GOOD CORPORATE GOVERNANCE: What matters most to directors?¹

CHRISTOFER ADRIAN, Department of Accounting and Corporate Governance, Faculty of Business and Economics, Macquarie University
SUE WRIGHT, Associate Professor, Department of Applied Finance and Actuarial Studies, Faculty of Business and Economics, Macquarie University
ALAN KILGORE, Associate Professor, Department of Accounting and Corporate Governance, Faculty of Business and Economics, Macquarie University

Over the past decade, corporate governance codes have been strengthened in many countries in response to large and high-profile corporate collapses. This paper examines directors’ views on the relative importance of corporate governance mechanisms or attributes. The results of this study provide feedback to regulators which may help to inform any potential future amendments of corporate governance codes in Australia.

In Australia, the Australian Security Exchange (ASX) focuses on effective corporate governance to maintain investors’ confidence in capital markets, through the establishment (and subsequent amendments) of ASX Corporate Governance Council’s Principles of Good Corporate Governance (POGCG) in 2003 and Corporate Law Economic Reform Program (CLERP) 9 in 2004. These principles address several corporate governance areas (which we term, attributes), such as recommendations on the proportion of independent directors on the Board and the Audit Committee. While the purpose of these attributes is to protect the interests of corporate stakeholders, there has been little prior investigation of the views of those stakeholders on which corporate governance mechanisms they consider to be most important.

Why do we focus on directors? They have positional power in the corporation. They are an important link between shareholders and management, and are able to make decisions that can affect other stakeholders. They oversee the requirements of the corporate governance codes in their firms. As well as representing shareholders, directors also have financial interests in the firm, including both remuneration and the risk of financial penalties for fraud. Arguably, there has been too much focus on protecting shareholders from directors’ supposed misbehaviour, without identifying directors as important stakeholders of firms. This research seeks to address this imbalance.

To examine the relative importance of corporate governance attributes from the directors’ perspective, we conducted interviews and an online survey. We based our survey of directors’ perceptions of effective corporate governance on nine attributes that we identified from prior literature and the requirements of the relevant corporate governance codes. These nine corporate governance attributes are summarised in Table 1, along with their operational definitions, relevant studies and, where applicable, the relevant recommendations that address these attributes. One attribute that is not part of an existing code is the prohibition on multiple directorships. A thorough review of the literature guided the initial selection of the attributes, which we refined and reduced in number, through interviews with a range of stakeholders. The operational definitions of these attributes are based on prior studies and the recommendations of ASX POGCG.

The directors’ reputation and legal liability arguments guided us in predicting that Board Composition, CEO Duality and Multiple Directorships would be viewed by directors as relatively more important than other attributes. These arguments posit that directors’ concern for effective corporate governance is related to their financial interests in the firm, which are affected by their reputation.

The Board of Directors is the main monitoring mechanism in firms and the importance of its independence in achieving effective corporate governance is widely known. Board independence is publicly disclosed, and affects both the reputations of the company and the directors. Previous studies have measured Board independence by the proportion of non-executive directors on the Board and also by whether the positions of CEO and Chairman are held by the same person. As Board independence is closely
executives, a financial commentator, an accounting practitioner and, of course, directors. The interviews were undertaken to refine the corporate governance attributes identified from the literature and to ensure that those included (summarised in Table 1) are consistent with the interviewees’ notions of effective corporate governance.

**Online survey**

The second phase of this research was conducted using an internet-based survey. We used Adaptive Conjoint Analysis (ACA) developed by Johnson (1987) from Sawtooth Software. Conjoint analysis is built around the concept of utility, i.e. people’s judgment in measuring the value of products and/or concepts. Conjoint analysis can be used to assess and analyse trade-offs for particular products and services with multiple attributes and characteristics (Green and Srinivasan 1990). It allows respondents to indicate their preference for particular attributes that comprise a product/concept and to indicate the extent to which they would choose one attribute over others. ACA is a computer-administered survey that customises the questionnaires uniquely to each respondent according to their previous responses. This method, being both adaptive and dynamic, enables us to obtain information on the relative importance, rather than the absolute importance of corporate governance attributes. Not only does

### Table 1: Corporate governance attributes

<table>
<thead>
<tr>
<th>CG Attributes</th>
<th>Operational Definition</th>
<th>Relevant Studies</th>
<th>Relevant Recommendations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Board Composition</strong></td>
<td>Proportion of independent directors on the Board</td>
<td>Agrawal and Knoeber (1996), Beasley (1996), Klein (2002)</td>
<td>ASX POGCG 2.1</td>
</tr>
<tr>
<td><strong>Board Size</strong></td>
<td>Number of directors on the Board</td>
<td>Yermack (1996), Kiel and Nicholson (2003)</td>
<td>ASX POGCG 2.4</td>
</tr>
<tr>
<td><strong>Multiple Directorships</strong></td>
<td>Number of directorships a director holds</td>
<td>Ferris et al. (2003)</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Audit Committee Composition</strong></td>
<td>Proportion of independent directors on the Audit Committee</td>
<td>Cotter and Silvester (2003), Klein (1998), Klein (2002)</td>
<td>ASX POGCG 4.2</td>
</tr>
<tr>
<td><strong>Audit Committee Size</strong></td>
<td>Number of directors on the Audit Committee</td>
<td>Xie et al. (2003), Anderson et al. (2004)</td>
<td>ASX POGCG 4.2</td>
</tr>
<tr>
<td><strong>Provision of Non-audit Services by the Auditor</strong></td>
<td>Ratio of Non-audit services fees to total audit fees</td>
<td>Dhaliwal et al. (2008), Kilgore et al. (2011)</td>
<td>CLERP 9</td>
</tr>
<tr>
<td><strong>Audit Partner Tenure</strong></td>
<td>Length of tenure of audit partner (in years)</td>
<td>Gates et al. (2007), Fargher et al. (2008), Kilgore et al. (2011)</td>
<td>CLERP 9</td>
</tr>
<tr>
<td><strong>Remuneration Committee Composition</strong></td>
<td>Proportion of independent directors on the Remuneration Committee</td>
<td>Vafeas and Theodorou (1998), Cotter and Silvester (2003)</td>
<td>ASX POGCG 8.2</td>
</tr>
<tr>
<td><strong>Chief Executive Officer Duality</strong></td>
<td>Whether Chief Executive Officer and Chair of the Board are the same person</td>
<td>Donaldson and Davis (1991), Carter et al. (2003), Rechner and Dalton (1991)</td>
<td>ASX POGCG 2.3</td>
</tr>
</tbody>
</table>

**Interviews**

The first phase of this research involved interviews with 11 key industry figures from various backgrounds including academics, a financial analyst, professional accounting body
attribute with a score of 10 is twice as important as an attribute with a score of 5. This interpretation is consistent with Clark-Murphy and Soutar (2004) and Kilgore et al. (2011), two prior studies that use ACA to investigate the relative importance of factors affecting individuals’ investment decisions and perceptions of audit quality, respectively.

The results of this study are shown in Table 2 and Figure 1. The top three attributes are CEO Duality (19.34), Audit Committee Composition (12.65), and Board Composition (12.31).

<table>
<thead>
<tr>
<th>Attribute</th>
<th>Relative Importance Scores (RIS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board Composition</td>
<td>12.31</td>
</tr>
<tr>
<td>Board Size</td>
<td>10.79</td>
</tr>
<tr>
<td>Multiple Directorships</td>
<td>9.03</td>
</tr>
<tr>
<td>Audit Committee Composition</td>
<td>12.65</td>
</tr>
<tr>
<td>Audit Committee Size</td>
<td>6.59</td>
</tr>
<tr>
<td>Provision of Non-audit Services by the Auditor</td>
<td>11.45</td>
</tr>
<tr>
<td>Audit Partner Tenure</td>
<td>7.87</td>
</tr>
<tr>
<td>Remuneration Committee Composition</td>
<td>9.98</td>
</tr>
<tr>
<td>CEO Duality</td>
<td>19.34</td>
</tr>
</tbody>
</table>

The results provide partial support for our earlier predictions. CEO Duality and Board Composition are confirmed to be relatively more important to directors than other attributes, but Multiple Directorships is not.

**CEO Duality**
This attribute was ranked as the most important corporate governance attribute compared to the others (Relative Importance Score: 19.34), supporting our prediction. The result confirms the findings of Rechner and Dalton (1991) who find that when the CEO and Chair of the Board is the same person, firm performance is negatively affected as management’s opportunistic behaviour increases agency costs and affects the wealth of shareholders. It also affirms the ASX Principles of Good Corporate Governance (ASX POGCG) Recommendation 2.3 which states that the chair position should be held by an independent director in order to ensure a separation of duties in the top-management of the company.
Audit Committee Composition

Audit Committee Composition was ranked as the second most important attribute (Relative Importance Score: 12.65), contrary to our expectation. Our explanation is that as the audit committee is an important subset of the Board, its performance and independence would also affect the Board of Directors and, in particular, their reputation. Nevertheless, this result affirms ASX POGCG (Recommendation 4.2) which states that the Audit Committee should consist of non-executive directors with a majority of independent directors.

Board Composition

The respondents ranked Board Composition as the third most important attribute (Relative Importance Score: 12.31). This finding supports our prior prediction and also affirms Recommendation 2.1 of ASX POGCG which states that a majority of the Board should be independent directors.

Provision of Non-audit Services by the Auditor

This attribute was ranked fourth in terms of its relative importance compared to the other attributes (Relative Importance Score: 11.45). This result is not surprising since the Provision of Non-audit Services has been given significant media attention, particularly in the aftermath of large corporate collapses in the US and Australia. It is widely believed that significant levels of Non-audit Service fees render auditors financially dependent on their clients, thereby reducing their ability to detect material misstatements. Our survey indicates that directors are concerned that lack of auditor independence might significantly affect their reputation.

Other Attributes

Directors identify three attributes that are closely related to the board, i.e. Board Size, Remuneration Committee Composition, and Multiple Directorships, to be relatively less important than other attributes. The result for Multiple Directorships is surprising to the authors and contrary to our expectation.

Conclusions

This study has investigated the relative importance of corporate governance attributes from the perspective of an important and often overlooked stakeholders group, directors. The results of the study provide feedback to regulators which may help to inform any potential future amendment of corporate governance codes in Australia. In particular, the results confirm that current regulations in relation to the separation of roles between CEO and Chairman (CEO Duality), and Audit Committee Composition and Board Composition are important to directors. Any future revisions to regulations might consider modifications in respect of those attributes that are perceived to be less important by directors.

An important implication of this study is that it broadens our understanding of which factors contribute to effective corporate governance. While previous studies in Anglo-American countries such as Australia and US place more emphasis on Board Composition as an integral attribute affecting corporate governance, the findings of this study show that one key group of Australian stakeholders (directors) perceives CEO Duality to be the most important corporate governance attribute. While all attributes might be important for the respondents, this study is able to identify which attributes are more important and to what extent they are more
important than others by requiring respondents to make trade-offs among attributes and attribute levels.

This study is subject to two limitations. First, the respondents who chose to participate may have a particular interest in the issue of effective corporate governance, which might affect the generalisability of the results. Second, we acknowledge that the views of directors may be influenced by existing codes and guidelines, and might not reflect their independent and unconstrained views.

The next step for our research is to listen to the views of other key stakeholder groups such as shareholders and analysts.

Acknowledgements
An earlier version of this paper was presented to the 3rd Financial Market and Corporate Governance Conference, Melbourne, Australia in April 2012, Financial Reporting and Business Communication Sixteenth Annual Conference, Bristol, UK in July 2012, and Curtin Research Seminar, Perth, Australia in April 2013. We thank participants and the anonymous reviewer for their helpful comments.

References