Corporate governance and trust in business

Corporate governance and trust in business: A matter of balance

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Abstract. The recent prominence of corporate governance was sparked by a decline in trust in business that followed on some spectacular corporate scandals. There is an expectation that adherence to the standards of good corporate governance can restore trust in business. This article examines the link between corporate governance and trust and finds that at least theoretically there is a positive correlation between corporate governance and trust in business. It is however argued that not any form or model of corporate governance will enhance trust in business. An appropriate balance needs to be struck between a number of polarities that exist in the corporate governance reform agenda. Three such polarities are explored and the nature of the balance that needs to be found with regard to each of these sets of polarities is outlined.

Key words: Trust, corporate governance, business ethics, corporate integrity, governance of ethics

Introduction

That trust in business corporations is on the decline is beyond dispute. It was made very visible in the 1999 'Battle of Seattle' where disgruntled opponents of global capitalism tried to disrupt the World Trade Organisation (WTO) meeting. Since then several surveys have added further testimony to the reality of this phenomenon of ailing trust in business. A Gallup International poll in November 2002 revealed that the levels of trust in business corporations are very low. Since then a global opinion poll conducted on behalf of the World Economic Forum (WEF, 2003) in twenty countries found that the trust in business leaders is even lower than trust in the institutions they are leading. Only 33% of people surveyed, indicated that they had either 'a lot' or 'some trust' in business leaders. Business leaders also enjoyed considerably less trust than leaders of NGO's, the UN and spiritual leaders. These low levels of trust are clearly reflected in the 2003 Zogby Poll of college seniors where 56% of respondents agreed with the proposition that: "the only real difference between executives at Enron and those of other big companies, is that those at Enron got caught" (Goodpaster, 2004:1).

Business leaders are obviously scorched by these findings and some do not hesitate to acknowledge that rebuilding trust in their institutions and themselves has to become one of their major challenges. Ewald Kist, CEO of the ING Group said: "Restoring trust is the principal challenge that leaders of big companies have to face" (Kist, 2002:1). The fact the theme of the 2003 World Economic Forum meeting in Davos was '*Building Trust during a Time of Global Uncertainty and Mistrust*' further illustrates this concern.

The surge in prominence of corporate governance witnessed over the last decade and a half can be directly related to declining trust in business. Often corporate governance reforms are a direct response to business scandals. The Cadbury Report on corporate governance in the UK for example was a direct response to the Maxwell scandal in that part of the world, while the US Sarbanes-Oxley act was prompted by the spectacular failure of ENRON and Worldcom. Also the First King Report in South Africa can be seen as a response to the distrust in business at the time when a new political dispensation was emerging in South Africa and when business stood accused of collaborating with and upholding the apartheid dispensation.

There clearly is an expectation that adherence to standards of good corporate governance can bolster trust in business (Payne, 2004:6). This point is well illustrated in the fact that the report on corporate governance reforms for MCI (the former WorldCom) that was produced after the scandal that ruined the corporation's reputation, is titled: "Restoring Trust" (Breeden, 2003). The objective of this article is first of all to determine whether such an expectation is realistic. Can adherence to good corporate governance indeed result in trust in corporations being enhanced? It will be argued that such an expectation is not misplaced. It will however also be argued that an appropriate balance need to be struck with regard to a number of polarities that are inherent in the corporate governance reform agenda. Unless such a balance is struck, the potential of corporate governance to bolster trust in business will not be realised. It is however first imperative to understand the respective natures of trust and corporate governance as well as the link between them.

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Trust

The phenomenon of trust received unprecedented attention over the last decade. Central to the new generation of definitions of trust are the concepts 'vulnerable' and 'reliance' (Soule, 1998:261). *Trust* revolves around the propensity of people to take the risk of making themselves vulnerable by relying on others for the protection or enhancement of their interests. The seminal work done by Mayer, Davis and Schoorman (1995) made an important contribution to the new generation of trust definitions. They defined trust as: "the willingness of a party to be vulnerable to the actions of another party based on the expectation that the other will perform a particular action important to the trustor, irrespective of the ability to monitor or control that other party" (712).

The quality of trust relations can vary both in terms of duration and intensity. Some trust relations are merely temporary, whilst others are more enduring. Equally in terms of intensity, some trust relations might be superficial whilst others are profound. These variations in trust have lead to a number of different kinds of trust being distinguished with regard to corporations. Brenkert (1998) for example distinguished between "Basic Trust, Guarded Trust and Extended Trust (303).

Basic trust is a kind of trust that has to be shared by all stakeholders of corporations. This is the kind of trust that underlies our social practices and that provides the necessary condition for social interaction. An example of basic trust is my trust in the banking system. When I enter a bank I assume that when I deposit my money, it will be safe in the bank and that I will have access to my money in the future. It reassures both the business and its stakeholders that they will not be taken advantage of. Individuals and institutions can of course abuse this basic trust and when this happens, the legitimacy of such practices or institutions are called into question.

Guarded trust applies specifically to situations where people enter into contractual relationships. No contractual agreement can ever cover all the possibilities that might arise in a contractual relationship. Certain areas of uncertainty and thus vulnerability to either or both of the contractual parties will remain. In order to cope with these deficiencies in contractual relationships, trust is required to bridge such unforeseen or non-articulated aspects that might arise in the lifespan of a contractual agreement.

Extended trust emerges when parties enter into relationships that go beyond or without the protection afforded by contracts. In such extended trust relationships, one or more parties in the trust relationship make themselves vulnerable by relying on the other party. Although this leads to higher risks, it can also afford either party more freedom in the absence of the constraints that typically accompany contractual relationships.

Trustworthiness

A crucial question with regard to trust is the question whether the level of trust between two parties can be changed. This question introduces the concept 'trustworthiness' (Bews & Rossouw, 2002a:150). Where trust is an action taken by a trustor (the party who trusts), trustworthiness is a characteristic of a trustee (the party who is trusted). It is an evaluation of the quality of a party as a trustee. A trustworthy party is one who is judged to be worthy of the trust invested in it (Brenkert, 1998:300; Brien, 1998:399). The level of trust of a trustor in a trustee is determined by the perception that the trustor has of the trustworthiness of a trustee. Changes in levels of trust thus depend on the perception of the trustworthiness of the trustee.

Studies on trustworthiness have revealed that a person's trustworthiness depends upon a number of characteristics. Those factors that determine how trustworthy a trustee is perceived by a potential trustor are referred to as *facilitators* (characteristics or antecedents) of trustworthiness. Research on trustworthiness highlights a number of core facilitators of trustworthiness, consisting of factors such as openness, competency, integrity, benevolence and reputation (cf. Bews, 2000; Becerra & Huemer, 2002:80). Parties who display these characteristics are judged to be more trustworthy than those who lack these qualities. This suggests that trustworthiness is a quality that can be developed and enhanced (Bews & Rossouw, 2002b; Verstegen Ryan & Buchholtz, 2001:183).

Trust and ethics

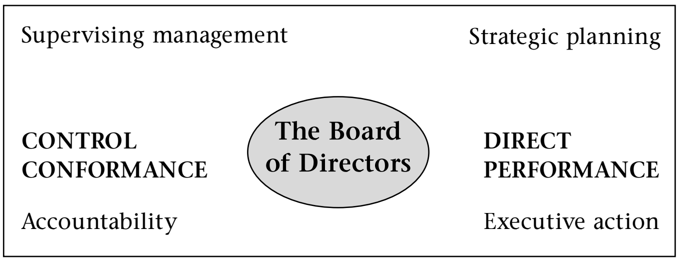
There is often a perception that trust is ethical in nature. The relation between trust and ethics is however ambiguous. In trust relationships the trustee is expected to respond positively to the objectives that the trustor has entrusted her or him with. The honouring of trust means that the trustee assists the trustor in attaining her or his goals. This creates the impression that the trustee behaves morally in respecting the interests of the trustor. The problem, however, is that there are no constraints on the objectives of the trustor. If the goals of the trustor are moral goals, then one can indeed agree that honouring trust is moral behaviour. If the trustor's goals are immoral, however, the honouring of trust does not amount to ethical behaviour. Trust is thus not moral where the interests of the trusting parties are advanced to the detriment of those outside that relationship. A case of fraud illustrates the point. Should a person involve another in defrauding the organization they both work for, they both stand to benefit from this trusting relationship. Their actions will, however, be detrimental to the interests of everyone else in that organization, and so their trust relationship cannot be considered moral.

This demonstrates the moral ambiguity of trust. Trust can be both moral and immoral. When trust is used to exclude third parties or to disadvantage third parties, it can constitute moral abuse of trust. This is the case when it is used to protect the interests of an in-group. Nepotism, cronyism, favouritism, racism, and sexism are all examples of trust used to exclude third parties.

Corporate governance

The most widely used definition of corporate governance is the one that was introduced by the Cadbury Report on Corporate Governance in the UK which defined it as: "the system by which a company is directed and controlled" (Smerdon, 1998:1). The responsibility for corporate governance lies with the board of directors of a corporation and consists of two main functions: the direction and control of the company. The board of directors is firstly responsible for determining the strategic direction and hence the ultimate performance of the company. (Reinecke, 1996:11). Secondly, the board of directors is responsible for the control of the company. This is referred to as their conformance responsibility. It entails supervising managers to ensure that they carry out the board's strategic decisions effectively as well as doing account to stakeholders for the way in which the company is governed.

These two responsibilities of the board of directors are demonstrated in the figure below:



Adapted from Garrett (2003)

The ethics of governance

Corporate governance has a distinct ethical nature. In directing and controlling the affairs of a company, the board has to ensure that it takes due care of the interests of the stakeholders of the company. This ethical nature of governance is reflected in what has become known as the four cardinal values of good governance. These values are fairness, accountability, responsibility and transparency (Rossouw & Van Vuuren, 2004:195-196). Fairness requires that the board has to ensure that their decisions and actions take into consideration the interests of all stakeholders of the company. Accountability implies that the board should be willing and able to explain their decisions and actions to stakeholders affected by the company and give account to those stakeholders who require the board to do so. Responsibility requires of the board to take due care of the assets entrusted to them and to take corrective actions to keep the company on its strategic path. Finally the value of transparency requires the board to disclose information to stakeholders in a manner that enables them to make a meaningful analysis of the company's actions. The typical arrangements and processes that constitute a corporate governance system, such as board compilation and functioning, risk management and auditing, disclosure requirements, etc., are all merely means to ensure that the corporation will act in a manner that is fair, accountable, responsible and transparent. Corporate governance is thus intended to ensure that a sound balance is struck between the interests of the company and those who are affected by the actions of the company. It is exactly this ethical foundation of corporate governance that gives rise to the hope that corporate governance will contribute towards an incline in trust in business.

Trust and corporate governance

Given the above exposition on the respective natures of trust and corporate governance, the question arises whether corporate governance has the potential of enhancing the trustworthiness of corporations and their leaders. In the light of the facilitators of trustworthiness identified above, the question more specifically revolves around the contribution that adherence to the principles and standards of good corporate governance can make towards the perceptions that trustors have of the openness, competency, integrity, benevolence and reputation of corporations and their leaders.

The principles and standards of corporate governance do emphasise factors that potentially might have a positive bearing on these facilitators of trustworthiness. Perceptions of openness can for example be enhanced by regular and sufficient disclosure of relevant information to stakeholders. Perceptions of competency can be bolstered through proper board compilation, the monitoring of board effectiveness and the regular review of board performance. The emphasis on ethical values and consistent adherence thereto (organisational integrity) in corporate governance can improve perceptions that stakeholders have of the integrity of corporations and their leaders. Perceptions of benevolence can be enhanced through corporate social responsibility or corporate citizenship that is often central to corporate governance discourse. Reputation is also a key concern in corporate governance as the protection of the symbolic assets (reputation) of a corporation is one of the driving forces behind corporate governance reform. Thus at least in theory a positive correlation between trust and corporate governance can be established.

Although a positive correlation between corporate governance and trust can be established, it will be argued in the remainder of this article that corporate governance will only result in increased trust, if an appropriate balance can be struck with regard to a number of polarities that exist within the corporate governance reform agenda. These polarities are the tension between exclusive and inclusive models of governance, performance and conformance as well as between mandatory and self-regulatory regimes of governance. These three polarities will now be discussed.

Exclusive vs. inclusive models of governance

A vital issue in the quest to restore trust through corporate governance revolves around the question about whose trust in business should be improved. Should the focus be on the trust of certain privileged categories of shareholders, such as institutional investors or majority shareholders, or should it be on the trust of all shareholders, including minority shareholders? Or should it go beyond shareholders towards the trust of all stakeholders, i.e. those who can affect or are affected by the corporation (Freeman & Evan, 1993:79)?

In the *exclusive* model of governance directors are regarded as the agents of shareholders and in that capacity they have to direct and control the company to the benefit of the shareholders. Although the four pillars of corporate governance, namely fairness, accountability, responsibility and transparency still apply, they are restricted in their application to shareholders. They do not apply to other stakeholders of the business. Thus the ethical responsibility of directors is limited to shareholders (Collier & Roberts, 2001:68).

Inclusive models of corporate governance emphasise that corporations should not only be accountable to their shareholders, but also have responsibilities to their other stakeholders. Such inclusive models of corporate governance emphasise the need to regularly engage with stakeholders to determine which aspects of corporate performance are material to them. The issues that matter to the non-shareholding stakeholders of a corporation are likely to include more than the mere economic performance of the corporation. They are likely to demand information also on the social and environmental performance of the company.

The same demand for triple bottom-line (or sustainability) reporting and disclosure can however also arise from institutional and individual investors who believe that sustainable economic performance requires good social and environmental performance. The difference however, lies in the fact that in the latter case the consideration of the interests of non-shareholding stakeholder has only instrumental or strategic value and no inherent value. Should shareholders not be negatively affected by the neglect of the interests of other stakeholders, then there would be no obligation on the board of directors to consider the interests of other stakeholders. Exclusive models of corporate governance are therefore only likely to inspire more trust in shareholders, but not in other stakeholders. As this trust relationship excludes other stakeholders, or might be to the detriment of other stakeholders, it cannot be considered a moral form of trust. Collier and Roberts (2001) are undoubtedly correct when they say: “The only ethical imperative at work here is a Friedmanesque dictum to pursue profit maximization” (68).

In the inclusive model of governance, the interests of all stakeholders enjoy a normative status, and not merely instrumental status (cf. Goodpaster, 1993). Companies in countries that adhere to an inclusive model of corporate governance will therefore consistently report information on their economic, social and environmental performance through processes of shareholder and stakeholder engagement. Consequently they stand a better chance of experiencing an improvement in the perceptions of trustworthiness that both their shareholders and stakeholders have of them, because the company will be perceived as both open and benevolent to all its stakeholders (see earlier discussion on facilitators of trustworthiness).

Performance vs. conformance

In the earlier discussion on the nature of corporate governance, it transpired that it consist of two dimensions, i.e. direction and control. The direction side of corporate governance emphasises the responsibility of the board to attend to strategic positioning and planning in order to enhance the *performance* and sustainability of the company. The control side of the definition emphasises the *conformance* responsibility of the board to oversee the executive management of the company in their execution of the strategy and control of the company. This responsibility results in the board doing account of the performance of the company to shareholders, stakeholders, security exchanges and other regulatory bodies. These two dimensions of corporate governance are often captured in the polarity between performance and conformance. Should the board of a company not be able to strike a proper balance between performance and conformance demands, trust is likely to be undermined.

In the era prior to the contemporary wave of corporate governance reform, the danger was that performance was emphasised to the detriment of conformance. Corporate governance reforms that have been introduced since tend to sway the pendulum in the opposite direction. The demand for conformance to various accountability standards and claims can drain the energy and focus of the board away from company performance (IFAC, 2004). This situation is further aggravated by the ever more stringent demands imposed by financial regulators on boards and also by the personal liability that directors potentially face in the case of corporate scandals and failures. When corporate governance has this effect on business, it not only can distract the board from its responsibility of enhancing company performance, but might also make directors risk averse. As corporate success is often intimately linked with risk taking and the exploration of uncharted possibilities, an over-emphasis on conformance might result in poor economic performance. The trust of both shareholders and all other stakeholders who stand to benefit from the economic performance of the company ironically might be dented should corporate governance result in undermining the performance of companies.

What is thus needed is a sound balance between performance and conformance. There is a growing body of empirical evidence, for example, the McKinsey (2001 & 2002) surveys that indicates that good corporate governance correlates with improved corporate performance and enhanced investor confidence. Should the board be able to strike a proper balance between the performance and conformance of the company, it stands to gain in trustworthiness, because it will be perceived to be both open and competent (see earlier discussion on facilitators of trustworthiness).

Mandatory vs. self-regulatory regimes

A distinction can be made between governance on the enterprise level and governance on the regulatory level (cf. Rossouw, Van der Watt & Malan, 2002). On the enterprise level governance refers to the way in which the company directs and controls its own affairs. This is the level on which governance has been discussed thus far in this article. Governance on the regulatory level refers to the regulatory environment within which corporations function. It consists of the control over companies that are exerted from the outside. For example, the state, the judiciary and stock exchanges exercise such external control over companies in general and over securities transactions in particular (Coffee, 1998:69; Romano, 1998:144). The state may also opt for delegating some of its control over companies to regulatory bodies. All of these arrangements combine to form the landscape of regulatory governance. The purpose of such control over the operations of companies is not only to lay down ground rules for key role players in order to provide protection to all stakeholders in corporate action, but also to prevent the market as such from failing due to malpractices (Romano, 1998:148).

An effective regulatory regime within which corporations operate can provide stakeholders with the peace of mind that their interest will not be taken advantage of and that their rights and interests will be protected. Through laws, regulations, listing requirements, professional codes, etc., stakeholders can be given the assurance that corporations can be trusted to adhere to certain standards of behaviour. In cases where corporations do not adhere to such standards, the regulatory regime provides stakeholders with the opportunity to seek recourse. These assurances provided by the regulatory environment is a necessary condition for cultivating what was earlier referred to as basic trust in corporations. Without an effective regulatory environment, the trust of stakeholders in business can be seriously undermined. Factors that can contribute towards instilling trust in the external regulatory regime of corporate governance include effective market regulation, predictable and equitable enforcement of regulations, disclosure requirements that ensure transparency, the protection of the rights of all shareowners and other stakeholders as well as mechanism that compels companies to act socially responsible.

Finding the appropriate balance between governance on the enterprise level and governance on the regulatory level is once more vital for the levels of trust that corporations are likely to enjoy. An overemphasis on regulatory governance can result in a situation where companies merely perform to the letter of the corporate governance and not the spirit thereof. When companies have to meet stringent mandatory governance demands issued by regulatory bodies, the danger always exists that they will merely conform formally to such demands, without putting much substance in their conformance. The so-called 'tick box mentality' then ensues in which companies quantitatively adhere to governance requirements without much qualitative substance. Such mere formal compliance can trigger cynicism amongst all stakeholders which will undermine the possible gains in trustworthiness that could have resulted from good governance.

When companies opt for self-regulation on the enterprise governance level, they are likely to do it based on the conviction that it is in the best interest of the company, as it will enhance its sustainability. Consequently it will probable conform to the spirit, standards and substance of good governance, because it is seen as important for the sustained success of the company. When adherence to standards of good governance is based on conviction rather that coercion, one can expect that companies will be perceived more favourably by their stakeholders, as less corporate governance failures are likely to occur. This consistence will over time translate in improved perceptions of integrity and reputation (see earlier discussion on facilitators of trustworthiness) that will bolster the trustworthiness of the company. In terms of the distinction made by Brenkert between different kinds of trust (see earlier discussion), a self-regulatory enterprise governance regime will facilitate extended trust between a corporation and its stakeholders.

Self-regulatory governance regimes are however weak in their ability to foster what Brenkert called basic trust, i.e. trust in the system that underlies our economic practices and that provides the necessary condition for secure economic interaction. This basic trust is provided by the regulatory governance regime. A self-regulatory enterprise governance regime cannot take care and deal with those companies who fail to adhere out of inner conviction with the standards of good governance. An external regulatory governance regime is required to deal with such failures. It is therefore once more imperative that a sound balance be struck between mandatory and self-regulatory governance. An effective and fair mandatory regulatory governance regime is a recondition for basic trust in business, but if it becomes too draconic and stringent it will undermine the incentive for enterprise level self-regulation which is a precondition for extended trust.

Conclusion

Corporate governance is portrayed as a balancing act between corporate objectives and societal needs. The idea and practice of good governance promises to increase trust in business as it will enhance its trustworthiness in the eyes of its stakeholders. Although there is a positive correlation between corporate governance and trust in corporations, this correlation will only materialise if a number of balances can be struck within the corporate governance reform agenda. Should the right balance be achieved between exclusive and inclusive models of corporate governance, between performance and conformance, and between mandatory and self-regulatory governance regimes, then it is reasonable to expect that corporate governance will facilitate more trust in corporations.

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