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# CLOUDS OF CHANGE

Charles Handy, like Peter Drucker, has always sought to identify the 'clouds of change' threatening society. Here he identifies one such possible threat – the dysfunctional behaviour of our large corporations

Peter Drucker has been a big influence in my life and work. I valued hugely my occasional meetings with him and my bookshelves groan under the weight of his many books.

One of his skills was his ability to spot the clouds of change in society while they were still far off on the horizon, long before the thunderstorm broke. I try to emulate his skill in my own work so that people can better prepare themselves for new futures.

One of the clouds on the horizon that currently worries me is the behaviour and the future of large corporations. Much though I admire and encourage the entrepreneurs of all sorts who are our futures and much though I enjoy my contacts with small organisations and family businesses, the fact is that the public corporations are the great elephants of our economies.

We ride on their backs. They provide the greater part of the new wealth of society as well as the bulk of the jobs, directly or indirectly. If they falter or do not live up to their responsibilities, we all suffer.

So when I see these great beasts getting fewer in number, particularly in America, as well as older, fatter and greedier I start to worry. They have served us well over the last 70 years but success can be the enemy of progress, blinding one to the need to change.

The Greeks of old called it *hubris*, which I was taught to translate as overweening pride, that which comes before a fall, the arrogance that infuriates the gods and brings down their wrath.

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The basic facts suggest that the corporate fall may be nearer than we know. A recent Brookings Institute research report found that firms aged 16 or older now represented 34% of all economic activity in the US, up 50% in 20 years. They are also lasting less long with fewer new entrants coming along, which bodes ill for the future. There are now 50% fewer publicly listed companies in America than there were 15 years ago; nor is it very different in the rest of the world. Business, the Brookings Report concludes, is getting old and fat.

Commenting on the report, the journalist Simon Caulkin says that "the quoted company, the engine of capitalism for the last 150 years is beginning to look like an endangered species". That should give us all cause for concern. There are more worries.

Those elderly elephants may be increasingly in danger of falling foul of what St Augustine called the great sin, that of being so "turned in on oneself" that you forget your greater purpose. This charge could be levelled against many of the boards of those companies who have been indulging in an orgy of share buybacks.

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William Lazonik, writing in the *Harvard Business Review* of September 2014, points out that the 449 companies in the S&P 500 index that were publicly listed from 2003 to 2012 used 54% of their earnings, a total of a colossal $2.4 trillion, to buy back their own stock in the open market. With dividends taking up a further 37% only a paltry 9% of earnings were left for reinvestment.

There are sometimes technical reasons to buy back stock, to compensate, for instance, for any temporary lowering of the share price when stock options are exercised. But the main reason has to be either that the board members have run out of ideas of how to spend their earnings on new projects or, quite simply, need to boost the value of their own stocks or options. Why, one might ask, would they need to do that given that the average annual take-home pay of the chief executives of those companies was $30 million?

It is only when you realise that 83% per cent of that pay is in the form of stock grants or options that the reason becomes clear, the buybacks are needed to preserve the underlying value of their pay packets. To put it bluntly, those directors are pocketing the seed corn of future generations and nobody is noticing or, if they are, nobody is caring. Am I not right to be worried?

Of course there are exceptions. Not all boards are so self-interested, but the exceptions are just that, exceptions. We need many more of them to set a new tone. Lazonick, who is professor of economics at the University of Massachusetts Lowell and co-director of its Center for Industrial Competitiveness, comments that from the end of the second world war until the late 1970s the prevailing orthodoxy in the boardrooms of the world was to *retain and reinvest* ones earnings. Now it is *downsize and distribute*, to ourselves and our supportive shareholders. We have moved from value creation to value extraction. He is right.

When I started work in 1956 in the Royal Dutch Shell Group I remember only too well the opening briefing that we fledgling executives received from one of the managing directors in our first week of training: "We are," he said, "an important part of the energy supply system of the world. Our job is to supply our customers with their needs and to secure the long-term future of the business. We need to make substantial profit in order to finance that future. We also pay a rent to our shareholders,

in the form of dividends, for the use of their money, a rent that includes a risk premium, although in our case that premium is low and we want to keep it that way."

There were no stock options or bonuses on offer then. We were all paid a rate for the job. You got more if you were promoted. The top management was well paid but not excessively so. The shareholders were bystanders, seen more as an indicator of public approval or disapproval, our business thermometer if you like, than as real investors since all new money had to come from our own earnings. So what was it that changed in the 1970s?

In 1970 Milton Friedman declared that the purpose of a business was the maximising of shareholder value, "the business of business is business".

This was developed by two ex-colleagues, Michael Jensen and William Meckling, into Agency Theory, which argued that the directors and managers were in no way the owners of the business, they were only the agents of the real owners, the shareholders.

It was well intended; it gave the business a clear objective and it implied that if the business made its owners rich this would in due course enrich society. All would be well for all. As it turned out all would only be well for some.

Directors and senior managers were quick to claim that if they were working for the shareholders, it was only sensible that their rewards should tie in with those of the shareholders, creating a community of interest. The world of stock options and bonuses tied to share prices came into being, and a new story began.

Perhaps John Maynard Keynes was right when he said that "Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of some years past."

Whatever the cause, the whole culture and *raison d'etre* of business changed from then on. The money men were in charge, supported, I am sorry to say, by enthusiastic business schools who now had one simple yardstick for success which they could pass on to their eager students.

Forty years later it is clear that the new formula has not worked for most. Not for society as a whole, which has had to live through two recessions and a financial crash; not for most individuals given that the median salary in both America and the UK has remained constant in real terms for the last 30 years; and, intriguingly, not even for the shareholders, the focus of the new philosophy. The rate of return on US capital in 2011 was one-quarter of what it was in 1965 and Roger Martin, former Dean of the Rotman School of Management at the University of Toronto, has calculated that the overall returns to shareholders in the 40 years before 1970 was larger than in the 40 years after.

It is odd, in hindsight, that nobody challenged the idea that a business should be seen as a piece of property to be owned by its financiers. That might have made sense to the Victorian mill owner in his mansion looking down at the mill he had built and then hired labour to work the machinery. But now the machinery and the buildings serve the workers not the other way round.

A company is more truthfully a community, a community of companions with a common purpose and no one can legally or even metaphorically own the people of a community. That would be slavery. In any case those shareholders are very seldom the original contributors of finance, who long ago passed on their right to the hoped for stream of dividends to a succession of others who can now be only passive onlookers, betting on their chosen stocks.

Their only rights are to elect the directors or to vote if the directors want to sell the company to another. Even if they were allowed to challenge the strategy of the company they are unlikely to have the competence to do so. Responsible owners they cannot be.

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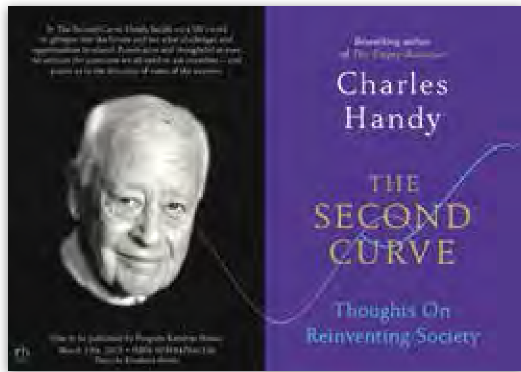
*Is it not time to return to the idea of a business as a responsible community that pays due heed to all its constituents, one whose core purpose must be to seek immortality through continuous self-improvement and investment?*




**Above**
In *The Seond Curve*, Handy builds on a life's work to glimpse into the future and what challenges and opportunities lie ahead. Provacative and thoughtful as ever, he sets out the questions we all need to ask ourselves – and points us in the direction of some of the answers.

The shareholder value doctrine, as it came to be labelled, is even wrong in law. As the leading legal expert Professor Lynn Stout, the Distinguished Professor of Corporate & Business Law at the Cornell Law School in the US, has shown, a company is an independent entity, it belongs to no one. The directors of a company have no reason to give preference to the shareholders. They are instead responsible to the company as a whole for its longer-term survival. They cannot, in law, give priority to any one group of stakeholders, be they shareholders or managers or workers. This is not peculiar to America.

Company Law in most other countries is similar. In Germany, the requirement that a business has a social as well as a financial purpose is written into their constitution, at the instigation, as it happened, of the Allied occupying powers who neglected to do likewise back home.

I see further worries looming. Some of those elephants are growing so large and so global that they are becoming beyond the scope of governments to control, since they can choose to domicile themselves wherever the tax regime is most favourable.

Nor are some of them subject to the usual disciplines of the regulators. How do anti-trust regulations apply when the dominant firm has no competitors because in the internet businesses the winner takes all and leaves everyone else stranded? Even the normal market constraints will not work in these situations. How does one compete with a business like Amazon that seeks to be the largest shop on the planet and feels no need to make a profit en route?

So, I ask, can we safely trust these huge, ageing, bloated and selfish organisations with our futures? Is it not time to return to the idea of a business as a responsible community that pays due heed to all its constituents, one whose core purpose must be to seek immortality through continuous self-improvement and investment?

I have concentrated on America where market capitalism has been most developed but the same trend is discernible in other economies. Continental Europe is protected to a degree by its more rigorous governance structures and its greater reliance on the banks as the longer-term financiers but even here the temptations and pressures of the shareholder value model can be felt. Capitalism is a wonderful social invention, but like all inventions it can turn on its creators if it is not used with care.

I have no easy or immediate solutions. I am not sure that any fiddling with the legal structures of a company will work. What we need is what the Drucker Forum in Vienna is calling for: "A Great Transformation", particularly in the attitudes and examples of those at the top of our great businesses. They need to be reminded that their responsibilities go way beyond themselves and their financial friends, that they cannot rely on the market to keep them fair and honest, and that their people are more than human resources, they are their community and not their property.

It is vital, in short, to all our futures that our business leaders remember St Augustine's warning that to be lost in oneself, to focus on means rather than greater ends, is a misuse of your talents, a waste and a sin, and that it applies to organisations just as much as it does to individuals.

*This article is an edited version of a presentation by Professor Charles Handy to the European Forum Alpbach in August 2014.*

**ABOUT THE AUTHOR**

*Charles Handy has moved through careers as an oil executive, a business school professor and BBC broadcasting and is widely acknowledged as a world leader in management thinking. His prolific authorship includes books which are standard works on bookshelves worldwide, including his memoir,* Myself and Other More Important Matters, *as well as* The Elephant and the Flea, *and* The Empty Raincoat. *His new book,* The Second Curve *will be published in March 2015. His concern for society and individuals as the world faces the changes that technology, demography and economics bring, has been awarded with a dozen doctorates or fellowships, numerous prizes, and a CBE.*