic way. This is evidenced by the fact that some supply chain finance allows suppliers to benefit from the purchaser’s better credit rating. As well as being fair, it would be economically more rational to pay suppliers quickly because that would avoid implicitly paying the price of their higher cost of capital.

Customers
No business that mistreats its customers can prosper in the long run. Boards thus need to ensure that customers are treated fairly and well. At its heart, this requires a fair price for the goods or services that are provided, so that the value the business provides to customers is clear to them. It means not exploiting customer inertia, and respecting fair market competition. It means investing in frontline staff and building a culture that genuinely treats customers well and fairly. Many companies talk about putting their customers first; fewer actually achieve it.

Tax
Minimising the corporate tax burden used to be seen as a duty by many managers, a way through which the quality of the finance team was assessed. But things are rather less clear these days. Many governments are working to end this corporate mindset, global regulations are shifting, and the need for national tax receipts is only increasing. There is a growing expectation that responsible businesses need to pay a fair level of taxation – though what is ‘fair’ is still a matter of discussion. As the debate about the tech giants proves, if there is a wide discrepancy between profitability – or in many cases revenues – and tax burden, increasing questions are asked. Companies need to be thoughtful and transparent, and get ahead of this trend by themselves considering what is fair.

Investors

Investors also must rise to the challenge of fairness, not least to reinforce the efforts of corporate boards to be fair. A recognition that investors will prosper only where companies treat other stakeholders fairly would help – as would a recognition that this also needs to occur within a more broadly fair financial system. Investors working to generate and support fairness on both these micro- and macro-levels will be serving their clients more fully and effectively. They will be treating their own customers with fairness.

They say that adversity brings out the best in people. I’m not sure that we’re currently seeing evidence of that across society and the corporate world. Rather, what seems to be happening is people are tending to revert to type. Good governance can help ensure that the type to which we revert is a thoughtful and fair one. Good governance using the lens of fairness will give us all the best chance to build businesses that will effectively deliver for all once we are beyond the current dreadful but temporary circumstances.

Paul Lee is an independent adviser to investors, companies and others on governance and ESG, having formerly worked at Hermes EOS, the NAPF and Aberdeen Asset Management. He blogs on these issues at www.senseoffairness.blog

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Conclusions

In this article, we have started to explore an integrated approach to incorporating risk, actions and behaviours in strategy planning and performance evaluation. We have argued that current models and approaches fall short in terms of recognising the interrelationship and interdependencies that need to be built in and propose a broader approach to add essential context. However, it is also key to integrate risk management and risk appetite into the approach. In the second part of this article, to follow next month, we will expand on these topics to further round the perspective and complete the approach that we have put forward.

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