



<b>Title</b>	The public good
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<b>Publication date</b>	2018-12-03
<b>Publication information</b>	Brennan, Niamh. "The Public Good." Institute of Chartered Accountants in Ireland, December 3, 2018.
<b>Publisher</b>	Institute of Chartered Accountants in Ireland
<b>Item record/more information</b>	<a href="http://hdl.handle.net/10197/11817">http://hdl.handle.net/10197/11817</a>
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## Niamh Brennan The public good

Corporations are being urged to prioritise long-term value over short-term profit, but old ways of thinking must first be tackled.



A number of academic papers published out of the University of Chicago in the 1970s and 1980s have had an extraordinary influence on corporate governance. These papers are based on mathematical formulae, which require extremely simplistic assumptions to solve the equations.

Company managers are assumed to be motivated solely by self-interest, not by moral obligation (notwithstanding fiduciary duty). It is assumed that it is possible to eliminate self-interest using incentives, so that company managers will look after shareholders' interests rather than their own self-interest. This perspective only considers two parties: shareholders and managers (otherwise, the mathematics would not work out). This way of thinking led Nobel laureate Milton Friedman to observe that the only responsibility of business is to make a profit. Thus, shareholders and profit maximisation became the imperative of business. Consequently, managers are incentivised to take excessive risks to generate returns at the expense of corporate resilience and long-term sustainable values.

The thought police, especially in the US, will not countenance alternative assumptions and ways of thinking. Many top US academic accounting journals will not publish papers based on alternative theories, with editors of those journals acting as gatekeepers to prevent expression of alternative perspectives.

The damage is exacerbated by institutional shareholders, who are not the ultimate beneficiaries of investment returns. Most stock market capital is pensioner monies. Pensioner beneficiaries require long-term sustainable returns. Institutional investors have a short-

term focus, exacerbated by end-of-year performance pay incentive systems. Institutional investors cannot be relied on to monitor company management or engage with their investees in a manner that will support long-term value creation. This perspective also ignores the law, specifically the fiduciary duties of directors to look after the company's (not the shareholders') interests.

These theories have been embraced by regulators. They have therefore impacted corporate governance by requiring separation of chairman and CEO roles; majority independent boards; and acquiescing to incentive systems such as performance pay and stock options, for example.

Accounting standards also reflect this perspective, with a heavy focus on providing users with useful information for decision-making purposes. Users are primarily shareholders making buy, hold or sell decisions. However, the tectonic plates are shifting. The Purpose of the Corporation, the Modern Corporation: Corporate Governance for the 21<sup>st</sup> Century and the Future of the Corporation projects are challenging these embedded notions. These projects argue that corporate governance should align with a socially beneficial corporate purpose. They conclude that corporate entities should aim to create long-term sustainable value for customers and shareholders while also contributing to societal well-being and environmental sustainability – objectives that can be mutually reinforcing.

They advocate that company law should require companies to specify their corporate purposes. Companies should adopt structures that ensure they uphold the public good as well

as their own private interests. In particular, companies that perform public and social functions such as utilities, banks and companies with significant market power should align their corporate and social purposes. In addition, the regulatory framework should promote an alignment of corporate purposes with social purposes and ensure that companies' ownership, governance, measurement and incentive systems are appropriate for these objectives.

Companies are urged to be more specific about the varied audiences for their corporate governance, customising their reporting for individual stakeholder groups. Methods of engaging stakeholders more effectively in corporate governance are discussed, including through representation and consultation.

Alignment of corporate with social purposes will generate increased scrutiny on the social and environmental impact of companies, the design of incentive and control systems and their relationships with corporate strategy, the role of corporate reporting and, finally, the role of investors.

These ideas are gaining traction. For example, the British Government recently agreed to introduce laws that will impose on pension schemes a fiduciary duty to protect long-term value by considering the environmental risks of the companies in which they invest. The new rules will push consideration of long-term value and environmental risks down the investment chain to investee firms.



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