Balancing act — the tightrope of corporate governance reform

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- ***Research study finds that Australian companies are developing useful and balanced governance systems***
- ***Their key costs are board time ensuring that appropriate structures are in place and professional experts***
- ***Benefits include improved definition of risks and the relationship between board and management***

Over the last five years, corporate governance has proved an insistent issue in the boardrooms of Australia. In March 2003, the Australian Stock Exchange (ASX) Corporate Governance Council launched its *Principles of Good Corporate Governance and Best Practice Recommendations* (the guidelines). The following year amendments to the *Corporations Act 2001* came into force, designed to improve corporate accountability and auditing practices. In annual reports for 2004–2005, Australian corporations were asked to disclose more information about their corporate governance practices than ever before. This prompted a review of existing governance structures and procedures against those recommended or required by the new regulation.

A research team at the Centre for Corporate Governance at the University of Technology, Sydney, has spent the last three years examining the extent to which the Australian corporate governance reforms have caused changes at a practical level within companies. The study, entitled *The Changing Roles and Responsibilities of Company Boards and Directors*, focused on qualitative changes in thinking and behaviour rather than on quantitative measures of compliance. It can be distinguished from the ASX's annual surveys of corporate governance reporting and provides evidence to support some of the findings of those surveys.[1] The research also offers qualitative support for recent corporate governance surveys conducted by CSA.[2]

The ultimate aim of the project was to discover how corporate governance might add value to companies, both in terms of accountability and performance. The research was carried out in partnership with Dibbs Abbott Stillman Lawyers and received funding from the Australian Research Council.

This article examines some of the highlights of the research. In light of the changes made by companies, it considers whether Australia has found the right balance in its corporate governance regime. On the basis that both the costs and benefits are difficult to precisely pin down, it is not an easy balancing act to achieve. Nevertheless, Australia appears to be on the right track in terms of developing a useful and well-balanced corporate governance system.

The research methodology

The research adopted a triangulated approach drawing upon three mutually reinforcing sources of data:

- a series of semi-structured interviews held with representatives of a wide ranging sample of 67 companies
- annual financial reports, company website information and other public statements on corporate governance released by each participating company and
- a series of workshops with leading corporate governance practitioners held at different stages of the research, used to obtain advice and input on the research direction and questions, the data collected and the scope of the research.

The research was conducted over the period 2005 to 2007 and represents the most in-depth analysis of corporate governance practice yet completed in Australia. It involved interviews with corporate officers, mostly company secretaries and directors of companies. The sample consisted of leading members of the ASX including BHP Billiton, National Australia Bank, Westpac, Fosters and Westfield; representatives of the ASX 300 including Adelaide Bank, Commander Communications and Transfield Services; small listed corporations including Cheviot Bridge and Engin; as well as recently-listed companies; and a selection of international and private corporations.

As a whole this sample represented the life cycle of corporate governance from the basic problems of establishing a listed company, to developing extensive systems of performance and accountability in the mature corporation. The sample of companies was constructed with reference to the industry workshops and the original spread of target companies stated in the ARC applications, based on the prevailing literature. The response rate to requests for interviews was approximately 12 per cent, which is higher than research questionnaires, which are often around 7 per cent response rates.

The companies also spanned a wide range of industries and geographical locations: from mining to medical technology; and from Perth to Brisbane. Each interviewee was asked a series of questions about how corporate governance was implemented within their company. The questions were broadly developed from the guidelines in consultation with workshop members, and explored recent changes in corporate governance structures and processes focusing on the changing behaviour and values of boards and directors. Prior to each interview a detailed report was produced, providing all of the publicly available information regarding the corporate governance of the company concerned in answer to the questions to be considered in the interview, this was provided in advance to the interviewee to allow the discussion to concentrate on the interpretation and analysis of the governance changes that had occurred.[3]

Summary of research findings

For most companies, implementation of corporate governance regulation proved a gradual process of formalisation and improvement rather than an outright transformation. Across all sectors of Australian business surveyed, there was evidence of intelligent engagement in corporate governance and professionalism in its implementation. To a degree this may have been a reflection of the interest in corporate governance of the companies and interviewees, the majority of whom demonstrated themselves to be highly informed directors, company secretaries and legal counsel.

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Engagement with the guidelines has proved a positive process in this sample of companies and to a large extent they have tailored their corporate governance structures to fit the needs of the organisation. Risk management systems had an obvious value in improving information flow and promoting better decision-making.

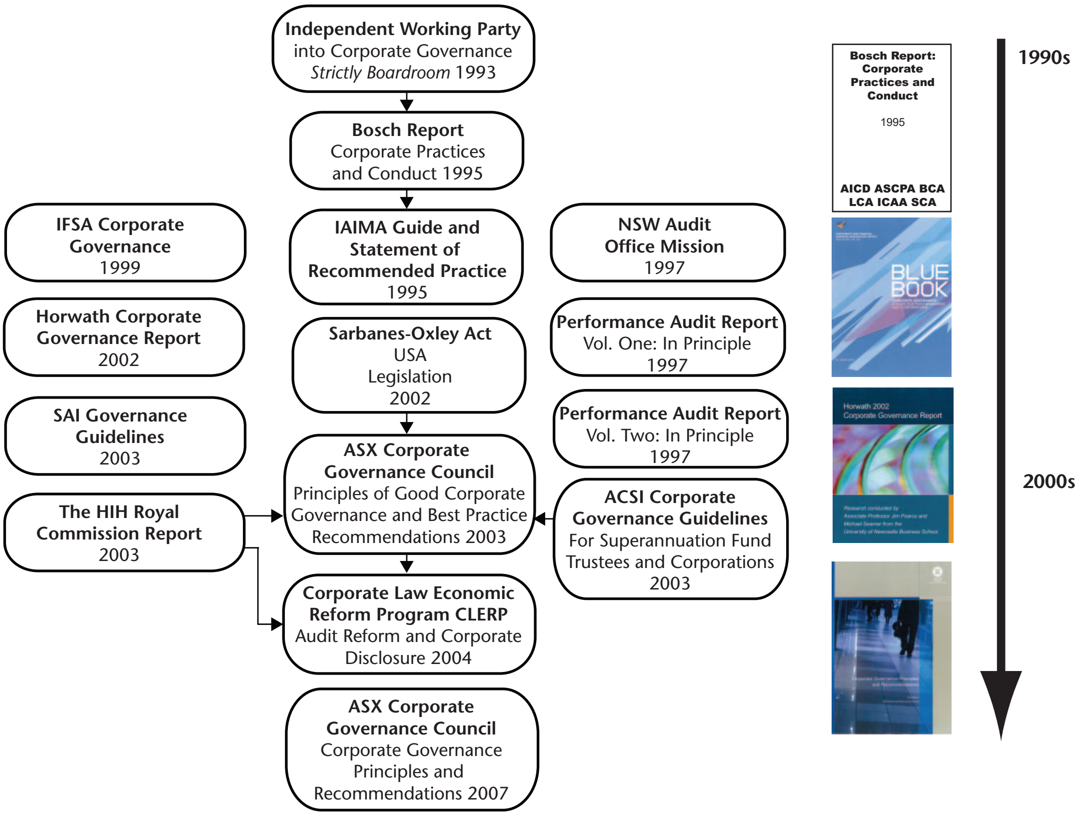
The research clearly revealed that the corporate governance practices appropriate for a company change as the business grows and develops. The governance needs of start-up companies and small enterprises are very different from those of mature ASX 100 companies. The role of the board and directors changes over time and board composition ought to reflect the needs of the company rather than conforming to any particular formula.

Corporate governance reform

The ultimate objective of the research was to provide valuable insights into the response of Australian corporations to recent regulatory reform. For some years, governments worldwide have actively increased corporate regulation in an attempt to reduce risk and restore the confidence of investors. In the US, the *Sarbanes Oxley Act* of 2002 was enacted in response to the costly disasters of Enron, WorldCom and other corporate failures. The UK issued an updated version of its *Combined Code on Corporate Governance* following the findings of the 2003 Higgs Report, and having conducted an extensive *Modern Company Law* review, issued the *Companies Act 2006* (UK) which revised the duties of company directors.

In Australia, amendments to the *Corporations Act 2001* came into force in 2004 taking into account the results of the Royal Commission investigation into the collapse of HIH Insurance.[4] The amendments are commonly known as CLERP 9, the ninth policy paper in the Commonwealth Government's Corporate Law Economic Reform Program. Also in March 2003, the ASX Corporate Governance Council launched the guidelines as a practical guide for listed companies. These have since been the focus of public consultation and a second edition was released in August 2007. The changes to the guidelines are not substantial: they have been streamlined and clarified rather than fundamentally altered. Figure 1 provides a summary of the Australian reform process, from the *Strictly Boardroom* report in 1993 to this recent review of the guidelines.

Figure 1: Australian corporate governance reform



Rules-based and principles-based approaches to reform

The guidelines are not mandatory, enshrining the 'if not, why not' or 'comply or explain' principle by which companies that do not wish to comply with particular guidelines can explain their reasons for non-compliance to the market. This was first applied in the UK 1992 *Cadbury Report*. This kind of market regulation can be less costly to comply with than prescriptive legislation because it acknowledges that one size does not always fit all. In contrast to black letter law, the guidelines are more adaptable to changes in best practice and easier to keep up-to-date and relevant. Additional advantages include the fact that the guidelines were able to be produced relatively quickly and were designed by experts with relevant industry knowledge, who together represented every part of the investment and corporate value chain.

The alternative regulatory approach of using prescriptive law has been adopted historically by the United States. Continuing this legal tradition, the *Sarbanes-Oxley Act* of 2002 (SOX) prescribes governance practices that must be followed and which can be enforced by way of penalties for non-compliance.[5] SOX was a direct response to the collapses of Enron and WorldCom and has been widely criticised as a knee-jerk reaction that imposes unreasonable costs on business. A concern of the rules based approach of SOX is that it has encouraged, both internally and externally, a heavily bureaucratised technical approach to auditing, that makes for inflexible processes and involves significant costs.[6]

In contrast, principles-based approaches are not as rigid in implementation, and improvements in standards of practice can be encouraged over time. Principles work to influence a broad set of practices meeting the expectations of the stakeholder community at large.

The debate on regulation in Australia

The debate about the need for regulation on the one hand, and the burden that regulation imposes on the other, is a long running one in Australia and other countries. However most criticisms of over-regulation encountered in this research were not about corporate governance regulation per se. Participants complained about regulation in the areas of occupational health and safety, financial services, food and drug safety, local government planning, accounting standards and money laundering but very few expressed negative views about Australian corporate governance regulation:

- In Australia, my view is that where we are now is about where we want to be. If we take it a few steps further companies will no longer be in control of themselves — their destiny would be in the regulators' hands, which is not where it should be.
- We welcome the approach of the ASX principles-based regulation — it makes it much easier for me to say — this is the principle — if this was known would it change the share price?
- The major costs have been in regulatory compliance rather than corporate governance, if you can separate them out.

Interviewees regarded the United States corporate governance regulation as a different matter. All participants who had been affected by SOX, particularly because of a US listing, said that it was out of proportion and very costly. Perhaps the favourable view of the Australian regime is a consequence of the belief that the alternative could be a lot worse:

- I don't think Australia's reforms are too bad. SOX is a great overcompensation — the cost has been extraordinary. Certainly it's cost us half a million and the ongoing things — internal and external auditors etc.
- The Section 404 certificate for SOX on internal controls has been a painful process, very expensive and has not produced anything worthwhile.

The prime reason why SOX is disliked is because companies feel that the costs outweigh the benefits. It is this cost-benefit equation that determines whether regulation is seen as good or bad; whether the company feels regulated or over-regulated. The fact that there was little complaint about the guidelines suggests that they have, for the most part, succeeded in finding the right cost-benefit ratio.

One of the most surprising aspects of the research was the lack of concern over the costs involved in implementing corporate governance reform. The majority of participants said the costs had been minimal, although often after some thought they came up with some indirect costs that could be linked to governance changes. Many respondents suggested the costs were largely up-front, and would not be significant once the new governance systems were well established. The participants' inability to provide specific cost information may be because expenses are amorphous and hard to identify:

- Minimal. We've involved solicitors in reviewing and drafting but it is a once-off cost and we will capitalise on the benefits — so, minimal.
- There have been no great costs. Not directly at least, maybe the board and management time spent on it.

The most common cost raised by participants was time, often their own personal time as sole company secretary in charge of governance and compliance, but also board time which they felt could perhaps be better spent on other matters.

- Time. We've not used any externals because we were tight on cash but it's taken up a lot of my time.
- The biggest cost has been my relationship with my wife from working all these hours! So, yes, time. It had to be done, though — we now have a good structure for the future.
- The real cost is how much board time goes into it — that is more significant, particularly at committee level.

Also, where external consultants had been used to implement new risk or remuneration systems costs were often quite high. These were likely to be a one-off cost and thus may only have been top-of-mind in companies where changes had only recently been implemented:

- The only extreme cost is the expert remuneration consultants — we have paid them at least $100,000.
- The risk management and additional reporting have incurred a significant cost — I'd say the first phase cost a million, probably more.
- There have been costs — legal fees and on the risk management side we have had independent experts come in to test our systems. It is difficult to put a quantum to it.

Participants welcomed recent efforts to simplify regulation and reduce costs, particularly the smaller companies. For example, the majority said they would take advantage of the option of online annual reports under the *Corporations Legislations Amendment (Simpler Regulatory System) Act 2007* which received royal assent on 28 June 2007. The changes to the guidelines are also likely to be welcomed on the basis that many participants complained about overlapping and inconsistent regulation.

Offsetting the costs of implementing corporate governance changes were the benefits seen by companies. Again, these were difficult to identify but tended to reflect the major changes that companies had made. Clearly, they were taking advantage of the flexibility of the guidelines, only making significant changes in the areas where they saw value:

- Being forced to spell out the financial and operating risks is a very good thing to assist you to think of all the risks.
- The CRO has really enhanced our risk focus — brought it to top of mind. There has been streamlining and consolidation of policies.
- It has vastly improved the relationship between the board and management. There is better understanding of the roles of the two — much smoother operation of the board and management's interaction with it. Much less harping and carping.
- Certainly it has introduced discipline — a more disciplined approach to decision-making — which is a benefit to the company.

The conformance versus performance debate

A tension between accountability and performance has always existed in corporate governance. Evidence from a survey conducted by Chartered Secretaries Australia in 2004 suggested a compliance mode continued to prevail in Australia with 20 per cent of companies implementing recommended practices, whether or not they would actually add value.[7] This pressure to conform was also revealed by the two reviews carried out by the ASX's Implementation Review Group (IRG).[8] Feedback from companies of all sizes, professional advisers and analysts suggested that companies felt compelled to conform to the guidelines or else face potential controversy. One factor contributing to this 'conform rather than explain' mentality was the perception that investment benchmarking would favour those companies that conformed to the guidelines. This kind of compliance approach can critically undermine the effectiveness of governance, and potentially create a void of meaningless routine. The UTS research was aimed at understanding whether companies still felt a pressure to conform or whether they were making the most of the inherent flexibility of the guidelines. The research supports the IRG's findings that the market forces created by 'box-ticking' investors could be a significant part of the problem:

- You are tarnished by not complying. The principles are often seen as the benchmark — what you should be doing.
- The incentive to conform to guidelines appears to come from a desire to avoid spending time on questions from shareholders that relate to what are seen to be minor issues.
- It's the institutions who force you to tick the boxes. They say they'll vote no if they can't tick all the boxes.
- It's a lot less trouble if you do comply so most give up on the 'why-nots' eventually, even if they do it for the first few years.

As argued above, the guidelines do not mandate or prescribe best practices. Rather they are designed to encourage good governance systems and practice via market mechanisms. Cadbury and Milstein have pointed out that the effectiveness of the system depends upon the extent to which shareholders are prepared to use their influence in support of governance recommendations. It seems we need to add to this principle the important qualification that the effectiveness of the system also depends upon shareholder engagement being intelligent and informed and not based on inflexible and inappropriate governance templates and checklists.

Corporate social responsibility

The one field in which Australian business appears to be falling behind the performance of other countries is in the reporting of corporate social responsibility and sustainability. The research discovered many examples of extensive commitment to corporate social responsibility and sustainability in both large corporations and in small enterprises. Although the balance of opinion remains in favour of voluntary rather than mandatory reporting, the lack of a framework for reporting and greater impetus to use this, suggests businesses here will not be reporting as comprehensively as in the UK, Europe and Japan.

- I don't think mandatory reporting would be welcomed — we are already heavily regulated. This is largely left to the environmental consciousness of the board and management.
- Mandatory reporting has not been discussed by the board although we are putting a steering committee on the issue. I think they would take a pragmatic approach and would prefer voluntary rather than mandatory reporting.

Conclusion

The results of this research suggest the standards of corporate governance in Australia are very high. Certainly as far as the companies in this research sample are concerned this country has struck the right balance between self-regulation and black-letter law. There was much comparison with the US regime which is generally thought to have failed in finding that balance by being too prescriptive and costly for smaller companies.

In contrast to the controversy often raised in the business press in Australia about the huge costs involved in governance regulation, in this survey few participants said that corporate governance reform had caused them to incur significant costs. The 'if not, why not' regime permits flexibility and individuality but forces companies to consider and justify their practices (explanations that investors must be encouraged to consider more sympathetically).

Having achieved major strides forward in putting corporate governance in order in Australian companies, there is, as yet, less evidence of the energy necessary to achieve world class standards on such a comprehensive basis in the implementation of corporate social responsibility.

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Notes

1 ASX (2007) *Analysis of Corporate Governance Practice Disclosure in 2006 Annual Reports* released 13 June 2007; ASX (2006) *2005 Analysis of corporate governance practice disclosure* released 22 May 2006; and ASX (2005) Analysis of Corporate Governance Practices reported in 2004 Annual Reports, available at: <http://www.asx.com.au/supervision/governance/monitoring_compliance.htm> [1 November 2007]

2 For example, Chartered Secretaries Australia: *Reporting against the ASX Corporate Governance Council Guidelines: Survey Results*, December 2004

3 Further details of the research methodology can be found in the final report

4 HIH Royal Commission (2003) *The Failure of HIH Insurance*, Volumes I, II, III, Commonwealth of Australia

5 For example, see B McDonnell (2004) 'Sarbanes-Oxley, Fiduciary Duties and the Conduct of Officers and Directors' *University of Minnesota Law School, Legal Studies Research Paper Series*, Research Paper No.04-13

6 DM Branson 'Too Many Bells? Too Many Whistles? Corporate Governance in the Post Enron, Post WorldCom Era' (February 26, 2006). Available at Social Science Research Network website: <http://ssrn.com/abstract=887176> [1November 2007]

7 Chartered Secretaries Australia: *Reporting against the ASX Corporate Governance Council Guidelines*: Survey Results, December 2004

8 ASX IRG Report to ASX Corporate Governance Council (31 March 2004) and *Second Report to the ASX Corporate Governance Council* (February 2005)

The final report is available on the UTS website at <http://www.ccg.uts.edu.au/project_changingroles.htm> [1 November 2007]