Can corporate governance add value?

Can the ability of companies to add value be improved by the way they are controlled?

How do we evaluate the costs and benefits of various approaches to corporate governance?

Shann Turnbull highlights recent initiatives by regulators and questions which must be considered by analysts, shareholders and directors.

In September 1994, the Australian Stock Exchange circulated a discussion paper on Disclosure of Corporate Governance Practices by Listed Companies. The paper foreshadowed the possibility of new ASX listing rules requiring companies to disclose the nature of board committees and processes, and the independence of their directors and chairmen. The paper also considered adopting listing rules similar to those introduced by the London Stock Exchange in 1993 to establish benchmarks of good practice and require companies to explain why any benchmark was not adopted.

In October 1994, the Reserve Bank of Australia announced that it had established benchmarks for corporations with a banking licence. The RBA benchmarks are in line with those proposed by the ASX. However, the RBA benchmarks are not voluntary. They have been mandated as part of the prudential requirements for banks, which must now:

- appoint a majority of non-executive directors to the board;
- appoint a chairman who is not an executive reporting to the board; and
- notify the RBA of any proposed changes in directors and disclose relevant company associations of directors.

It is interesting that the RBA does not meet its own requirements: its chairman is a full-time executive, the bank discloses only some of the company associations of its directors and it is not obligated to give advance notice of board changes. So, how important are these benchmarks and what are their costs and benefits?

The interest by the RBA and the ASX in the structure of boards has been encouraged by concerns here and overseas that directors may not be adequately protecting the interest of investors, be they bank depositors or shareholders. It is mainly the regulators in "Anglo" cultures who are taking the initiative, in response to a systemic weakness in their system of owning and controlling corporations. Cultural differences in the ways corporations are owned and controlled are outlined in the table and the chart.

Historically, supervisory boards were established in Europe by lead investors who wished to avoid personal liability in common-law companies by not being involved in management and by holding bearer shares so that their identity was not recorded. The lead shareholders, who took a long-term active interest in the performance of management, would today be described as "relationship investors". Other investors, whose identity may remain hidden today through bearer shares, rely on the ability of the lead investors to monitor and control management, as occurs with listed family companies in Asia. Active investors are found in only some Anglo companies outside Asia, as indicated in the table.

The 1992 World Competitiveness Report showed that Anglo countries such as Canada, United States, United Kingdom, Australia and New Zealand cluster with the bottom third of OECD countries in terms of annual change in real GDP/persons employed. It also noted: "In 1984, exactly 50 per cent of the top 50 firms on the Fortune list of largest international companies were

Shann Turnbull FSIA pioneered in 1975 the education of company directors and the study of corporate governance as a founding author of the company directors course run for the Australian Institute of Company Directors.
Table 1: Ownership structure of corporations by culture

<table>
<thead>
<tr>
<th>No. of companies</th>
<th>Anglo</th>
<th>French</th>
<th>German</th>
<th>Japanese</th>
<th>Basque</th>
</tr>
</thead>
<tbody>
<tr>
<td>15,000²</td>
<td>1,651</td>
<td>786</td>
<td>665</td>
<td>1,651</td>
<td>200</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Types of owners</th>
<th>Government</th>
<th>Bank(s)</th>
<th>Suppliers/customers</th>
<th>Corporate/family</th>
<th>Institutions &amp; funds</th>
<th>Small investors</th>
<th>Employees</th>
<th>Shareholders in bold type signify cultures where they typically take an active role in corporate governance; i.e., they become “relationship investors”.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Negligible</td>
<td>None</td>
<td>Few</td>
<td>Some³</td>
<td>Majority</td>
<td>Minority</td>
<td>Some</td>
<td>Listed on a stock exchange except in the Basque culture which has invented a unique governance structure for employee/consumer cooperatives formed around the town of Mondragon. While customers and the Mondragon bank do not own shares in the cooperatives, these stakeholders participate in the governance of the cooperatives through “relationship associations” and “contracts of association”, respectively.</td>
</tr>
<tr>
<td></td>
<td>Significant</td>
<td>None</td>
<td>Common</td>
<td>Major influence</td>
<td>Influential</td>
<td>Minority</td>
<td>Some</td>
<td>US, UK, Canada, Australia, South Africa, Hong Kong, Kuala Lumpur, Singapore, New Zealand.</td>
</tr>
<tr>
<td></td>
<td>Some</td>
<td>None</td>
<td>Common</td>
<td>Majority</td>
<td>Majority</td>
<td>Minority</td>
<td>Some</td>
<td>Family control is both typical and significant in Asian cultures.</td>
</tr>
<tr>
<td></td>
<td>None</td>
<td>None</td>
<td>None</td>
<td>None</td>
<td>None</td>
<td>None</td>
<td>All</td>
<td></td>
</tr>
</tbody>
</table>

Shareholders in bold type signify cultures where they typically take an active role in corporate governance; i.e., they become “relationship investors”.

1 Listed on a stock exchange except in the Basque culture which has invented a unique governance structure for employee/consumer cooperatives formed around the town of Mondragon. While customers and the Mondragon bank do not own shares in the cooperatives, these stakeholders participate in the governance of the cooperatives through “relationship associations” and “contracts of association”, respectively.

2 US, UK, Canada, Australia, South Africa, Hong Kong, Kuala Lumpur, Singapore, New Zealand.

3 Family control is both typical and significant in Asian cultures.

not American, whereas seven years later (1991) almost 70 per cent of the same sample turned out to be non-American.”

A 1992 research report by Professor Michael Porter from Harvard University concluded that US corporations were not competitive with those in Germany and Japan. He identified the lack of shareholders who had a long-term working relationship with management as a contributing reason. To overcome this problem, Porter recommended increased employee ownership and the involvement of employees, customers, suppliers and other community representatives in the control of corporations. The table shows the extent to which these operational stakeholders are involved in the governance of German and Japanese companies. The Porter recommendations are supported by US and Australian research which has found that companies with employee ownership perform better than those without.

In addition, corporations in Germany and Japan have banks as significant shareholders who become actively involved if the company suffers financial stress. A similar pattern of long-term, patient-but-active ownership is present in the worker/client cooperatives found around the town of Mondragon in the Basque region of Spain. The performance of these stakeholder-owned and controlled firms has been found to be superior to traditional investor-owned firms on a number of measures, with none failing during the first five years from start-up. In Australia, more than 70 per cent of firms fail during the first five years and in the US the figure is above 80 per cent.

Competitive advantages

Relationship investors such as employees, customers and suppliers can add value to a company because they have the most detailed knowledge about its operations and the competitive standing of its goods or services. In addition, it is in the self-interest of such operationally involved stakeholders to work cooperatively with the company to improve its operations. In other words, competitive advantages are obtained by establishing cooperative relationships with operational stakeholders.

With some exceptions, Anglo corporations typically do not have operational stakeholders involved in either their ownership or control and so suffer a competitive disadvantage. In any case, the appointment of operational stakeholders to a unitary board of an Anglo corporation would introduce conflicts of interest which could be counter-productive. This problem can be mediated in non-Anglo corporations with multiple boards, as shown in the chart. Compound boards provide a basis for reducing, eliminating and/or managing conflicts of interest.

As well as introducing a separation of power and checks and balances, multiple boards introduce specialisation of duties to simplify the information, knowledge, skills and abilities required by those involved in corporate governance. It is by this means that ordinary people can achieve extraordinary results such as those found in Mondragon.

Unitary boards require a higher level of skill, knowledge and ability and this makes it far more difficult to find suitable people. As directors of unitary boards have greater responsibilities, they are also exposed to greater liabilities and
personal risk. Operational stakeholders who have related-party interests become particularly vulnerable as members of a unitary board. In any event, it may not be in the best interests of the company or its stakeholders to appoint individuals to a unitary board who have related-party conflicts of interest.

This explains why the RBA defines independent directors in the language of the UK Committee on the Financial Aspects of Corporate Governance, chaired by Sir Adrian Cadbury. The 1992 Cadbury committee report, on which the London Stock Exchange 1993 corporate governance listing rules were based, specified that the majority of non-executive directors should be “independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement, apart from their fees and shareholding”. The US term “non-affiliated independent directors” (NAIDs) will be used to describe non-executive directors who meet these conditions.

By definition, NAIDs cannot be operational stakeholders. Corporations with unitary boards made up of only executives and NAIDs may be at a disadvantage as the NAIDs may not have access to information, independent of management, on the qualitative performance of the company and its executives. There will be no-one in the board room to challenge management on the quality of goods, services, competitiveness and industry relations, etc. NAIDs may become captive to information provided by management to evaluate management. Even audited quantitative financial information is prepared on procedures controlled by management.

The ability of NAIDs to obtain independent verification of the quality of management and the competitiveness of its output will depend on their own limited observations and idiosyncratic networks. There is a strong case for NAIDs to institutionalise independent information networks through operational stakeholders. It should also be in the interest of executive directors to obtain independent feedback on the information provided to them by their subordinates.

The establishment of independently appointed stakeholder councils to advise NAIDs and executive directors on, say, a quarterly basis, would create a process for obtaining competitive advantages. In this way the recommendations of Professor Porter could be implemented without introducing unacceptable board conflicts.

On a number of recent occasions in Australia customers and other types of operational stakeholders – such as borrowers or product users – have spontaneously established action groups to protect their own interests. Management has typically tried to suppress such associations rather than establishing a value-adding working relationship.

Cost and benefits

The pressure by regulators and professional bodies for the appointment of more NAIDs to boards, and for a majority of NAIDs on audit, remuneration and nominating committees, is focused on the processes by which value can be expropriated from shareholders rather than on processes which can add value. If shareholders accept the need to appoint more NAIDs, then they should also require that stakeholders’ councils be established.

If shareholders accept the need to appoint more NAIDs, then they should also require that stakeholders’ councils be established.

We now need to ask how effective the Cadbury code might be in protecting shareholder wealth.

In this regard it worth noting that the ASX paper quotes the United States Law Institute which recommends that “every large publicly held corporations should have a majority of directors who are free from any ‘significant relationship’ with the corporation’s senior executives, unless a majority of the corporation’s voting securities are owned by a single person, a family group or a control group”. This statement recognises that NAIDs cannot be effective in controlling corporate abuses when their appointment to the board is subject to the grace and favour of a “control group”.

For NAIDs to provide minority investors with any meaningful protection they need to be appointed to the board independently of any control group. This can be achieved through electing directors by cumulative voting, which is mandated in the US for all federal banks. Cumulative voting avoids the situation existing in Australia which allows the control group to appoint all directors and so make any NAIDs subject to their grace and favour. Cumulative voting allows the appointment of directors in proportion to the number of shares voted by various interests. In this way, minority interests obtain representation even when there is a controlling group or even a parent company.

Without cumulative or some other form of preferential voting, NAIDs cannot be seen to be independent and cannot in fact be appointed independently of management or any control group. The ASX discussion paper considers various definitions of non-executive directors but ignores how they are elected. The powers of independently elected non-affiliated directors (IENADs) to protect investors by acting as a loyal opposition to a control group or management are substantially greater than those of directors elected with the grace and favour of a control group.

Proposals by the RBA, ASX, Cadbury Committee and others on the number of non-executive directors on a board and its subcommittees are likely to prove ineffectual in protecting depositors or investors. If NAIDs are appointed through the grace and favour of a control group then they may well
be captured by management and refrain from blowing the whistle on the next generation of corporate cowboys, in the same way that they failed to stop the last generation.

The initiatives by the RBA and ASX to promote NAIDs will introduce costs with little benefits unless cumulative voting is also introduced to create TENADs. Indeed, cumulative voting should be a precondition for introducing other corporate governance prescriptions. It can be universally applied without incurring compliance costs.

The introduction of audit, remuneration and nominating committees, constituted with, say, at least three NAIDs, would introduce significant costs which will not be acceptable for many smaller companies. If NAIDs are paid at the rate of $200 per hour and the time required for each committee on average is 15 hours a year, then the total cost of the three committees would increase directors' fees by $24,000 a year before travelling and other out-of-pocket costs. While the costs might be smaller for some companies, they could well be very much more for larger companies - although these cost are not significant for large companies such as those listed on the New York Stock Exchange, which has mandated audit committees in its listing rules.

However, a much less costly and far more effective approach would be to constitute the audit, remuneration and nominating committees as an independently elected "corporate senate" as described in the December 1992 issue of JASSA. As senators have no management responsibilities and their role is largely mediating board conflicts of interest, the cost of their services and the time required to perform the role is much less. The ASX could fix a maximum hourly rate for senators at, say, half the rate typically paid to directors.

Directors would retain all of their responsibilities but be subject to a senate veto on matters in which they had interests.

Instead of promoting detailed prescriptive processes involving significant costs and dubious benefits, the ASX should promote experimentation and competition to find the most cost-effective investor safeguards and structures for adding value for shareholders. A small step in the process would be the establishment of an annual award for the listed company which made the most significant contribution to improved corporate governance and for the company which maintained the best standards. (The winners could be given a rebate on their listing fees) The ASX and other organisations such as credit rating agencies, auditors, specialist governance advisers and industry associations might like to establish corporate governance ratings for investors.

There are many cost-effective initiatives to consider beside cumulative voting and senates. These would include establishing, publishing and maintaining standards for many of the contentious issues not covered in the Corporate Practices and Conduct booklet published by the working committee chaired by Henry Bosch.

- use of shareholders' funds for non-company purposes;
- contributions to political parties;
- dividend distribution and reinvestment policies;
- conduct of shareholders' meetings;
- the methods of nominating and voting on the election of directors;
- action to be taken before making a takeover bid or on receiving one;
- basis for remunerating directors and evaluating their performance;
- when directors should retire and what benefits they should obtain;
- share trading by insiders;
- protocols for private briefing of large investors.

A vital omission was guidance on the issue of shares or options to directors and employees or the purchase of shares for employees. To consider this matter, as president of the Australian Employee Ownership Association, I convened the first working group established between the Australian Institute of Company Directors (AICD) and the Australian Shareholders Association (ASA). Representatives of both the ASX and the ASC attended meetings of this working group with the Australian Investment Managers Association (AIMA) being kept informed. The guidelines developed by the ASA, and accepted by the AEOA, were published in JASSA in June 1994.

The ASX discussion paper raised the question of whether listed companies should disclose their code of ethics and whether their disclosures should be subject to audit. As various industry guidelines for acceptable or best practice are developed, there is a case for disclosure as to the adherence to
standards (with independent verification— not necessarily by the auditor, who can be captured by management). One cost-effective standard which could be subject to verification would be the conduct of general meetings of members.

In September 1994, the AICD and the ASA jointly published guidelines for the conduct of shareholder meetings. To obtain agreement, issues which the AICD found contentious were omitted. However, there could well be listed companies that might like to win an ASX governance award by introducing some of the proposals which the AICD could not support.

One example is the appointment of an independent chairman for meetings of shareholders, so the chairman of the board could speak to motions supported by the board without having a conflict of interest with members who opposed board proposals. This would also protect the reputation of the board chair, as she or he could not be accused of gagging speakers or biasing procedural matters over which the meeting chair has considerable power.

Other proposals involved not using proxy votes for procedural motions, management of proxies by the auditor rather than by management, the form of proxies, the facility for confidential proxy voting, etc.

In the US, proxy solicitation is subject to approval by the SEC, to encourage shareholder control of corporations. The ASX proposals are concerned with control by directors. The control of directors and the processes which they put in place to protect and enhance shareholder wealth is a shareholder responsibility.

The first step in improving corporate governance should be to prescribe processes by which shareholders can look after themselves and the investing public. There is much which can be done in this regard and to promote self-governance rather than regulation.

---

**Chart 1: Control structure of corporations by culture**

**Anglo with senate**
- Shareholders
- Senate (no employees or affiliates)
- Board
- Employees

**Dutch/Indonesian**
- Shareholders
- Supervisory board (no employees)
- Board of executives
- Employees

**German**
- Shareholders (with bearer shares)
- Supervisory board (outsiders, affiliates and employees)
- Board of executives
- Employees

**French**
- Traditional
  - Shareholders (with bearer shares)
  - Conseil d'administration
  - President/director-general
  - Comité d'entreprise
  - Employees

**French**
- (optional since 1966)
  - Shareholders (with bearer shares)
  - Cours des comptes/censeurs
  - Conseil de surveillance
  - President/director-general, directoire
  - Comité d'entreprise
  - Employees

**Basque**
- (Mondragón, Spain)
  - Employees and strategic stakeholders
  - Bank
  - Board (no executives)
  - Management council
  - Executive committee
  - Employees

*Three-tiered boards are required for state-owned companies, which have a cour des comptes, with private-sector financial institutions having a censeurs.