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CLAREMONT McKENNA COLLEGE

THE NEXT CATALYST FOR CHANGE: HOW CORPORATE SHARED VALUE IS RESHAPING CAPITALISM

SUBMITTED TO

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FOR

SENIOR THESIS

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CHAPTER 1: INTRODUCTION TO CORPORATE SHARED VALUE

1.1 The Relationship between Business and Society

Businesses are an integral and deeply embedded part of society. Yet, one common point of contention is the appropriate level of reciprocity that there should be between the operations of a business and the communities with which it must interact. More conservative views postulate that companies only need to make their contributions to society by making a profit, which theoretically invigorates employment, wages, consumer purchasing power, investments, and taxes.[1] This purely for-profit system only requires two parties for any transaction: a producer and a consumer. While this position reflects the behavior of a free market system, it ignores the fact that a company requires the participation of many additional communities, such as raw material processors, distributors, and information technology centers. In fact, many for-profit companies run the risk of destroying these resources by being negligent about these communities. By cultivating this symbiotic relationship instead of disregarding it, companies may find it worthwhile to concentrate on these communities' health, which could both improve their profit-making abilities and contribute to the betterment of society. Firms can do this by redefining their concept of value. "Value" does not simply have to be the difference between revenues and expenses; when encompassing a broader scope, it can be defined as the net benefit to people, the environment, and the societal structure within which the companies are operating, or "shared value."

For-profit corporations often disassociate from "bettering society" if it requires them to sacrifice any of their profit, either by reducing earnings or investing in these efforts somehow.

[1] Michael E. Porter and Mark R. Kramer, "Creating Shared Value," *Harvard Business Review* (2011): 66.

Businesses have viewed this benevolent mentality, ranging from altruism to simply enforcing safety regulations for employees, as a simple economic constraint. Furthermore, considering their impact on society often makes businesses confront the issue of externalities. Some issues are negative externalities, which occur when certain activities of the company present costs or other forms of harm to a third party. Some issues are positive externalities, which occur when certain activities benefit third parties at the expense of the company. Either way, some party is harmed in the process, and the firm eventually ends up shouldering the cost. While a company's negative externalities can be reacted upon with government regulations, taxes, and fines, positive externalities can be viewed as a waste of the company's time and resources; either way, the firm tries to minimalize the internalization of tradeoffs that it otherwise would not have to bear. Engaging in broader conceptualizations of value can help firms reduce the damage of these costs.

1.2 How to Create Corporate Shared Value

Michael Porter and Mark Kramer argue that there are three potential ways for firms to create shared value: by reconceiving their products and markets, by redefining productivity in their value chain, and by building industry clusters in locations that are beneficial to the company.[2] In theory, these improvements will provide companies with opportunities to reduce existing costs, while continuing to build their businesses. Even better, if corporations look to improve shared value in every step of the development of their distribution of goods or services, they may be able to ameliorate not only their imprint on society, but also their competitive advantage in their respective industries.

In order to reconceive their products and markets, companies should reevaluate the relationships that they have with their consumers, and then incorporate shared value into the

[2] Porter and Kramer, "Creating Shared Value," 65.

process of goods exchange. For example, they can use their influential power – often manifested through aggressive advertising campaigns or the status symbolization of their products – to direct consumers towards goods that, through particular shared value techniques, benefit more than just the company itself. They can also rebrand their mission to be more socially conscious, so that consumers will be attracted to the company as well as its products. Utilizing this power can potentially redirect consumers' demands towards outcomes that are more beneficial for society, both domestically and abroad. Addressing the many unmet needs of the global economy may empower consumers to change existing global issues, making corporations the a necessary catalyst. This can subsequently motivate consumers to become more selective in their consumption choices; increased awareness may lead these socially conscious consumers to stop purchasing goods and services from companies that are not engaging in corporate shared value. Therefore, the "reconception" of products and markets can, and may continue to, lend itself to increasing shared value through corporations.

One of the dangers of this approach is that aggressive firms may rebrand their company and its products as promoting shared value, when, in reality, they are simply trying to capture the "socially conscious consumer" demographic. Therefore, shared value is not truly created until companies are actually implementing it into their value chains. Improving the efficiency of production through knowledge distribution is one of the best ways a firm can add shared value to its value chain. This will, in turn, lend itself to more effective labor and employment, improving both the quality of life for those working for the company and the production proficiency of the firm in the market, giving them a competitive advantage.

Finally, as is true with most of the above issues, location is an indisputable source of discord within corporations. With the increasing prevalence of globalization, firms have been moving

more of their value chains abroad. While global expansion does not automatically reflect the benefits of lower costs; it may encourage companies to embrace a more location-centric mentality from a shared value perspective. These sources of outsourced labor and production are called clusters, mostly because they are geographically localized. Porter describes this paradigm shift:

> Although location remains fundamental to competition, its role today differs vastly from a generation ago. In an era when competition was driven heavily by input costs, locations with some important endowment—a natural harbor, for example, or a supply of cheap labor—often enjoyed a *comparative advantage* that was both competitively decisive and persistent over time. Competition in today's economy is far more dynamic. Companies can mitigate many input-cost disadvantages through global sourcing, rendering the old notion of comparative advantage less relevant. Instead, competitive advantage rests on making more productive use of inputs, which requires continual innovation.[3]

Therefore, companies started to centralize their global involvement around efforts to reduce costs through means like inexpensive overseas labor, which was giving them a consistent comparative advantage. However, this mindset has evolved into valuing the improved production of output instead of cutting costs. This shift in mentality has the potential to benefit both the company and their workers and suppliers – the members of their localized clusters – in the long term. This focus on location lends itself to creating shared value through local cluster development. Because firms are focusing more on the "productive use of inputs" than the "input costs," the most successful clusters will exhibit easy collaboration, high levels of efficiency, and enhanced productivity, all of which will lead to higher rates of employment, more skilled workers, and a stronger cluster community. According to Porter and Kramer, one of the most important aspects

[3] Michael E. Porter, "Clusters and the New Economics of Competition," *Harvard Business Review* (1998): 78.

of cluster growth in both developing and developed countries is the formation of open and transparent markets.[4] One of the most significant ways that productivity can suffer is through a discrepancy in knowledge creation between the firms and their clusters. Transparency enables suppliers to receive fair prices for their goods, which would give them incentive to improve their quality, as well as put money back into the local economy, thus improving the cluster's productivity as well as their own. Other solutions are also available: for example, providing education and training for employees makes them more skilled workers, which also improves productivity. With information and knowledge transfer between a firm and its cluster becoming more specialized and thorough, clusters will not only benefit from a higher quality of life, but will aid the firm in the market.

However, even an insufficiency of cluster operation can work against a company. Because a cluster is a network of different practices and industries, there are many links in the chain that can jeopardize its success. For example, when worker conditions suffer, such as low education levels, minimal training, or unaccountability of worker health, productivity suffers, which puts those workers in jeopardy, both on the job and more long-term. Discrimination contracts the pool of available workers, and poverty limits their ability to participate in the cluster's economic cycle, which minimizes its benefits. Therefore, a company that takes a shared-value outlook on cluster development can improve much more than its own business.

1.3 Why Firms Should Consider Corporate Shared Value

There are many ways to address the question of how a corporation should infuse itself more directly into the world's interests. A firm engaging in shared value practices needs to do more than simply try to improve the company's reputation, which is a transparent effort in the grander

[4] Porter and Kramer, "Creating Shared Value," 73.

scheme of the business's practices. Corporate shared value is a more profound and more deeply-integrated business practice. It utilizes the company's resources to create economic value through creating social value by deriving their corporate shared value practices internally (that is, through their specific business practices). Knee-jerk reactions to external pressures or negative publicity are short-term remedies that do not provide any actual solution; corporate shared value realigns the entire company's budget, mode of operation, and intention in order to create a long-term plan for societal improvement and responsible, yet profitable, business practices. The task of reconstructing the majority of a company's business practices is both daunting a risky, and many executives are risk-averse. They fear that any divergence from the *status quo* will communicate instability to consumers or investors, resulting in eventual bankruptcy of the company. However, these fears, although not unfounded, are unrealistic; a company that refuses to consider corporate shared value as an integrated business practice is actually running the risk of losing its competitive edge in the market. Shared value is a significant opportunity for businesses to use their international power and influence for the greater good of the world.

Chapter 2: REDEFINING CAPITALISM

Taking into consideration a more traditional view of the role of business is critical for creating a context to demonstrate why more companies should consider the idea of shared value. Because the economy is a pillar of human society, many firms believe that tampering with the long-established principles of the free market and supply-demand equilibrium will force them to incur unnecessary costs. Corporate shared value is an especially objectionable proposition, because it is not only a process that interrupts the workings of the free market, but is also a direct contradiction of the traditional view of the role of a corporation in the economy.

2.1 Milton Friedman's Capitalism

Milton Friedman, the winner of the 1976 Nobel Prize for Economics and an influential figure in the studies of monetary theory, inflation, and employment, is a well-known advocate of the free market, which some people regard as the purest form of capitalism.[5] He has also proposed that corporations, as agents of a free market, need to follow the simplest and most unadulterated corporate expectations. Driven by his libertarian ideals, Friedman has also been a vocal advocate of minimal government involvement in business and in society, and has used this standpoint to encourage the freedom of institutions and to purify market competition. For example, in his book *Capitalism and Freedom*, he emphasizes that, in free societies such as the United States, the roles of government should only be

> …to provide a means whereby we can modify the rules, to mediate differences among us on the meaning of the rules, and to enforce compliance with the rules on the part of those

[5] Lanny O. Ebenstein, *Milton Friedman: A Biography* (New York: Palgrave Macmillan, 2007), 3.

> few who would otherwise not play the game. The need for government in these respects arises because absolute freedom is impossible.[6]

He argues that government should only be a mechanism used to enforce laws and rules to benefit the greatest number of people, while protecting their constitutional rights. Because "absolute freedom is impossible," government should simply maintain the bare minimum level of societal involvement. Otherwise, individual freedom, and the freedom of society, is jeopardized. Friedman also argues, through analyzing the inflations and contractions of the United States economy that have taken place between 1867 and 1958, that government intervention in monetary issues has been "'a potent source of instability'"[7] rather than a facilitation of improvement. In his view, the most significant problem is "not to construct a highly sensitive instrument that can continuously offset instability introduced by other factors, but rather to prevent monetary arrangements from themselves becoming a primary source of instability."[8] By removing government immersion in monetary policy, such as through correcting inflation rates and monitoring taxes and tariffs, Friedman argues that the economy, which is already "highly sensitive," would operate more smoothly with less overcorrection implemented by these external government forces, and should instead be left to operate autonomously. Essentially, Friedman states that the government should only be involved on the periphery of monetary policy. Any additional involvement contradicts the main purpose of government – simply the prevention of instability – and runs the risk of increasing instability rather than eliminating it through natural free market forces.

Another warning that Friedman offers about excessive government involvement is that "any Government section beyond promoting freedom and providing the rules creates a dangerous

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[6] Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962), 25.
[7] K. Puttaswamaiah, ed., *Milton Friedman: Nobel Monetary Economist* (Enfield: Isle Publishing Company, 2009), 9.
[8] Puttaswamaiah, *Milton Friedman*, 9.

negative externality."[9] This continues the previous point that government, when too involved, can hurt more than help. Freedom of choice is a cornerstone of his beliefs, and it extends to economic contexts as well. In his view, with individual choice unhindered by external regulation, governmental, as explained previously, or otherwise, the market has the potential to maximize its profits through self-regulation. Companies are free to pursue profit maximization without absorbing the costs of complying with governmental – or other – restrictions because there is no "overcorrection" taking place. In other words, the prices of goods and services are a direct, self-correcting reaction to the demand of consumers, which usually matches a low-price, high-quality standard. Consumers and suppliers reach free market equilibrium when the price of consuming a good equals the marginal cost of producing a good. A producer that attempts to sell his goods or services at a price that is higher than the equilibrium level must offer a noticeably superior product, or else consumers will not be willing to pay the more for the goods or services, and the price will fall back to equilibrium. Conversely, a producer that lowers the price of his goods or services below the equilibrium level will attract more consumers, because they will want to pay less; the producer will thus want to earn more profits from this increased demand, and will raise the price. This will also eventually return the price of the goods to match the equilibrium level of demand. Therefore, any divergence from a free market equilibrium, on either they consumer or the producer side, will eventually self-correct if there are no external forces adjusting behavior.

However, with interventions such as government regulation, the free market equilibrium is not able to self-regulate. For example, when the government raises taxes, there are implications for both consumers and producers. Therefore, it is clear that Friedman believes that companies participating in this less-than-free market system will be at a disadvantage in the market. He

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[9]Puttaswamaiah, *Milton Friedman*, 15.

warns that "[the] postulate of profit maximizing behavior by entrepreneur is supported by the fact that those who do not manage to maximize profits are likely to be eliminated by competition in the course of time."[10] This quote embodies Friedman's argument about corporations: the less government regulation there is, the more freedom corporations have to operate. This freedom allows corporations to focus solely on earning money and making profits.

2.2 Milton Friedman's Corporation

Friedman maintains that this freedom provides companies with the tools to accomplish their only responsibility:

> "In such an economy, there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as its stays within the rules of the game, which is to say, engages in open and free competition, without deception or fraud."[11]

In his purest, unadulterated form of a free market economy – one that "engages in open and free competition" and does so "without deception or fraud" – Friedman describes what he believes should be a business's only focus: to increase profits. As has been previously described, non-free market obstacles, such as government regulation, prevent the maximization of this endeavor of profit accumulation. However, there are other ways that Friedman warns companies can compromise their profit-maximizing efforts. He goes further by addressing the fact that a business that is doing more than its "one social responsibility" is not only acting recklessly, but is also squandering resources that should be allocated only to the business and is shareholders, or those who have an equity stake in the company. In his view, a business has no obligation to

[10] Puttaswamaiah, *Milton Friedman*, 17.
[11] Friedman, *Capitalism and Freedom*, 133.

contribute to any entity other than its own employees and shareholders, saying that "[such] giving by corporations is an inappropriate use of corporate funds in a free-enterprise society."[12] In fact, any other use for the company's profits would be considered not only inappropriate, but also irresponsible and wasteful. However, Friedman believes that companies have been irresponsible with their resources by participating in social responsibility, regardless of the form. In a *New York Times* article written on September 13, 1970, he aggressively confronted the idea of a business that follows its "social conscience" along with its goal of making profits:

> The businessmen believe that they are defending free enterprise when they declaim that business is not concerned "merely" with profit but also with promoting desirable "social" ends; that business has a "social conscience" and takes seriously its responsibilities for providing employment, eliminating discrimination, avoiding pollution and whatever else may be the catchwords of the contemporary crop of reformers. In fact they are--or would be if they or anyone else took them seriously--preaching pure and unadulterated socialism. Businessmen who talk this way are unwitting puppets of the intellectual forces that have been undermining the basis of a free society these past decades.[13]

This quote exposes many important pillars of Friedman's beliefs on corporate social responsibility, and he confronts the issue head-on. First, he fears that businessmen are not defending the idea of the "free enterprise" economy; they are actually destroying it by distracting the firm from its original goal to maximize profits, thus using them for means other than they should be intended. He mocks anyone who falls under the spell of these "catchwords," or slogans that imply that the "social conscience" is not much more than hype created by reformers desperate to create a new marketing ploy. He even calls these reforms a form of "socialism,"

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[12] Friedman, *Capitalism and Freedom*, 135.
[13] Milton Friedman, "The Social Responsibility of Business is to Increase its Profits," *New York Times*, September 13, 1970, http://www.umich.edu/~thecore/doc/Friedman.pdf.

inferring that this social conscience is operating under the ruse of "promoting desirable 'social' ends," but is instead a way to restrict free choice and to tighten the regulatory grip on companies' operations. He thoroughly rejects any possibility that firms have any additional purpose – no matter how socially benevolent – other than "merely" for making a profit. In other words, the flaw he finds with firms engaging in socially responsible activities by allocating their profit money to their benevolence is what threatens the "basis of a free society."

Friedman offers additional warning to any entity that is considering moving in a more socially responsible direction: "Few trends could so thoroughly undermine the very foundation of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible."[14] As he sees it, when businesses make profits, the money is given back through the corporation in the forms of employment, wages, repayment to debt holders, dividend distribution to stockholders, taxes, and in the value chain. Thus, in a way, businesses are being responsible by keeping their profits within the parameters of their own business operations. A corporation should thus be an autonomous operation that should harbor no additional distraction to its mission to accumulate profits. Friedman thus embodies one of the purest conceptualizations of business, advocating for minimal external intervention or distraction. He argues that the more freedom a business has to operate, the more profit it will be able to accumulate, and the more profit the company will be able to keep for itself. It is not that corporations are inherently socially irresponsible by only earning profits; it is that earning profits is their only responsibility to society, because earning profits and creating wealth is one of the most important components of a functioning society.

[14]Friedman, *Capitalism and Freedom*, 133.

2.3 The Limitations of Milton Friedman's Capitalism

Many for-profit companies consider Friedman's view of capitalism an ideal. They find that government involvement creates many negative externalities; any level of intervention beyond protecting peoples' constitutional rights limits freedom of choice, and any level of intervention beyond preventing preexisting monetary arrangements from causing instability destroys the free market system. When government tries to overcorrect the naturally occurring behaviors of free choice and the free market, then consumers and suppliers no longer have a balanced system on which they can rely for stability. This abhorrence towards the intervention of the free market also applies to how corporations should manage their own operations; a firm's only role is to increase its profits, and allocating these profits elsewhere in a way that detracts from the firm's earnings is inappropriate and irresponsible. These conditions are ideal for for-profit firms for three reasons. First, because they do not feel any responsibility to any entity except themselves, they do not have to concern themselves with any corporate "moral compass." Second, they do not feel obligated to distribute their profits, meaning that, compared to any competitors who do decide to distribute their profits, they can report higher overall earnings. Finally, they fear that if they were to choose to expand their "social responsibility," they would have to confront risk in the short term, which can deter them, their consumers, and their stockholders. Therefore, for-profit firms are dissuaded from engaging in corporate shared value, because in the more conservative roles of business in the free market, doing so would create unwanted cost and waste firm resources. However, a flawless free market system does not exist, and firms already incur costs that they would not otherwise confront in perfect competition. Furthermore, the benefits of corporate shared value actually follow the same supply-demand function; therefore, the

Friedman view is becoming increasingly outdated, and firms that use his view to steel themselves against corporate shared value no longer have valid reasons for doing so.

Chapter 3: CORPORATIONS IN THE CAPITAL MARKET

One of the main concerns that firms always keep in consideration when addressing their position in the capital market is how stable they appear to investors. Many executive management teams believe that stability is a direct result of meeting quarterly goals and reporting increasing earnings. They are extremely averse to any risk that may sacrifice short-term successes because they fear that investors will react negatively; thus, investing in endeavors like corporate shared value seems impractical and precarious.

3.1 How Corporations Report Performance Measures

One study, conducted by Graham, Harvey and Rajgopal in 2005, surveyed 401 financial executives to determine which factors they preferred to use, both as a performance measurement and as an amount reported for public disclosure for investors and shareholders to use when tracking their company's progress in the market. It was found that many companies use short-term indicators as a benchmark for measuring earnings in order to ensure that investors will see that the company is growing steadily by tracking this growth on a quarter-by-quarter basis. When companies use these short-term benchmarks, illustrating growth in small increments, the executives feel placated that investors will be able to discern trends and be more willing to invest in the company. Indeed, the study found that managers want to meet, and subsequently surpass, these short-term benchmarks for four reasons: to build credibility with the capital market; to

maintain or increase the stock price; to improve the external reputation of the company's management team; and to convey future growth prospects.[15]

Many of these concerns are rooted in long-understood empirical evidence. For examples, Barth, Elliot and Finn conducted a study in 1999 on the trends of market reactions based on a firm's increased earnings. They found that "firms with patterns of increasing earnings have higher price-earnings multiples than other firms, and that patterns of increasing earnings are positively correlated with proxies for growth and negatively correlated with proxies for risk."[16] These conclusions demonstrate two important points. First, a trend of increasing earnings leads to an increase in a firm's price-earnings multiple, or its Earnings Per Share (EPS) value; Second, this earnings increase has a direct effect on longer-term growth and risk indicators. The study's "growth proxy," which they define as a five-year compound annual growth rate of the company's book value of equity,[17] is positively correlated with an increase in earnings, meaning that these earnings increases indicate an increase in the firm's longer-term growth success. On the other hand, the study defines "risk proxy," as a firm's debt-to-equity ratio,[18] which is a measure of a company's financial leverage; it is a common indicator of a firm's risk because it indicates how much of the company's growth is being financed by debt. A large debt-to-equity ratio indicates a high level of risk; the study shows, however, that when a company reports increased earnings, the debt-to-equity ratio, or the risk proxy, decreases. Therefore, executives want to ensure that their reporting stays consistently positive from quarter to quarter, because short-term earnings growth can indicate longer-term growth and a reduction in risk. Therefore,

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[15] John R. Graham, Campbell R. Harvey, and Shivaram Rajgopal, "The Economic Implications of Corporate Financial Reporting," National Bureau of Economic Research working paper number 10550, January 11, 2005, 34.
[16] Mary E. Barth, John A. Elliott, and Mark W. Finn, "Market Rewards Associated with Patterns of Increased Earnings," *Journal of Accounting Research (*Vol. 37, No. 2, 1999), 410.
[17] Barth, Elliott, and Finn, "Market Rewards Associated with Patterns of Increased Earnings," 390.
[18] Barth, Elliott, and Finn, "Market Rewards Associated with Patterns of Increased Earnings," 390.

short-term growth is, to these executives, one of the strongest indicators of the company's success because it builds market credibility, which will increase the number of investors and drive up the stock price.

Conversely, one of the prevailing concerns for these executive management teams is the risk of not improving, or even falling below, the previous quarter's earnings. Barth, Elliot and Finn also discover through their study that "the earnings multiple decreases when a firm that previously exhibited a pattern of increasing earnings experiences an earnings decrease."[19] Thus, just as an increase in earnings leads to an increase in the firm's EPS value, a decrease in earnings leads to a decrease in the firm's EPS value. This effect on EPS has wider implications as well, which are further outlined by Graham, Harvey and Rojgapal:

> Failure to hit earnings benchmarks creates uncertainty about a firm's prospects, and raises the possibility of hidden, deeper problems at the firm. Moreover, managers are concerned about spending considerable time after the earnings announcement explaining why they missed the benchmark, rather than presenting their vision of the firm's future.[20]

A company that is failing to meet its short-term expectations may thus run into three distinct, yet interrelated, problems outlined in the above evidence. One concern is that a decrease in EPS will lead to a higher risk premium, which will decrease the stock price. The second is that any failure to meet projected earnings may make investors question both the credibility of the company within the capital market and the credibility of the executive management team. The third is that these executives will have to devote time to reassuring investors about the company's stability, which may divert attention from continuing to focus on the company's growth. These executives fear that any of these situations can jeopardize the company's future prospects; therefore, it is

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[19] Barth, Elliott, and Finn, "Market Rewards Associated with Patterns of Increased Earnings," 410.
[20] Graham, Harvey, Rajgopal, "The Economic Implications of Corporate Financial Reporting," 34.

clear why they are tempted to focus all of their attention on reaching their companies' short-term goals instead of worrying about longer-term growth.

One of the questions that the Graham, Harvey and Rajgopal address is which benchmarks are the most important financial metrics to report externally. The survey that they conducted used a ranking system, in which they asked a sample size of 305 chief financial officers: "Rank the three <u>most important performance measures</u> reported to insiders"[21] to rank the performance measures they deemed most important to report to outsiders. The #1 ranking received three points, the #2 ranking received two points, and the #3 ranking received one point. Through the accumulated data, it was found that 159 of the respondents ranked Earnings – which was assumed to be interpreted by the CFOs as "earnings per share"[22] – as the most important metric to report. Through interviewing these CFOs, the study found that "interviewed CFOs indicate that the GAAP earnings number, especially EPS, is the key metric upon which the market focuses."[23] This trend was due to the fact that investors use this value frequently to summarize corporate performance so that they can easily compare analogous companies. By using one value with which to track companies' successes, investors have an easier time discerning whether or not companies are successfully meeting their earnings goals.

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[21] Graham, Harvey, Rajgopal, "The Economic Implications of Corporate Financial Reporting," 50.
[22] Graham, Harvey, Rajgopal, "The Economic Implications of Corporate Financial Reporting," 9.
[23] Graham, Harvey, Rajgopal, "The Economic Implications of Corporate Financial Reporting," 10.

Table 1.
Survey Responses to the Question: Rank the three most important performance measures reported to outsiders.

Panel A: Unconditional averages.[24]

Measure	#1 Rankings	#2 Rankings	#3 Rankings	Total Points	Average Points
Earnings	159	67	31	642	2.10
Revenues	36	97	75	377	1.24
Cash Flows from Operations	36	72	93	345	1.13
Free Cash Flows	30	41	42	214	0.70
Pro Forma Earnings	38	10	24	158	0.52
Other	7	13	28	75	0.25
EVA	2	4	5	19	0.06

As can be seen in Table 1, "Earnings," or the earnings per share value, received the highest average points value of all of the performance measures, showing that executives consider it to be one of the most important indicators of healthy company performance. Additionally, the earnings variable was given an "average points" value of 2.10, revealing that on average, the executives that were surveyed ranked it as more critical to report than what they generally considered to be their second-most important performance measure. These data point both to the significance that the earnings per share value has on the market, and the intense concentration that executives have on keeping their earnings reporting robust.

The study further penetrates the question of benchmarks by asking the CFOs how important certain earnings per share benchmarks are to the company. Each respondent indicated their level of agreement on a scale where "agree or strongly agree" was allocated a value of +2, "disagree or strongly disagree" was allocated a value of -2, and intermediary levels of agreement were assigned accordingly.

[24] Graham, Harvey, Rajgopal, "The Economic Implications of Corporate Financial Reporting," 51.

Table 2.
Survey Responses to the Question: How important are the following earnings benchmarks to your company when you report a quarterly earnings number?

Panel A: Unconditional averages.[25]

Question	% agree or strongly agree	% disagree or strongly disagree	Average Rating
1) Same quarter last year EPS	85.1%	6.9%	1.28
2) Analyst consensus forecast of EPS for current quarter	73.5%	10.2%	0.96
3) Reporting a Profit (i.e., EPS > 0)	65.2%	12.0%	0.84
4) Previous Quarter EPS	54.2%	20.1%	0.49

It can be seen on Table 2 that the "same quarter last year" earnings per share value is considered the most important, with 85.1 percent of CFOs strongly agreeing about its significance, and an average rating of +1.28. However, all four benchmarks were considered important by the CFOs.[26] 73.5 percent agreed or strongly agreed that analyst consensus forecast of earnings per share for the current quarter was important; this demonstrates that the less incongruity there is between the company's internally-calculated forecasts, the more significant the number is to report. 65.2 percent agreed or strongly agreed that reporting a profit, or a positive earnings per share value, was important; 54.2 percent agreed or strongly agreed that the previous quarter's earnings per share value was important. The CFOs do not place as much magnitude on previous quarter EPS as they do on the EPS from the same quarter of the previous year, showing that while extremely short-term growth is very important, the year-long time span gives the company a chance to demonstrate growth over the previous four quarters. Therefore, it can be seen that CFOs consider all of these earnings per share benchmarks as important, and, on average, none of them are considered insignificant; however, they place the greatest importance on analyzing company growth over a period of time as opposed to quarter-by-quarter earnings.

[25] Graham, Harvey, Rajgopal, "The Economic Implications of Corporate Financial Reporting,", 52.
[26] Graham, Harvey, Rajgopal, "The Economic Implications of Corporate Financial Reporting," 11

Essentially, an overarching theme of the study conducted by Graham, Harvey and Rajgopal is that the predictability of earnings is a main concern among CFOs. For example, 78 percent of the surveyed executives were found to be hypothetically willing to sacrifice economic value in exchange for smooth earnings.[27] This is a clear indication of the CFOs' severe aversion to missing benchmarks, due to the fear of a variety of ramifications. The survey asked them their reasoning behind this acute anxiety. Each respondent indicated their level of agreement with the following statements on a scale where "agree or strongly agree" was allocated a value of +2, and "disagree or strongly disagree" was allocated a value of -2.

Table 3.
Survey Responses to the Question: Do these statements describe why your company tries to avoid missing an earnings benchmark?

Panel A. Unconditional averages.[28]

Question	% Agree or Strongly Agree	% Disagree or Strongly Disagree	Average Rating
It creates uncertainty about our future prospects.	80.7%	7.5%	0.97
Outsiders might think there are previously unknown problems at our firm.	60.0%	18.7%	0.49
We have to spend a lot of time explaining why we missed rather than focus on future prospects.	58.2%	18.6%	0.48
It leads to increased scrutiny of all aspects of our earnings releases.	37.6%	28.4%	0.07
Outsiders might think that our firm lacks the flexibility to meet the benchmark.	28.1%	36.3%	-0.14
It increases the possibility of lawsuits.	25.7%	37.8%	-0.20

[27] Graham, Harvey, Rajgopal, "The Economic Implications of Corporate Financial Reporting," 2.
[28] Graham, Harvey, Rajgopal, "The Economic Implications of Corporate Financial Reporting," 53.

The survey found that 80.7 percent of the CFOs agreed or strongly agreed with the statement that their companies avoid missing their earnings benchmarks because it "increases uncertainty about [their] future prospects." As mentioned previously, uncertainty in the market can lead to a decreased level of investor confidence, which makes the company run the risk of losing investors altogether. 60 percent agreed or strongly agreed with the statement that their companies avoid missing their earnings benchmarks because they are afraid that "outsiders might suspect that there are additional problems" at the firm of which they have not been aware. This can reduce confidence in the executive management teams, which can also lead to a decrease in the number of investors. These two issues received an "average rating" of 0.97 and 0.49 respectively, showing that on average, CFOs agreed with both of these statements. The aversion to these threats shows that CFOs greatly fear any room that investors have to question the success of the company; uncertainty is, in their minds, one of their biggest threats, because it runs the risk of depressing the company's stock price, losing investors, and exposing weaknesses in the company.

3.2 Risk Aversion in the Corporation

While the study by Graham, Harvey and Rajgopal found that an overpowering 96.9 percent of CFOs responding to their survey would prefer smooth earning paths to irregular earning paths, keeping cash flows constant,[29] this opinion is based upon the importance that executives place on risk reduction. CFOs believe that the smoother earnings are, the less volatile the stock price will be, which will reduce the risk premium and make the company more attractive to investors. Earnings consistency also makes it easier for the companies' analysts to predict future earnings, which is one of the main things that CFOs find is important when reporting successes to

[29] Graham, Harvey, Rajgopal, "The Economic Implications of Corporate Financial Reporting," 54.

outsiders. CFOs make decisions based on this principle because the market typically flees from any signs of volatility; smooth earnings imply less risk, and easier predictability attracts investors.[30]

Even though this study thoroughly analyses risk aversion in executive management teams, it concludes that all of the aforementioned trends that are currently taking place in many companies may become detrimental in the long run. This identifies one of the biggest flaws with a heavy concentration on short-term results; often, long-term results can suffer.

> The majority of CFOs admit to sacrificing long-term economic value to hit a target or to smooth short-term earnings. Such actions suggest a flaw in corporate governance practices. For example, Boards of Directors are presented with the large investment projects that management is advocating. They do not usually see the projects – some having substantial positive net present value – that management declines to bring forward.[31]

Even though this study addresses trends in the minds of the CFOs, it puts into question the corporate governance practices that currently revolve so stubbornly around short-term results, and whether or not the fears that these executives feel need to be readjusted. It must be considered that being stuck in a rut of worrying only about short-term results, especially at the expense of focusing on long-term company health, is instead more detrimental to the company.

All of the factors that foster an environment of fear and aversion to uncertainty can often be detrimental to a company's long-term growth. The concentration on quarterly results can divert attention from longer-term strategies for value creation, especially when they run the risk of reducing current earnings. However, this overconcentration on short-term earnings means that

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[30] Graham, Harvey, Rajgopal, "The Economic Implications of Corporate Financial Reporting," 36.
[31] Graham, Harvey, Rajgopal, "The Economic Implications of Corporate Financial Reporting," 36.

companies have to reprioritize, and if companies aren't focusing on their longer-term strategies, then the company won't last, which will render short-term successes irrelevant anyway. Therefore, companies need to devote more time to their long-term strategies. One of the ways that companies can reprioritize is by sharing the emphasis on both short-term performance earnings and the company's underlying health, or "the ability to sustain and improve performance year after year after year."[32] Short-term earnings will build confidence, and consistent short-term strength will bolster the ability of the company to grow in the long term. It is undeniable that these short-term indicators do provide a lot of information about the company's stability, and provides inertia for customers, suppliers, and employees, and investors to support it. However, focusing too heavily on these results diverts attention that would be better suited for the longer-term health of the company, because the long-term health of a company is paramount to converting the company's growth forecasts, capabilities, relationships, and assets into future cash flows.[33]

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[32] Ian Davis, "How to escape the short-term trap," *McKinsey Quarterly*, (11 April 2005).
[33] Davis, "How to escape the short-term trap."

Chapter 4: LONG-TERM CAPITAL MARKET POTENTIAL

Despite the trend of executives feeling like they have fallen victim to the whims of the capital market, markets recognize how important long-term health is. Their sacrifice of long-term company performance is self-imposed. In fact, the most stable and affluent companies do not consider short-term growth and long-term success mutually exclusive; they recognize that the two need to be synergetic in order to keep the company operating at an optimal level. Ian Davis, the chief executive of McKinsey & Company from 2003 to 2009, addressed this mindset in a breakthrough article written for the McKinsey Quarterly in 2005. In it, he states that the complaints from companies that "financial markets focus on quarterly results and give little credit to longer-term value creation strategies...must be challenged,"[34] because companies operate under assumptions that are incorrect, and they are subsequently putting themselves at a disadvantage. They need to learn how to manage both time frames simultaneously in order to ensure its future success. If companies can manage to do this, then they are adequately prepared to consider investing in corporate shared value.

4.1 Determinants of Long-Term Success

The reason why these assumptions are incorrect is because in "almost all industry sectors and almost all stock exchanges, up to 80 percent of a share's market value can be explained only by cash flow expectations beyond the next three years."[35] In other words, the value that markets assign companies through their earnings per share metric is not simply a composition of data to

[34] Davis, "How to escape the short-term trap."
[35] Davis, "How to escape the short-term trap."

quantify the value of the company. Instead, about 80 percent, or the vast majority, of the earnings per share metric is a concentrated projection of cash flow expectations past the next three years; this shows that the earnings per share metric is unequivocally calculated with long-term company progress in mind. Therefore, executives need to recognize that short-term and long-term results are inextricably linked.

This is due to the fact that these cash flow expectations are driven by the market's conclusions on company growth and long-term profitability. Thus, if companies are not reaching their industry expectations and growing at the rates that their industries dictate they must reach in order to continue their operations, then this may lead to longer-term decline. It may indicate that investors deem the company too risky to invest; with reduced equity, earnings will decrease, leading to customers not buying the company's products. This will necessitate the management team's intervention, meaning that they will need to find ways to cut costs.

Future cash flow expectations also affect the stock price. As mentioned before, investors assign a lot of significance to a company's earnings per share value. Earnings per share is calculated as the amount of net income minus any dividends that the company may have paid out in that quarter, divided by the weighted average of the amount of shares outstanding that the company has issued. A strong earnings-per-share trend indicates a promising determinant of a share's price. It is important to remember, however, that because it is a ratio, companies with differing levels of equity but a similar earnings-per-share ratio could be managing their capital differently; the efficiency with which a company manages its capital compared to its equity levels is very important. Because the earnings value is subject to accounting manipulation, the earnings-per-share value can be manipulated as well. For example, companies with less equity may show on their balance sheet that they are managing their capital more efficiently.

Therefore, earnings per share is not the only parameter that investors should consider when contemplating whether or not to invest in a company.

Furthermore, because the earnings-per-share ratio is used in calculating the price-earnings ratio of a company (which is the market value per share divided by the earnings-per-share ratio), the level of earnings can be a huge indication of company health. The price-earnings ratio can also essentially be considered the amount that investors are willing to pay per dollar of the company's earnings. However, as mentioned above, the complication of earnings manipulation applies here too, so investors have to make sure that they are not basing their investment decisions on the price-earnings ratios alone. This also emphasizes the fact that tracking earnings period by period – that is, meticulously following short-term cash flows – can mean that investors are turning a blind eye to other indicators of firm strength, because if they rely too heavily on these values, they may be misleading themselves in their investing decisions by ignoring companies that have stronger long-term potential but slower short-term growth, thus putting these companies in a weaker position in the capital market.

4.2 How to Foster Long-Term Success

When a company focuses more on its long-term health, it can determine which components to work on. Another way to look at it is that company health helps the management teams prioritize in the current period so that it can maximize the company's future potential.

> Thinking about health, as opposed to short-term performance, helps management teams understand how to look after companies today in a way that will ensure that they remain strong in the future. It focuses the mind on what must be done today to deliver the

> outcome of long-term performance. Companies are not focusing enough on managing the health of their businesses.[36]

It is easy to see that management teams and executives feel the pressures of the market. However, while short-term earnings are a very significant part of valuing a company and determining its current level of health and potential future growth prospects, it is a flawed system. Therefore, companies must find other ways that they can indicate their health and potential.

One of the ways that they can do this is by identifying which factors contribute to the heavy focus on short-term results, and then adjust them to reflect more long-term goals. The recent volatility of the market has made many investors wary of the stock market in general, and these conditions have been exacerbated by the fact that 10 of the largest 15 bankruptcies have occurred since 2001.[37] Bankruptcy is often considered a death sentence for many companies, regardless of the type. Chapter 11 bankruptcy, also known as corporate bankruptcy, is a restructuring of debt repayment strategies, while Chapter 7, also known as straight bankruptcy, is a liquidation of the company's assets; either option is a daunting prospect, because an increased risk of bankruptcy makes the company much riskier to invest in. Increased regulatory and legal reforms have also contributed to this overarching market wariness. Compliance with ever-evolving regulations and fluid legal requirements, many of which pertain to reporting the company's financial results, both current and historical,[38] is making companies more transparent, but is also exposing historical data that may have readjusting effects on how investors see current-term earnings values. An increase in the number of complicated compliance programs also runs the risk of confusing the management teams already in place. Some of these developments require

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[36] Davis, "How to escape the short-term trap."
[37] Davis, "How to escape the short-term trap."
[38] Davis, "How to escape the short-term trap."

an average 50 percent increase time commitment for these managers.[39] As mentioned in the previous section, when management teams have to divert the attention that they would normally be allocating to focusing on meeting company goals, they run the risk of neglecting important deadlines or not meeting benchmark goals. For example, 58.2 percent of the CFOs surveyed in the study by Graham, Harvey and Rajgopal agreed or strongly agreed with the statement that their companies avoid missing their earnings benchmarks because they are afraid that they, as the management team, will "have to spend a lot of time explaining why [they] missed [the benchmarks] rather than focus on future prospects."[40] This indicates a more general aversion towards diverting the attention of management teams from focusing on company progress to exercising damage control for their customers and investors.

Further, Davis reported that one McKinsey survey of over 1,000 directors found that more than 50 percent of them admitted to having only a "limited" understanding of what their companies' future objectives were in the next five to ten years.[41] When managers and executives only partially grasp the long-term goals of the company, they cannot successfully lead the company in any particular direction, even though that is their responsibility. Therefore, this lack of focus on the future sacrifices much of the potential that a company could provide itself. If management teams are having a hard time managing both the short-term and long-term time frames simultaneously, then both short-term success and sustained performance are being compromised.

There are several things that companies can focus on in order to better ensure the company's success, including a vigorous and reliable strategy, productive and well-maintained assets, innovative products and services, and a positive relationship with customers, suppliers,

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[39] Davis, "How to escape the short-term trap."
[40] Graham, Harvey, Rajgopal, "The Economic Implications of Corporate Financial Reporting," 54.
[41] Davis, "How to escape the short-term trap."

employees, regulators, and other "stakeholders."[42] Additionally, these improvements should accommodate both short-term and long-term timeline goals. One of the best ways to improve long-term success for many companies is by engaging in activities that contribute to corporate shared value.

[42] Davis, "How to escape the short-term trap."

Chapter 5: CLUSTERS

Clusters are a conglomerate of different links in a company's value chain, concentrated in one geographical location. Many companies choose to utilize clusters for their product development and distribution. Since clusters have developed because of firms' intentions to cut their production cost by outsourcing various links in their value chains, the preexisting communities have suffered from negligence. If companies exercise corporate shared value effectively, they can not only increase the efficiency of their clusters, but restore and improve the conditions of the geographic locations that they have taken over.

5.1 Globalization

With an increase in globalization, one of the best ways for firms under pressure to increase their competiveness and improve their position in the market, especially the global market, is to focus on refining the productivity and innovation of their clusters. Michael Porter and Mark Kramer provide an in-depth definition of clusters as

> …geographic concentrations of firms, related businesses, suppliers, service providers, and logistical infrastructure in a particular field…Clusters include not only businesses but institutions such as academic programs, trade associations, and standards organizations. They also draw on the broader public assets in the surrounding community, such as schools and universities, clean water, fair-competition laws, quality standards, and market transparency.[43]

Because clusters are based on geographical location, firms are permeating already-existing local communities that have educational institutions or organized labor. Thus, one of the main ways

[43] Michael E. Porter and Mark R. Kramer, "Creating Shared Value," *Harvard Business Review* (2011): 72.

that firms can improve the health of their clusters is by "upgrading" these particular aspects. Firms that operate internationally can find many ways to decrease their production and distribution costs by improving various links in their value chains. One of the ways that they can do this is by analyzing each link separately and adjusting it accordingly. By doing so, firms gain a competitive edge in the market, not only by reducing their costs, but are also by taking steps to improve their quality, efficiency, and development.

5.2 Acquisition and Dissemination of Knowledge

Firms use their clusters both for cost-reduction and production improvement. There are several ways that they can take this approach. They can increase the level of innovation in their production process; they can access new and distinctive markets; and, they can produce new and improved goods and services, while concentrating on perceived customer benefit.[44] Firms are concentrating on distinguishing their products in the market, finding new markets to which they can offer their goods and services, and focusing on evolving customer demand through these improvements and renovations. One of the most important ways that firms can do this is by relying on the accumulation of specific and differentiated knowledge – knowledge that makes their products distinct from those of similar firms – in order to gain a competitive edge.

In order to communicate these adjustments throughout the different steps in their production and distribution processes, firms need to find a way to educate and train those who operate and maintain the different steps in their value chains. Maskell and Malmberg paraphrase the studies

[44] Peter Maskell and Anders Malmberg, "Localised Learning and Industrial Competitiveness," *Cambridge Journal of Economics* (Volume 23, Issue 2, 1999), 167.

of Anne P. Carter, who, in her working paper on knowledge-based economies,[45] sums up this sentiment of knowledge dissemination:

> [The] knowledge-based economy is characterized by three elements: the growing importance of economic transactions focused on knowledge itself; rapid qualitative changes in goods and services; and incorporation of the creation and implementation of change itself into the mission of economic agents.[46] (167)

Therefore, in order for firms to be most successful in increasing firm value through their counterparts, they need to focus on education and training, or the passing on of knowledge. As Carter explains, knowledge accumulation is becoming an increasingly important element to economic transactions. The alacrity with which firms can educate the participants of their value chains will aid in giving them a competitive advantage. Finally, once the concept of these advantages is accepted by the entire company, it will have achieved a higher level of success in this knowledge-based economy. Therefore, knowledge is an essential element to company success.

One of the ways that firms can improve their store of knowledge is by focusing on local cluster development, especially with the increasing level of globalization. Concentrating their attention on their local clusters is essential because "knowledge creation of even the most globally oriented firms or sectors is, at least to some extent, influenced by differences in the economic properties of their place of location."[47] As Maskell and Malmberg describe, "[the] formation of the world market…increases the importance of heterogeneous, localized

[45] Anne P. Carter, "Measuring the Performance of a Knowledge-Based Economy," Brandeis University, Departments of Economics, Working Paper No. 337.
[46] Maskell and Malmberg, "Localised Learning and Industrial Competitiveness," 167.
[47] Maskell and Malmberg, "Localised Learning and Industrial Competitiveness," 168.

capabilities for building firm-specific competences."[48] Globalization has led to a homogenization of the distinguishable characteristics between many firms' goods and services. This reduction in product differentiation has not only made goods and services more similar between comparable firms, but has also made the factors of production less distinctive, minimizing any beneficial isolation that firms try to create for themselves. Therefore, the importance of increasing heterogeneity in the global market through focusing on cluster development has become increasingly critical over recent years. "Firms are progressively stimulated by and dependent on localized capabilities in order to maintain and increase their competitiveness precisely because of the drive towards globalization and the resulting homogenization of formerly critical factors of production."[49] Companies that have international capabilities have retained an advantage in cultivating heterogeneity through their localized clusters. This amplified concentration on local clusters emphasizes that their health and prosperity are directly correlated to a firm's success in all steps of the value chain. Firms need to concentrate some of its efforts on ensuring that clusters are being run as efficiently and effectively as possible in order to ensure that they are maximizing the benefits available to them through this knowledge generation process.

"Knowledge," in itself, is a concept that can deter many companies; Dosi and Orsengio express this by explaining that knowledge creation is "an activity with a basic element of uncertainty and with an absence of the necessary relevant information to facilitate rational decision-making."[50] This definition implies that firms approach the process of knowledge accumulation with uncertainty and speculation; as seen in previous sections, executive management teams have consistently abhorred any activity that harbors uncertain outcomes or increases risk. For example, executives will see the lack of "necessary relevant information" as a

[48] Maskell and Malmberg, "Localised Learning and Industrial Competitiveness," 172.
[49] Maskell and Malmberg, "Localised Learning and Industrial Competitiveness," 168.
[50] Maskell and Malmberg, "Localised Learning and Industrial Competitiveness," 169.

deterrent to invest in improving upon the knowledge that the firms already use, because a "rational decision-making" process cannot be followed through without essential and significant material upon which the firm can build. In order to convince firms that knowledge accumulation is a worthwhile investment for the firm over the long term, executives will need to see that the benefits of this knowledge will outweigh and overcome the "uncertainty" of the process.

Knowledge can be amassed, and thus applied, to any link along the value chain with the goal of increasing its efficiency and quality. It is often embedded in different parts of the value chain, but this can often present a challenge for the clusters working in these different parts to extract the knowledge they need from the tasks they perform. If they cannot retrieve the knowledge required to complete their work, they will not be able to maximize their efficiency. If this happens, both the company and the cluster will suffer. Maskell and Malmberg refer to these obstacles as "identification impediments,"[51] which make knowledge hard to identify when it is concealed in places such as specific skills or fixed capital. However, the more hidden this knowledge is, the more complicated the identification process becomes.

> But especially when created knowledge is embodied in the organization of the firm – in the form of internal procedures, routines and the gradual building of a firm-specific culture – it is often very difficult to identify exactly *where* in the organization the knowledge and the skills are embodied and *how* the embodiment has taken place.[52]

Maskell and Malmberg suggest that there is an important distinction between knowledge that can be easily attained and improved upon, and knowledge that is firm-specific. When knowledge is firm-specific, it is thus not transferrable to other firms, making it more difficult to identify and learn. However, this also implies that each company that has firm-specific knowledge immersed

[51] Maskell and Malmberg, "Localised Learning and Industrial Competitiveness," 171.
[52] Maskell and Malmberg, "Localised Learning and Industrial Competitiveness," 171.

in its operations, thus giving it an edge in the market, because more commonly obtainable – or in other words, transferrable – knowledge will not suffice. Therefore, the more that firms focus on knowledge that is firm-specific, the better they can maximize their operations.

Firms can ameliorate the conditions of their clusters by expanding their stores of knowledge. The more knowledge the clusters accumulate, the more they will be able to apply it to their own community's improvement. However, many executives, due to the risky nature of knowledge accumulation and dissemination, would most likely not agree to engage in this kind of social responsibility unless the firms also benefit; therefore, they must make their operations more efficient and effective in order for the process to be deemed worthwhile in the long run.

5.3 Codification of Knowledge

Because knowledge is not always readily available to clusters, firms can find ways to ensure that the clusters are receiving it in a cost-efficient and easily understandable way. One way to do this is through the process of codification. Maskell and Malmberg use P. David's definition of codification, which he presented in 1992 at the World Bank Annual Conference on Development Economics:

> "Codification of knowledge is a step in the process of reduction and conversion which renders the transmission, verification, storage and reproduction of information especially easy. Codified information typically, has been organised and expressed in a format that is compact and standardized to facilitate and reduce the costs of such operations (David, 1992, p. 7)."[53]

Every cluster is unique, based on a combination of its location, culture, and affiliation with outside firms. Therefore, if a firm can find a way to create a better way to transfer, authenticate,

[53] Maskell and Malmberg, "Localised Learning and Industrial Competitiveness," 172.

accumulate, and apply the specific knowledge that its clusters require to operate most efficiently, every part of the value chain will benefit. Zander and Kogut (1995) explain that codification increases the speed of knowledge-transfer by lowering transaction costs; this cost reduction inevitably provides the economy – both throughout the firm and within the cluster – with a higher level of efficiency.[54] They elaborate by saying that "[the] capacity to speed the internal transfer of a production capability to new markets (e.g., those in other countries) is, consequently, of fundamental significance in a competitive environment."[55] Thus, speed of knowledge transfer to a firm's clusters is paramount to global market success. Moreover, the cluster will be able to apply the knowledge it acquires to the rest of the cluster who is not affiliated with the firm. In other words, a firm's investment in improving information transfer to its clusters will improve not only its own operations, but also the environment in which the cluster exists.

The issue of knowledge, however, is quite layered. If knowledge is easily transferable amidst the work of the cluster, the cluster's overall productivity will be drastically improved. However, if knowledge is too attainable, then rival firms may acquire it, and the firms will lose their competitive edge in the market. Therefore, firms must find a balance between easily communicable, but not too communicable, knowledge in their clusters in order to foster their development by using this method of codification to its full potential:

> [A] logical and interesting consequence of the present development towards a global economy is that the most easily codifiable (tradable) knowledge can be accessed, the

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[54] Maskell and Malmberg, "Localised Learning and Industrial Competitiveness," 171.
[55] Udo Zander and Bruce Kogut, "Knowledge and the Speed of the Transfer and Imitation of Organizational Capabilities: An Empirical Test," *Organization Science* (Vol. 6, No. 1, 1995), 76.

> more crucial does tacit knowledge become for sustaining or enhancing the competitive position of the firm.[56]

This idea of "tacit knowledge" is crucial to the firm for creating and maintaining a competitive edge in the global market. The more universal, and thus accessible, the "codifiable" knowledge is for the competition to obtain, the easier it may be for other firms to use it to reduce competition. Therefore, firms need to hone their transfer of tacit knowledge to their clusters in order to secure their unique position in the global economy.

One modifier to this transfer of tacit knowledge is that because clusters are so condensed and localized, "codifiable" knowledge is spread much easier. This can sometimes work to the cluster's advantage. Nevertheless, the increased levels of globalization have been making many production factors and capabilities that have been recently assigned abroad to clusters much more omnipresent.[57] Firms need to find a way to retrieve tacit knowledge from these increasingly universal operations.

> What is *not* ubiquified, however, is the non-tradable/non-codified result of knowledge creation – the embedded tacit knowledge – that at a given time can only be produced in practice. The fundamental *exchange inability* of this type of knowledge increases its importance as the internationalisation of markets proceeds.[58]

Firms must concentrate on the "exchange inability," or the unique and untradeable quality, of the knowledge that they instill in their clusters. Because one of the most distinct ways that clusters are unique and independent from one another is their location, firms can use this aspect to their advantage; "both the formation of the world market and the process of codification increases the importance of heterogeneous, localized capabilities for building firm-specific competences and

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[56] Maskell and Malmberg, "Localised Learning and Industrial Competitiveness," 172.
[57] Maskell and Malmberg, "Localised Learning and Industrial Competitiveness," 172.
[58] Maskell and Malmberg, "Localised Learning and Industrial Competitiveness," 172.

thus for variations between firms in their competitiveness."[59] Firms need to focus heavily on determining how they can maximize the unique potential of each of their clusters, because doing so can both improve their business and the quality of the cluster.

5.4 Localization of Cluster Development

Firms have an immense influence on the regions in which they operate, so their involvement can either help or hinder the process of knowledge creation, which can have an enormous effect on the development of the region. The institutional endowment, another way of referring to the power that firms have over their clusters, is essential to the health of a cluster, and firms have a strong effect on their clusters' health and welfare.

> The regional institutional endowment…has a directional effect on the efforts of firms in the region by supporting and assisting some types of knowledge creation while hampering or preventing others. The institutional endowment simultaneously spurs and confines the development of firms in the region, thereby exerting a strong – but never deterministic – influence on the future of the region.[60]

This demonstrates that firms have a "directional effect," or can strongly influence, the way that clusters in particular regions create, acquire, and cultivate knowledge, and that this influence can be either positive or negative. However, the effectiveness of the knowledge transfer depends on many components.

For example, firms often adopt clusters and bring them into their value chains on the basis of commissioning the firms' specifications. Because the clusters must conform to the expectations

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[59] Maskell and Malmberg, "Localised Learning and Industrial Competitiveness," 172.
[60] Maskell and Malmberg, "Localised Learning and Industrial Competitiveness," 174.

of the firms, they are not able to manufacture the products or carry out their tasks according to their own design.[61] This conflict of interest is significant because the geographic regions that the firms now permeate with their production and distribution processes most likely had their own interpretations of labor distribution, education levels, and community involvement. The issue exposes the fact that firms use clusters for their own advantage, but can sometimes be blind to the effects that they are having on the community and culture that had been there before. Firms are not focusing enough on the maintenance and improvement of their clusters, but are instead too driven by their own economic desires. Additionally, the length of the relationship between clusters and the outside firms is important. This issue reverts back to another fundamental principle of firm operations in the global market: short-term realizations must be incorporated in conjunction with long-term success. Firms that only maintain short-term relationships with the local clusters are often focusing only on, as previously mentioned, carrying out operations – such as design or technical content – that conform to the wishes of the firm. However, this becomes detrimental to the cluster, because even though they are able to obtain and apply new knowledge and techniques, they are not given the time to absorb more long-term knowledge that could help them in the long run, such as management techniques.[62] This lack of long-term knowledge, coupled with the end of an already short-term relationship with an outside firm, can have drastic consequences on the cluster.

5.5 Upgrading the Cluster

When the local producers in the cluster are introduced to this knowledge transfer, they are presented with multiple options for how to upgrade their activities. "Process upgrading" is when

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[61] Fiorenza Belussi and Alessia Sammarra, eds., *Business Networks in Clusters and Industrial Districts* (New York: Routledge, 2010), 178.
[62] Belussi and Sammarra, eds., *Business Networks in Clusters and Industrial Districts*, 179.

inputs are converted into outputs more proficiently by reorganizing the production system or introducing superior technology; "product upgrading" is the shift towards more complex and efficient product lines; "functional upgrading" is the acquisition of new functions, or abandoning existing functions, to increase the overall skill content of the activities being performed; "inter-sectoral upgrading" is when firms of clusters move into new areas of production different than their original tasks.[63] Knowledge transfer from a firm to its clusters, who are performing all of these tasks, can help the clusters benefit from these forms of upgrading. If firms can identify into which category their clusters' activities fall, they will be able to provide them with the appropriate tacit knowledge to improve their operations and minimize the business costs to make their operations more efficient, while improving the quality of the cluster.

Firms need to differentiate themselves from the production of standard products in order to stay competitive. When they are producing standard products, the measures of coordination between steps in the value chain – what is being produced, how it is being produced, and physical product flow[64] – are relatively easy.

> Markets are particularly effective for standard products. Coordination requirements between different points in the chain are low, valuation of the product and monitoring of supplier performance is relatively easy, and economies of scale are likely to be significant. Buyer and supplier maintain arm's length market relations.

These requirements are relatively simple to conform to. The market has a substantial amount of influence over firms' operations in this case, because the principles revert back to the simplest form of capitalism; production is dictated by demand, and demand dictates price. Firms are thus

[63] John Humphrey and Hubert Schmitz, "How Does Insertion in Global Value Chains Affect Upgrading in Industrial Clusters?" *Regional Studies* (Vo. 36.9, 2002), 1020.
[64] Humphrey and Schmitz, "How Does Insertion in Global Value Chains Affect Upgrading in Industrial Clusters?" 1021.

at the disposal of the global market, and transaction costs can be easily kept at a lower level. Once products become more customized and tailored to individual demand instead of an all-encompassing market demand, however, transaction costs become more volatile. It would be possible for firms to ignore the increasingly specific demand; however, with the evolution of demand, firms would be remiss to pass over it. Porter, in his paper on the competitive edge of nations, explains the importance of firms paying attention to the evolving demand of their customers.

> In recent years, research in business economics has further called attention to the significance of close contact with a group of demanding and advanced public or private customers, whose needs wholly or partly anticipate the development of the global market. (Porter, 1990). In this situation, demand is primarily functioning as a qualitative factor. It is the contact with advanced customers, expressing sophisticated demands, that is of value in knowledge creation, rather than the quantitative element of easy access to a large market *per se*.[65]

The importance of paying attention to consumer demand is undeniable. It is clear, therefore, that because "value" is not regarded only as an objective, quantifiable point of comparison, that companies operating under such a mindset run the risk of repelling the people who support their businesses in the first place. Consumers and investors, therefore, have a huge impact on market demand, and companies need to be receptive to their influence on their business through the "invisible hand" philosophy of Adam Smith. Under this system, instead of just the corporations reaping the benefits of these transactions, "[e]xchanges will not normally occur unless there is an increase in value of both parties to the exchange. The exchange process is usually a positive sum

[65] Maskell and Malmberg, "Localised Learning and Industrial Competitiveness," 168.

game, as both parties to the exchange believe themselves to be better as a result."[66] Therefore, the values of the goods and services provided to investors and consumers are comprised of consumer demand and producer supply and production.

With an increase in globalization comes an attraction for firms to move their operations to places where it is less expensive for them to operate, even if it is detrimental to the places in which they are establishing parts of their value chain. Although the immediate growth in the region can be remarkable, and can lead to short-term benefits such as lower rates of unemployment, if firms do not invest long-term in these clusters, then the clusters will collapse. Wages will be too low to sustain a reasonable standard of living, especially as the cost of living will increase due to the presence of globalization. The state of the infrastructure will deteriorate and fall into ruin because the necessary investments are not being made to maintain it. Additionally, when firms are simply entering into these regions as "a passive mechanism,"[67] or one that is only there to increase the efficiency of their own operations, then the firms have little or no incentive to disseminate knowledge that could actually benefit all sides of the business. However, when firms create international networks that are fully integrated with the clusters, they are no longer just a presence, but they are actively contributing to its success because foreign firms are the main sources of knowledge creation in a cluster.[68] This, in turn, contributes to the success of the business by giving them a competitive edge.

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[66] Rogene A. Buchholz, *Rethinking Capitalism: Community and Responsibility in Business* (New York: Routledge, 2009), 100.
[67] Belussi and Sammarra, eds., *Business Networks in Clusters and Industrial Districts*, 183.
[68] Belussi and Sammarra, eds., *Business Networks in Clusters and Industrial Districts*, 183.

5.6 Firm Distribution Within the Cluster

One of the challenges that clusters can run into concerns how firms share the geographical region with other global firms. When global firms decide to move parts of their production and distribution processes abroad, they will inevitably end up sharing the location with other international firms. With this global competition, which is usually conducted on a worldwide scale, concentrated in one particular geographical area, clusters can suffer. Thus, in order for cluster development to improve the welfare of the cluster, firms need to agree to amalgamate their efforts to improve the entire region. One of the ways that they can do this is through a concept called "governance," which is a "coordination of economic activities through non-market relationships."[69] Even though these competing firms are concentrated in specific geographical areas, it does not imply that the clusters have to suffer from this strongly collected market competition. However, firms have to make a conscious effort to focus on cluster improvement, or else the clusters will suffer; governance can thus play an essential role. Firms can exercise inter-firm cooperation by focusing on improving the public and private institutions of the cluster, such as schools and universities, infrastructure regulators, or trade associations. When external firms compile their funds to improve the conditions of the cluster and its internal resources, they are promoting communal efficiency; this efficiency can directly translate into more efficient operations for the firms.

Firms can further this competitive edge by utilizing the geographical distinctions between different regions. Often, a geographical collection of firm activity means that many different kinds of firms, who are all using the clusters for their individual development, have to coexist in

[69] Humphrey and Schmitz, "How Does Insertion in Global Value Chains Affect Upgrading in Industrial Clusters?" 1018.

the concentrated area. Sharing in a cluster can adjust the region's environment to become more relevant to the firm's requirements for its operations.

> [The] optimal location would usually be a region with a long track record of servicing firms in just that sector: only such a region has had the opportunity to develop the desired capabilities. The differences in capabilities between regions will (by definition) be revealed in discrepancies in the competitiveness of firms located there, with long-term consequences for their survival rate.[70]

Geographical contiguity is something that can work to the advantage of both the firm and the cluster. Therefore, when collaboration is encouraged in a regional cluster, everything becomes much more efficient. However, geographical proximity is not the only proximity that will help clusters become more efficient. "Time geography," or the distance between participants, can, *ceteris paribus*, make interactive collaboration and knowledge transfer less expensive and smoother, the shorter the distance is between the participants.[71] This emphasizes that information can be transferred most easily between parties that are closely located to one another; therefore, firms need to focus on expanding the knowledge of the groups of people that are concentrated in the cluster. Another aspect of proximity that is important for firms to pay attention to pertains to the social and cultural customs of those living within the cluster. "To communicate tacit knowledge will normally require a high degree of mutual trust and understanding, which in turn is related not only to language but also to shared values and 'culture.'"[72] Therefore, firms must place significant importance on the concept of proximity, which can be geographical, communal, social, and cultural. The best ideal of proximity will combine all of these. However, one concept is essential: the idea of "mutual trust" is an essential

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[70] Maskell and Malmberg, "Localised Learning and Industrial Competitiveness," 176.
[71] Maskell and Malmberg, "Localised Learning and Industrial Competitiveness," 180.
[72] Maskell and Malmberg, "Localised Learning and Industrial Competitiveness," 180.

component for firms to apply to the operations of their clusters. If firms do not trust their clusters, they will not be willing to share their tacit knowledge in order to continue to operate with them; if the clusters do not trust the firm, then they will not benefit from the influences that the firm brings to them.

Chapter 6: CONSUMER SOVEREIGNTY

Consumer sovereignty plays a unique role in the market economy. Firms determine what products to sell based on the demand of their consumers; therefore, the level of control that consumers have over the market is referred to as their "sovereignty" over production. Conversely, firms have perfected endeavors like advertising in order to reverse this process and regain some control over the market. However, regardless of which group holds more influence, corporate shared value can appeal to both consumer and producer desires; if companies use this to their advantage, they will gain an advantage by investing in shared value.

6.1 Defining Consumer Sovereignty

Although consumer sovereignty was a phrase coined by W. H. Hutt in 1936,[73] it is a concept that has been widely understood and taken into account for a long time. It has accumulated many different definitions, but "…the basic question in assessing the principle of consumer sovereignty is whether consumer preferences are an adequate representation of interests and, if not, how they have to be extended, qualified, or replaced to provide such an adequate representation."[74] In other words, consumer sovereignty is a tool that companies can – and should – use to determine consumer demand for goods and services. It is the direct reflection of the consumer's ideal type, quantity, quality, and price of goods that are being distributed and sold; these indicators are irreplaceable benchmarks for businesses that are trying to create the most efficient and profitable products. The more receptive a company can be to its consumers'

[73] G. Peter Penz, *Consumer Sovereignty and Human Interests*, (New York: Cambridge University Press, 1986), 12.
[74] Penz, *Consumer Sovereignty*, 2.

demand, the better it can determine what to produce, how much of it to produce, and the price that they assign the goods.

It can be argued further that the company that responds best to its consumers' sovereignty will be more successful.

> [The] notion of consumer *sovereignty* and the argument as it stands imply the *subordination* of producer interests to consumer interests. It seems that the argument is not merely that consumer interests are the only ones that need institutional protection, but also that they are the only ones to be valued.[75]

While this statement is somewhat restrictive by saying that consumers' interests are the only interests with which a company should concern itself, it does reflect an important principle of the perfectly competitive market: in theory, with no external intervention – just as reflected in Milton's Friedman's arguments – consumer demand will naturally adjust the way that producers make their decisions. Because the perfectly competitive market does not exist, companies cannot leave the market to coordinate all of their production decisions autonomously; however, this process can have a directly positive effect on how companies readjust their production and market positions.

Furthermore, the market sovereignty of consumers is often driven by motivators that are not simply rooted in demand for a good or service. These wants are referred to as "social wants," which can be defined as "wants that are not merely for some form of individually private enjoyment, but involve the behavior, feelings, or interests of others."[76] Therefore, price is not always the sole factor in a consumer's decision to purchase a good; consumers may decide to

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[75] Penz, *Consumer Sovereignty*, 30.
[76] Penz, *Consumer Sovereignty*, 41.

purchase goods and services that are not simply for their own individual gratification, but are also connected to external elements in their production and distribution.[77] This is a distinct way in which corporate shared value infuses itself into the decision-making power of the consumer. While there are many variations on the different types of social wants that may motivate a consumer, there are three that are connected to the concept of corporate shared value that are worth mentioning.

6.2 The Effects of Social Wants on the Corporation

The first, called *altruistic wants*, are wants for the satisfaction of the benefits of others, combined with the alacrity to sacrifice one's own interest.[78] Altruistic wants often pertain to self-sacrificing consumers who are willing to forego their normal level of satisfaction in order to promote justice for other groups of people or the environment. The second kind, called *norm-imposing wants*, reflects the desire to not only promote the interests of others, such as with altruistic wants, but to also encourage others to "meet certain standards for reasons that have nothing to do with [one's] own self-interest."[79] The third kind, called *collective-state wants*, is an expanded version of the norm-imposing wants by applying not to individuals, but to society or the environment.[80] These three principles indicate that consumer preferences are more complex than simply considering the price of a good or service and purchasing goods for individual consumption. Therefore, when combining these social wants with consumer sovereignty, it is clear to see that companies need to take into consideration the fact that consumers are not only

[77] Penz, *Consumer Sovereignty*, 41.
[78] Penz, *Consumer Sovereignty*, 42.
[79] Penz, *Consumer Sovereignty*, 42.
[80] Penz, *Consumer Sovereignty*, 42.

aware of the interests of other people and the environment. They also need to be aware that if these consumers – those who exercise these altruistic, norm-imposing, or collective-state wants – disapprove of the way that companies produce and distribute their goods and services, they will be at a severe disadvantage in the market. Therefore, by becoming more aware of how their operations impact others, companies may be able to keep these philanthropic consumers while attracting new ones, thus improving their competitive advantage.

6.3 The Effects of Advertising on the Consumer

Companies use the powerful effect of advertising to influence consumers, relying on the message that the consumption of their goods conveys to society. "Based on their exposure to, and discriminating appropriation from, the advertising/popular culture mix, people are then able to purchase the items that give off desired symbols."[81] Companies readily recognize the importance of these "desired symbols," and thus want to ensure that consumers will associate their products with certain social representations. They can do this by almost assaulting consumers with advertising campaigns that are so aggressive that they are essentially creating demand for consumers where there may never have been any previously, or at least demand of which the consumers had been unaware.

> [The] messages of the advertiser must be constructed so as to make the fullest contact with the mind of the consumer. The human mind has two components of interest to the creators of advertising: One is the area of the mind governing the individual as a social creature, and the other is the area of the mind housing basic instincts, impulses, drives,

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[81] Jib Fowles, *Advertising and Popular Culture* (Thousand Oaks: Sage Publications, 1996), 49.

> and needs. The most successful advertising will incorporate symbolizing appeals to both.[82]

The goal of advertising is to penetrate the conscious and unconscious decision-making process of the consumer, and companies do this in two ways simultaneously: appealing to the "desired symbols" that are expressed in the "social creature" capacity of the purchaser, and connecting with the basic predispositions embedded in his or her human instincts. The social wants mentioned previously are manifestations of the consumer's "social" behavior, and the natural consumer reaction to price changes in a perfectly competitive market is a manifestation of the consumer's visceral behavior. As the citation stresses, the most successful companies, in their advertising campaigns, are able to permeate both levels; this is an incredibly powerful tool.

Some companies have already made this distinction, but have instead taken a superficial approach to improving their competitive advantage. The advertising process is a clear indication that the power that corporations hold over the consumer may not be prioritizing consumer sovereignty to the extent that it should be. However, with more research being done about the importance of social and environmental awareness, consumers' tastes may continue to evolve along the parameters of the altruistic, norm-inducing, and collective-state wants. By combining the influence of consumer sovereignty with the remaining influence that companies have over their consumers, consumers may potentially be able to redirect business activities and operations towards outcomes that are more beneficial for society, both domestically and abroad. Addressing the many unmet needs of the global economy may give consumers the power to change existing issues, with corporations being a necessary catalyst. Furthermore, improving society in this way can give companies the power to improve their own productivity. Therefore,

[82] Fowles, *Advertising and Popular Culture*, 93.

the “reconception” of products and markets has, and may continue to, lend itself to increasing shared value through corporations by using the power of consumer demand.

Chapter 7: CONCLUSION

This reaction can compel purely for-profit corporations to actively avoid social involvement. However, with the evolution of social wants in consumer sovereignty, companies are realizing that there is potential to increase their customer base, yet only on a superficial level. This shallow contribution to social good is referred to by some economists as corporate social responsibility. Advocates of socially aware companies, such as Michael Porter and Mark Kramer, consider corporate social responsibility to be too one-dimensional. "Corporate responsibility programs – a reaction to external pressure – have emerged largely to improve firms' reputations and are treated as a necessary expense. Anything more is seen by many as an irresponsible use of shareholders' money."[83] Corporate social responsibility programs are thus seen as a marketing ploy, simply a knee-jerk reaction to external pressures from either governments and non-government organizations, or consumers who fervently support "socially conscious" businesses. Corporations seek to exercise corporate shared responsibility in order to protect their reputation. Therefore, it is seen as simply another business expense. The problem with this mindset is that these firms are considering corporate shared responsibility as a means to an end; they will invest the minimum amount of money as possible into these programs so that they can capture these consumers, driven by social wants, without excessively depleting their bottom line. This bare-minimum mentality demotivates the companies from further pursuing any other sort of contributory value to society. However, if firms were to readjust their concept of value to encompass a more "shared" perspective, they may realize two important points. This reconceived perception of value, called "shared value," "recognizes that societal needs, not just conventional economic needs, define markets. It also recognizes that social harms or

[83] Michael E. Porter and Mark R. Kramer, "Creating Shared Value," *Harvard Business Review* (2011): 65.

weaknesses frequently create *internal* costs for firms."[84] First, companies may find that they possess untapped potential for firm growth; and second, they may unknowingly be incurring costs by ignoring societal needs. This concept goes beyond corporate social responsibility because shared value creates long-term potential for a company's profitability and competitive position in the market, while corporate social responsibility is a short-term remedy that is hard to justify in the long run.[85] Porter and Kramer provide a useful table in order to illustrate the differences between the two concepts, which is loosely reproduced below:

Table 4.
How Shared Value Differs from Corporate Social Responsibility.[86]

Corporate Social Responsibility (CSR)	Corporate Shared Value (CSV)
• Value: doing good	• Value: economic and societal benefits relative to cost
• Citizenship, philanthropy, sustainability	• Joint company and community value creation
• Discretionary or in response to external pressure	• Integral to competing
• Separate from profit maximization	• Integral to profit maximization
• Agenda is determined by external reporting and personal preferences	• Agenda is company specific and internally generated
• Impact limited by corporate footprint and CSR budget	• Realigns the entire company budget

The differences between the two concepts are important for companies to distinguish. While corporate social responsibility is based in philanthropy and doing "good" for society, its impacts are too reactionary and cursory to make a significant impact in improving either society or the company's earnings potential. Corporate shared value, on the other hand, is a readjustment of

[84] Porter and Kramer, "Creating Shared Value," 65.
[85] Porter and Kramer, "Creating Shared Value," 76.
[86] Porter and Kramer, "Creating Shared Value," 76.

the company's overall operations. Therefore, the main distinction between the two is that corporate social responsibility is a short-term solution; corporate shared value is a long-term realignment of the company's entire budget, market position and overall mission.

Corporate shared value requires a long-term plan in order to be implemented effectively. This long-term investment requires incremental short-term investments in order to solidify that the corporation is pursuing shared value; however, it is important for management teams to realize that these short-term investments are not detrimental to the firm. Changing products, increasing information transfer, and maintaining the conditions of local clusters all require monetary attention. Additionally, particularly in clusters, cooperation with firms that are sharing geographical regions is essential. Corporate shared value does require short-term sacrifices. However, the more firms realize that the long-term benefits outweigh the short-term costs, the better off society, and the global economy, will be.

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