Maximizing Corporate Reputation Through Effective Governance: A Study of Structures and Behaviors

by

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Maximizing Corporate Reputation Through Effective Governance:

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A Dissertation

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College of Behavioral Sciences

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In Partial Fulfillment of the Requirements for the Degree

Doctor of Philosophy

by
Daniel F. Oriesek

March 2004

Approval

We, the undersigned, certify that we have read this dissertation and approve it as fully adequate in scope of quality for the degree of Doctor of Philosophy:

Author: Daniel F. Oriesek

Title: Maximizing Corporate Reputation Through Effective Governance: A Study of Structures and Behaviors

Dissertation Committee:

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C. Wells, Ph.D. Date:

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Abstract

Title: MAXIMIZING CORPORATE REPUTATION THROUGH EFFECTIVE GOVERNANCE: A STUDY OF STRUCTURES AND BEHAVIORS

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Institution: Southern California University for Professional Studies

The aim of this dissertation research is to develop an understanding of how components of the organizational structure, leadership structures at the top level and resource allocation decisions may affect corporate reputation as defined by the reputation quotient (RQ), and which aspects of running a company top management should *keep an eye on* in order to maximize the reputation of their company?

Based on a literature review on the topic of corporate reputation and governance, which comprises the first part of the dissertation, a positivistic, deductive approach was chosen and a self-administered questionnaire has been developed that was sent out to the CEOs of the 60 companies currently covered in the 2002 RQ-rankings. The detailed discussion of the research method can be found in the third chapter.

Due to a low response rate, the original research approach had to be adapted, in that - where available - the information requested in the questionnaire was filled by the author with publicly-available data from various sources, including the Securities and Exchange Commission (SEC), brokerage reports, company web sites and third-party information providers, aggregating information from these sources. Because the data points obtained this way, in all cases are based on official company disclosures (i.e. SEC-filings,

press releases, published web sites), for which the companies are held legally liable, it is assumed that the quality of the data points obtained this way is just as accurate as from having received it as part of the filled-out questionnaires. This for one, because of the legal implications mentioned above and for the other because the answers to the questionnaire would have been based on the same internal data used to provide information to the Securities and Exchange Commission and general public.

This adaptation of approach narrowed down the original sample size of 60 to 32 companies, because for 28 companies not sufficient public information was available and/ or the companies were not listed in both the 2001 and 2002 RQ-rankings. A second effect is that fewer of the originally intended aspects, especially relating to leadership, could be investigated, as no reliable public information was available. Nevertheless, the sample size was sufficient to draw statistically valid conclusions.

The fourth chapter discusses and evaluates the actual results from running extensive statistical analysis and modeling.

The last part of the dissertation discusses the limitations of this research, indicates areas for further research and discusses the implications of the findings for the practicing manager.

Chair Approval for Publication: Date:

TABLE OF CONTENTS

LIST OF FIGURES AND TABLES

GLOSSARY

Anthropomorphism	The attribution of human qualities to non-human entities.
Board Practices	The totality of actions that describe how the Board of Directors operates. This includes how many people sit on the board, how many of them are insiders versus outsiders, how often the board meets, how long its sessions last, how decisions are reached, how long individuals serve on the board etc.
Business Process	A clearly defined sequence of tasks and factors involved in completing a specific business purpose.
Corporate Accountability	Describes the fact that corporations, like individuals are held responsible for their actions.
Corporate Actions	All actions that take place on behalf of an incorporated organization. The organization that is incorporated is an entity and not an individual.
Corporate Behavior	A recurring pattern of an incorporated company's corporate actions.
Corporate Reputation	The shared public perception or evaluation of a company based on its past, current and expected future actions.
Corporate Roles & Responsibilities	The functionality and responsibility assigned to corporate bodies (e.g., Executive Board, Board of Directors etc.) or individual members (e.g., CEO, CFO).

Corporate Social Responsibility (CSR)	The role of corporations in, for example, promoting the health and safety of their workers; protecting the environment; limiting bribery and corruption; responding to natural disasters and ensuring human rights are respected in communities in which they operate.
Corporate/ Organizational Goals	Corporate/Organizational Goals are statements – typically at a high level – that serve multiple purposes, such as providing the organization with general guidance and direction, defining targets that serve as basis for motivating employees, giving the organization an legitimization of its purpose, setting corporate wide standards. These goals may serve to unify all members of the organization in shared efforts.
Operational Goals	Operational goals are a derivative of corporate/ organizational goals and serve the purpose of steering/ evaluating the everyday activities of a corporation. They are very specific, usually quantitatively measurable and related to specific business processes or procedures.
Directive	A binding instruction valid for an unlimited period, covering in detail particular topics of corporate concern. Directives typically do not require additional instructions before their implementation by the addresses.
Firm Value	The total value of a firm, based on the value of its tangible and intangible assets, including the potential to generate future cash flows.

Governance	The function of controlling, directing and influencing, which also includes directing the making and administration of governance systems in order to ensure proper corporate and individual actions and behavior.
Governance Systems	The totality of governance tools, designed for management to steer an organization, e.g., management processes.
Governance Tools	Instruments designed to manage and steer an organization. Governance tools include vision, mission statement, philosophy, organizational structure, management processes, roles & responsibilities, business processes as well as policies & directives.
Intangible Asset	Non-physical assets such as technical expertise, trademarks, copyrights, patents and reputation.
Liquidation Value	The value derived from selling all tangible and intangible assets that can be traded. In this paper liquidation value does not include the sale of intangible assets.
Management Processes	The processes designed to regulate a corporations activities at the management level, e.g., between the Board of Directors, the Executive Board, Divisions and Country or Regional Organizations. Examples of management processes would be: Strategic Planning, Financial Planning, Communication (Planning of Corporate Messages), Vision and Mission Development, Changes in Organizational Structure, Acquisitions/ Divestitures, Business Field Entry/ Exit Decisions and Innovation Management.

Market Multiples

This term encompasses several common applications in the financial markets. The most commonly referred to is the Price Earnings Ratio (P/E), which measures how many times the Earnings per Share (EPS) are reflected in a company's current market price. If one takes the weighted average of all P/Es of companies traded in a given market, one gets the market P/E. These P/Es can further be differentiated by industry, sector or peer groups. Other common multiples are Price To Book Ratios, or Price To Sales.

Market Value

Also called market capitalization is the value that the stock market is willing to pay for publicly traded companies. It can be calculated by taking the actual stock price X shares outstanding.

Organizational Structure

Organizational Structure describes the internal relationships, division of labor, and means of coordinating activity within the organization.

Personal Goals

An individual's personal planned target of aspirations.

Policy

A binding guideline valid for a time period. The content of which may cover the spectrum of a particular and basic functional activity. Corporate policies typically serve as a basis for more detailed instructions and/or action plans.

Reputation Quotient (RQ)

Measure designed to help identify the relative placement of a company's reputation among competitors in the marketplace.

Reputational Capital

A company´s reputational capital is the excess market value of its shares – the amount by which the company's market value exceeds the liquidation value of its assets.

Stakeholder	Stakeholders are individuals and groups that have an involvement or investment in a company's decisions and in its social and economic exchanges. The involvement may be direct or indirect.
Tangible Asset	Physical assets, such as machinery, factories and office equipment.

Chapter 1

1. *Introduction*

1.1. *The Dissertation Topic*

"You can't build a reputation on what you are going to do."
Henry Ford *(1863 -1947)*

Over the past decade managers, especially in the United States, came to realize that intangible assets can generate far more value for a corporation than the immediate benefits generated through patent protection or, for example the acquisition of proprietary know-how about manufacturing processes, or special technologies. Managers have recognized that the intangible asset of *corporate reputation* can provide their companies with a sustainable competitive advantage over their competitors in generating more sympathy with their current and future customers, employees, investors, suppliers as well as the regulatory authorities, unions, public interest groups etc. Positive reputation, unlike Ford's statement above, may have several positive effects for the company e.g., the increased willingness to buy the company's trusted products, the desire of job seekers to work for this company, higher price premiums in the stock markets, and favorable relationships with public interest groups. The three effects just mentioned, can be measurable by repeat sales per customer, employee turnover, recruiting expenditures per candidate attracted or price/ earnings ratios in the stock markets. Corporate reputations are fragile and take a long time to build, but a few incidents of irresponsible behavior may destroy them.

1.2. Background of the Problem

On March 24, 1989, the tanker Exxon Valdez was grounded on Bligh Reef in the upper part of the Prince William Sound. The tanker was carrying approximately 53 million gallons of crude oil, 11 million of which spilled into the Prince William Sound. Besides the environmental catastrophe, the incident proved to be a large set back for the Exxon corporation. This was due to reactive crisis management which lost considerable goodwill with the general population and environmental groups. The cost of the catastrophe was about one billion dollars in market capitalization during the time period two weeks before and after the incident (Fombrun, 1996).

In the Exxon case, contingency crisis planning both in terms of actions and communication could have prevented at least some of the damage. This type of planning may have communicated that Exxon does care about the environment, and that the company is decisive in preventing any further damage. The case illustrates that in order to guard a corporate reputation, a company should have a governance system in place. Not only for times of crisis, but also during uneventful times, such a system ensures the smooth running of the company, consistent behavior of the individuals working for the company, and consistent behavior of the company as a whole i.e., corporate behavior.

Corporations and organizations in general are characterized by the fact that they are made up of people, acting together in order to pursue a common goal (Hodge, 1996). Inherent in this definition is the potential exposure of individual members of the organization to conflict of interest between personal and organizational goals. This is because, at least during working hours, the members izational goals. This is because, at least during working hours, the members of an organization are expected to subordinate their personal goals to the goals of the organization.

Organizational members or individuals, in general, are driven by personal goals, which are important determinants of their behavior. This behavior is made up of past and current actions, which were perceived by other people in the individual's environment. As a consequence, the observers form a mental picture, which, good or bad, constitutes a crude definition of what could be called an individual's reputation.

The concept of reputation associated with individuals is probably as old as mankind itself, and one of the most critical determinants of social behavior (Bromley, 1993). Reputation, for an individual is in respect to his standing in a social environment, corporate reputation determines a corporation's standing within a business context.

The existence, or absence of, reputation can constitute a source of competitive advantage or disadvantage for a corporation in its market environment (Fombrun, 1996). Because, if a corporation has a good reputation, it is likely to sell more to customers, receive more job applications, get more favorable coverage from financial analysts and journalists, and get more opportunities to enter business relationships with new customers, who have heard favorable things about it. A good corporate reputation, therefore, is one of the most valuable intangible assets to a company (Hall, 1992; 1993). The accumulation of reputational capital (Fombrun, 1996) is highly desirable, and thus a way to maximize firm value.

Both corporate and individual reputations are determined by actual or perceived actions. While in the case of an individual, these actions are driven by the individual's own behavior, in the case of organizations, they are made up of the collective behavior of the members. This collective behavior can be described as the sum of all individual behaviors of members of an organization.

Whereas an individual ultimately determines and is responsible for his or her own behavior, the collective behavior of an organization, is at least in part a function of effective design and the influence of leadership. The recent bankruptcy case of the Swiss national carrier *Swissair* or the energy giant *Enron*, have shown once more how fragile corporations are and how important effective governance systems are not only to ensure smooth operations, but also in order to prevent fraudulent or negligent behavior of individuals or groups within the organization.

In the current literature, the term *Corporate Governance* is typically associated with the governance function at the level of the Board of Directors. The focus is currently on how boards are or should be structured, and how decisions are or should be reached. It does not include the view of governance as a management system, made up of various governance tools at different levels of the organization, which must interact in order to ensure proper conduct and behavior throughout the entire organization. Nor does it look at the role of leaders, in general, to enforce such a governance system, in order to bring it to life.

This dissertation will refer to the term of *Governance* as the totality of actions and measures taken in order to ensure proper corporate and individual actions and behavior.

1.3. Statement of the Problem

As depicted in figure 1-1, individual and thereof derived corporate behavior directly affects a company's reputation in both positive and negative ways. Through means of a governance system, established and enforced by top management, a company intends to steer individual and corporate behavior in such a way that it produces a favorable outcome on the corporate reputation and thus creates value for the firm. In establishing a governance system, top management can employ a series of governance tools. One such tool is the structural setup of the organization in terms of number of divisions, number of countries served etc., another tool is the selection and number of people running the company, namely the members of the board of directors and the executive directors. These people and their respective leadership styles or lack of leadership determine how things are run at the corporation. Since top management cannot possibly oversee all actions, it will install a management system, made up of critical management processes (i.e., strategic planning, financial planning, management by objectives, contingency planning etc.) aimed at institutionalizing decision making along the lines of what top management thinks is best for the company. This system ultimately determines how resources are allocated. The focus of top management will determine what resources are used to reach certain objectives (i.e., focus on shareholder value, focus on financial stability, focus on customers and other interest groups). The problem to be investigated is: How components of the organizational structure, leadership structures at the top level and resource allocation decisions may affect corporate reputation as defined by the reputation quotient (RQ), and which aspects of running a company top management should *keep an eye on* in order to maximize the reputation of their company?

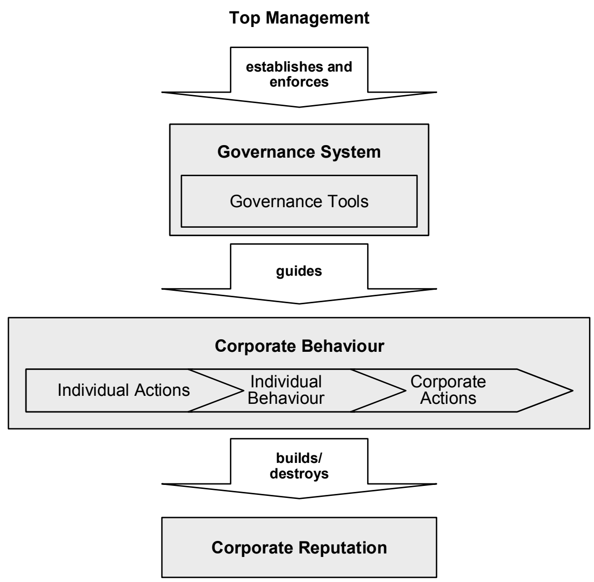

Figure 1-1: Top management, governance systems, corporate behavior and corporate reputation

1.4. Purpose of the Study

This dissertation investigates the significance of structural and leadership aspects of corporations in order to determine how they affect a company's reputation as measured by the reputation quotient (RQ). Based on the findings, specific recommendations for the practicing manager will be formulated with respect to which levers he can pull to maximize his company's reputation. In order to obtain the desired results, three broad questions need to be answered:

1) Is there a link between how a company is governed and it reputation?

2) Which aspects of a governance system have a significant impact on the corporate reputation?

3) Are there any recommendations for practicing managers?

1.5. Theoretical Framework

Corporate reputation is an intangible asset (Hall, 1992; 1993). Reputational capital (Fombrun, 1996) can be accumulated or lost over time and thus affects a company's value. Understanding corporate reputation as an intangible asset and component of overall firm value, it is possible to quantify its value by dissecting a corporation's market value into its liquidation value, i.e., the amount that would be realized if all the tangible assets were sold and what the market is paying on top of that (Fombrun, 1996). This rough estimate of the totality of intangible assets (i.e., what the market believes the firm is worth on top of its tangible assets) then needs to be adjusted for several things, such as for example general valuation trends (i.e., market multiples for specific industries or sectors, which implicitly value future earnings potential). Ultimately this provides a good indication of what a corporation's reputation is worth in the eyes of the market, which includes representatives of all or at least some stakeholder groups. After publication of his book *Reputation – Realizing Value from the Corporate Image* in 1996, Fombrun fine-tuned his definition of reputational capital and expanded it to taking the market value and not only deducting the liquidation value, but also the present value of future earnings, which would give a more accurate picture of the reputational premium investors are willing to pay for a company. Since 1999, corporate reputations are measured, using the Reputation Quotient^{SM} (RQ). The RQ is surveyed and calculated following a standardized procedure and then published by the Reputation Institute and Harris Interactive.

Broadly defined, corporate governance refers to the process of managing and controlling the activity, direction, and performance of corporations. Its study began with Berle and Means (1932), when they first described the separation of ownership and control inherent in the corporate form. Traditionally, effective corporate governance was viewed as a way to, first of all, maximize profits. Over the years, however, corporate governance has evolved to include corporate accountability, corporate social responsibility, and the protection of the interests of shareholders and other stakeholders (Conference Board 1993; NACD, 1995; Monks and Minow, 1995; Pava and Krausz, 1995; Blair, 1995' Sifonis and Goldberg. 1996; Keasy and Wright,1997).

The concepts of corporate governance and corporate reputation both involve stakeholders and while corporate reputation depends on the perception of a corporation's actions, which implies that certain actions are more desirable in the eyes of certain stakeholders than others, corporate governance aims at managing and controlling corporate actions in general and as well towards specific stakeholders. The aim of this paper is to identify which systems and practices are most suitable to maximize a corporation's reputation.

1.6. Main Research Hypothesis

HO) There is a link between how a corporation is governed and its reputation.

H1) The composition and cooperation of the board of directors have a significant influence on the company's reputation.

H2) The organizational structure has a significant influence on the company's reputation.

H3) The focus (priority setting) of top management has a significant influence on the company's reputation.

1.7. Importance of the Study

The study will expand the current knowledge about what affects a company's reputation beyond the current studies, which are almost entirely focused on reputation from a communicative and perception-focused point of view. It will offer a better understanding of and how certain structural and leadership aspects will affect a company's reputation and thus help to broaden the understanding how various governance tools must interact in order to yield the desired results. Practicing managers will find recommendations of how they can optimize their existing governance systems in order to maximize and safeguard their corporation's reputation and firm value. The study further provides the foundation upon which early warning and monitoring tools for governance systems could be developed in order to minimize the reputational risk for a company at any given point in time.