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INTERVIEW WITH PHIL ARMSTRONG

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Phil Armstrong has wide experience of corporate governance starting with large listed companies in South Africa where he was closely associated with the King Reports, notably King II. He has held senior positions with the International Finance Corporation and has been adviser on governance to the Commonwealth Association. Currently he is director for governance at the Gavi Alliance in Geneva.

In this wide-ranging interview he talks to Peter Montagnon about why companies need to work on their relations with society from which they derive their licence to operate. This need applies to both listed and unlisted companies in a world where news travels fast often prompting an instant response from corporate activists. Viewed from this perspective, there is a big difference between corporate responsibility and corporate philanthropy.

Why should companies worry about their relations with society?

Relations with society will determine business success in one way or another. Generally in this very much more transparent world people don't want to think they are being exploited by companies. So it's the old adage about having a licence to operate.

However, the question of what sort of relations depends on the type of business you are in. With banks there are questions of integrity and fair treatment of customers. It's important for a bank to have a measure of trust in the broader community. If you're a large multinational, people need to trust your products and think they're getting a fair deal. It may be different for small IT companies that perhaps have a targeted client, but even they may well be a supplier to a larger company that can be affected by its relations with society – you only have to look at Facebook and Google.

Is this true for privately and state-owned companies just as much as for listed ones?

State-owned companies very rarely get this right because political considerations determine the way they operate. That said, I don't see why there should be a distinction. At the end of the day, it's the way the company is perceived by the public which matters. Privately-owned companies are not necessarily immune and their public image can still face exposure to the media and civil society activists.

Yes but surely family-owned companies start out with the strong values represented by the founder....

At the beginning of their lives, family-owned companies have a better understanding of community and society, because they started life in a community to which they were attached and by which the founding family wanted to be held in respect and had a strong relationship. Later they grow and move away from this and as new generations succeed they take on a broader perspective and their focus may become a lot more economic. Yet the decisions and choices made in the board and by management are still an investment in the long term, probably more so than professionally managed companies. You see that in Latin America, for example, where family businesses make up a strong component of the corporate sector.

So what exactly do shareholders and stakeholders expect?

Of course, there are different types of investor – hedge funds, private equity, asset managers and so on. They all have different approaches, but the general point is that the days of investing in a company and holding for the long term seem to be something of the past and you have this large churn rate. The point is that shareholders are still looking at economic return. They talk about stakeholder issues but I'm not fully convinced.

Yet stakeholders do put pressure on them....

Yes investors do need to be seen to be playing a role in this process. They are themselves increasingly coming under scrutiny. They are being told that they have the power and the authority to make companies do what they're supposed to and the stewardship code movement in some ways demonstrates this point. The very large investor firms have a degree of self-interest in responding. At the end of the day we shouldn't complain about this if it produces a good outcome.

So what do companies have to do?

Companies have to respond. Rules and regulations don't necessarily determine behavior. Shareholders, the media, civil society are all part of the process that does. Society is becoming much more vocal. Technology has created huge access to information which is available in a split second. That gives society a much greater insight, opinion and influence on how things are dealt with. Companies, boards and investors can't ignore that.

Thirty, forty or fifty years ago the Vale disaster in Brazil would have been an issue only for the company, national regulators and local community. Now it's headline news all over the world. This quickly leads active engagement and coalitions between the local community and local and international activists. It happens much more quickly than it used to and can become very difficult to manage.

Who are boards accountable to in all this?

The board is accountable to the company. Directors display this through their reporting as required by the law and regulations and that then starts taking you into the realm of governance and governance standards. Directors have to understand that they are appointed to ensure the continuing success of the company and that they are therefore accountable to the company.

There can be conflicting choices. You have to start looking at what makes a successful business. This is not solely a question of economic return. If you get a bad reputation, people won't buy your products.

I can understand why this process holds good in developed markets, but surely the reputation risk you describe is less in emerging markets.

Western society consumers are much more sensitive to corporate conduct. In the emerging markets it's much less developed, though you do see it in Brazil and South Africa. Elsewhere it's not so widespread, partly sometimes because the media is inhibited from challenge, but even in China you are starting to see a sense of increasing consumer sensitivity with the growth of the middle classes, who are looking for a high quality of life. In China, India and Indonesia the new middle classes are millennials, who are increasingly much more sensitive and socially aware.

The game changes for companies as they expand internationally, especially into Western markets, even if they are not facing civil society pressure at home.

In some markets people consider corporate **philanthropy important. Is this different from corporate responsibility and is it a substitute for it?**

Corporate philanthropy can be an important tradition founded on deeply held social, moral and religious conviction. But this is not always the case, and it can simply become another way of confirming a licence to operate. We need to be careful to distinguish between philanthropy that supports good causes such as the social benefits funded by Tata in India as an example and companies that often use it to favour certain vested interests and seek to buy public respectability.

We also have to look at history. In the early 20th century you saw the development of large corporations in the US. The "robber barons" who ran them were big philanthropists but they were buying respectability.

This has evolved into something much more sophisticated over the course of the 20th century in a society that has become much more demanding in its expectations of companies and those who lead them. Companies operate in a much more sophisticated environment and it is incumbent on the board and management to be very clear about the scope of interests in its activities and how to respond. I should add that philanthropy does not equal social awareness.

How can boards tell if the company is getting its relationships with society right?

It's not just a question of whether your products are rolling off the shelf. You have to be aware of what's being said out there in the market and which is not coming through in internal memos. Consumer surveys are one source, also what investors say. Essentially boards should also be aware of what's being said on social media and use the many tools it has at its disposal to trace public opinion and identify communication gaps and potential risks, especially reputational, among other things.

And when social media has got it wrong?

Companies can't just sit there and say it's all a lie. Part of their risk strategy has to be about how they manage misleading reports. You have to have a communications strategy that understands the risks of very visible social media posts and the extent of mischief around that and misinformation.

Surely employees are a very important stakeholder.

Yes, very important. In these days when you have massive disparities of income between the lowest paid and senior executives, these things get picked up. Employees want to feel they're not being exploited. That's another reputational issue for the management of the company and for the company itself. It's important to civil society and to investors, but it's also important to the welfare of employees and their communities. That's where the more traditional family companies are often successful given their close affinity with the communities from where they originate.

Employee sentiment surveys can be an important source of information, especially if they are carried out independently and can highlight disparities between what the company believes about itself and what employees may themselves believe. It takes a certain measure of courage. Management may not be very comfortable, and it can be even more difficult in family businesses, but boards need to be clear about the importance. Satisfied employees are an important window on the company.

Are all these social issues particularly important for companies which aspire to public listing?

In the old days that was the big driver. For example, the need for higher standards of governance was why the Novo Mercado was created in Brazil. This is still true today but nowadays it's more about the fact that we live in a global economy where information and events are no longer a matter only of local interest and can become a matter of global interest with potentially significant consequences. The struggle that the banking sector has had in redeeming its credibility since the financial crisis in 2008 illustrates the challenges when the school of public opinion turns against you.