PREDICTING FIRM SUSTAINABILITY THROUGH GOVERNANCE: THE RELATIONAL CORPORATE GOVERNANCE APPROACH

Francesco de Zwart
B Comm (Melb), LLB (Hons) (Melb), Grad Dip Ed (Monash), LLM (Monash)
Adelaide Law School
Faculty of the Professions
The University of Adelaide

31 January 2014
ABSTRACT
PREDICTING FIRM SUSTAINABILITY THROUGH GOVERNANCE:
THE RELATIONAL CORPORATE GOVERNANCE APPROACH

The relational corporate governance approach presented in this thesis is a tool which complements and enhances the explanatory power of the existing principal 'law and economics' theories and models of the firm. It maps the effectiveness of corporate Governance Variables in use in corporate Governance Codes and laws around the world and assesses reform proposals in the field. The approach can be used by regulators, policymakers, law reformers and corporate actors as a diagnostic tool to analyse the governance health of individual companies and the governance actions required to remedy sub-optimal governance and management arrangements. The principal aim of the relational approach is to describe and evaluate the interrelationships between the most significant fields of corporate governance study and practice and the Governance Variables to which these fields give rise. In this way, the relational approach can be used to make predictions in relation to the relative importance of Governance Variables inter se in reducing (or increasing) agency costs and enhancing (or reducing) the long-term efficiency and survival of the for-profit firm.

The relational approach is built from an artificial environment that simulates the real world sphere of corporate governance and is comprised of the four Key Fields drawn from the Social Science Research Network database: (1) application of the principal theories of the firm to the relational approach; (2) 'autopsies' of the Enron and Hastie corporate collapses; (3) comparative corporate Governance Codes; and (4) empirical studies of the effectiveness of Governance Variables. From these Key Fields a 'Weighing Mechanism' is constructed comprising four theoretical components.

First, the thesis introduces a new definition of relational corporate governance known as the Three Relational Axes of Good Governance. These Three Relational Axes act like a set of scales to theoretically 'weigh' the competing interests of those 'inside' the corporation and those 'outside'. Second, the thesis establishes a set of eight Governance Factors which are the principal or central themes underlying the four Key Fields. These eight Governance Factors are the eight most common themes in the thesis' simulated representation of real world corporate governance. The theoretical 'weighing' of the Governance Factors in the Three Relational Axes of Good Governance is already completed and presented for the reader. Thus the interrelationships between the eight Governance Factors are presented in two diagrams called Interrelationship Schemes, one for the shareholder (primacy) model and the other representing the stakeholder model. From these Interrelationship Schemes the thesis constructs – for each of 39 Governance Variables – a relational effect path that seeks to explain which Governance Factors are affected by each Governance Variable and the direction of the effect.

The interrelationships depicted in a relational effect path for each Governance Variable are then summarised in operational tables. The greater the number of Governance Factors affected by a Governance Variable in either direction, then the greater is the relative importance of that Variable in affecting agency costs and the long-term efficiency and survival/sustainability of the for-profit corporation.
ACKNOWLEDGEMENTS

This thesis would not be possible without the supervision, guidance, help and love of a lot of people.

I began the thesis at Monash University in Victoria with the supervision of Dr George Gilligan and Associate Professor Helen Anderson. I thank them for their supervision of the genesis of the thesis and its early form. The thesis would not have been possible without them.

At the University of Adelaide, my profound gratitude to Associate Professor Chris Symes and Dr Suzanne Le Mire who took up the supervision of the mid and end points of the thesis - at short notice - when I moved to Adelaide. The accessibility of the thesis owes a great deal to their careful guidance. I thank them for a wonderful thesis experience rich in new knowledge and direction for me and many thoughtful discussions.

Truly great friends came to the aid and support of me and my family during an illness I suffered and I thank them for their great faith in me – Domenic and Sharon Carbone, Max and Nicole Haitana, Monica Soncin and Simon Jolly, Stefan Klaebe and Helen Gilbert, Associate Professor Bernadette Richards and Dr Paul Richards and Professor John Williams. There would be no completion without them.

My wider family was tireless support during the whole thesis and again during my illness and I count myself very lucky to have them – June de Zwart (grandma) and Peter Fitzpatrick (Papa) for their tireless help with my children; Fiona McLennan, David McLennan and Catherine and Nick Forge for their love of my children; Peter and Justine de Zwart at crux time; Del Sladdin for sending “flash money” when we needed a treat and Elivio and Kit Bonollo for their prayers.

It is difficult to express my love and admiration to my own family and I feel very undeserving of their great love and support of me. To my children – Bronte for being a grown-up at only 10 years old and Emily who is 8 who prayed every night at dinner time that Dad would finish his thesis.

Finally, to my wife Associate Professor Melissa de Zwart. I have admiring love for the tireless way you look after all of us, for your great enthusiasm and inclusiveness at everything you do, for the way you keep going when things get really difficult, for your amazing decision-making in pressure times, for your Dutch sense of humour (I still think you are telling me off), for thinking David Tennant is the best Dr Who when I think it is Matt Smith, for how you love Stephen Silvagni of Carlton and Jeronimo of Adelaide United, for how you never age and your steadfastness in all you do. You are the most wonderful and beautiful person I have ever met. Thanks for Loving.
THESIS DECLARATION

I certify that this work contains no material which has been accepted for the award of any other degree or diploma in my name, in any university or other tertiary institution and, to the best of my knowledge and belief, contains no material previously published or written by another person, except where due reference has been made in the text. In addition, I certify that no part of this work will, in the future, be used in a submission in my name, for any other degree or diploma in any university or other tertiary institution without the prior approval of the University of Adelaide and where applicable, any partner institution responsible for the joint-award of this degree.

I give consent to this copy of my thesis, when deposited in the University Library, being made available for loan and photocopying, subject to the provisions of the Copyright Act 1968.

I also give permission for the digital version of my thesis to be made available on the web, via the University's digital research repository, the Library Search and also through web search engines, unless permission has been granted by the University to restrict access for a period of time.

Signed by Francesco de Zwart

Dated
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>SECTION AND TITLE</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>CHAPTER 1:</strong></td>
<td></td>
</tr>
<tr>
<td>THE CHALLENGE OF CORPORATE GOVERNANCE</td>
<td>1</td>
</tr>
<tr>
<td>1.1 The Global Financial Crisis and Failures of Corporate Governance</td>
<td>1</td>
</tr>
<tr>
<td>1.2 Separation of Ownership from Management and the Role of Corporate Governance</td>
<td>2</td>
</tr>
<tr>
<td>1.2.1 The Balancing of Interests of ‘Insiders’ and ‘Outsiders’</td>
<td>2</td>
</tr>
<tr>
<td>1.2.2 Separation of Ownership, ‘Nexus of Contracts’, Agency Costs and the Shareholder Model</td>
<td>4</td>
</tr>
<tr>
<td>1.2.3 The Shareholder-Wealth Maximisation Principle</td>
<td>6</td>
</tr>
<tr>
<td>1.3 ‘Core’ Areas of Corporate Governance and Corporate Failures</td>
<td>7</td>
</tr>
<tr>
<td>1.3.1 Multiple Failures in Core Governance Variables</td>
<td>8</td>
</tr>
<tr>
<td>1.3.2 Key Fields and Research Questions in Firm Sustainability</td>
<td>11</td>
</tr>
<tr>
<td>1.4 Relational Corporate Governance</td>
<td>15</td>
</tr>
<tr>
<td>1.5 Agency Costs and Sustainability in this Thesis</td>
<td>16</td>
</tr>
<tr>
<td>1.6 Scope of the Thesis</td>
<td>17</td>
</tr>
<tr>
<td>1.7 Overview of Thesis</td>
<td>17</td>
</tr>
<tr>
<td>1.7.1 Overview of Relational Corporate Governance Approach</td>
<td>17</td>
</tr>
<tr>
<td>1.7.2 Introduction to Thesis Chapters</td>
<td>18</td>
</tr>
<tr>
<td><strong>CHAPTER 2:</strong></td>
<td></td>
</tr>
<tr>
<td>THE FRAMEWORK OF THE RELATIONAL CORPORATE GOVERNANCE APPROACH</td>
<td>21</td>
</tr>
<tr>
<td>2.1 Approach to the Relational Corporate Governance Framework</td>
<td>21</td>
</tr>
</tbody>
</table>
2.2 Overview of the Firm-Specific (Micro) and Macro-Economic Benefits of ‘Good’ Corporate Governance

2.3 The Components of the Relational Approach

2.3.1 The Three Relational Axes of Good Governance

2.3.2 The Purpose and Interrelationship of the Three Relational Axes

2.3.3 The Weighing Process of the Three Relational Axes

2.4 Introduction to the Governance Variables

Table 2.4: Summary of Governance Variables

2.5 Principal Considerations in the Selection of the Governance Factors

2.5.1 The Governance Factors are Drawn from the Key Fields

2.5.2 What is a Governance Factor?

2.5.3 Governance Factors Must Be Distinguished From Governance Variables

2.6 The Governance Factors are Recurring Themes and Tensions From the Key Fields

2.6.1 Reporting Factor No. 1: Transparency, Timing and Integrity of Financial and Other Reports

2.6.2 Compliance Factor No. 2: Corporate Governance and Legal Compliance

2.6.3 Alignment Factor No. 3: Alignment of Management and Shareholder Interests

2.6.4 Compensation Factor No. 4: Board, CEO and Management Compensation and Incentives

2.6.5 Monitoring & Audit Factor No. 5: Internal and External/Audit Monitoring Quality

2.6.6 Stakeholders Factor No. 6: Identification, Participation and Protection of Stakeholder Interests

2.6.7 Decision-making Factor No. 7: Quality of Board, CEO and Management Decision-Making
2.6.8: Responsibility Factor No. 8: Delineation and Disclosure of Powers, Duties and Lines of Responsibility

2.7 Interrelationships between Governance Factors – The Interrelationship Schemes

2.7.1 The Two Interrelationship Schemes

2.7.2 The Direction of the ‘Effect’ in the Interrelationship Schemes

Figure 2.7.2A: Shareholder Primacy Interrelationship Scheme

Figure 2.7.2B: Stakeholder Model Interrelationship Scheme

2.8 Conclusion - The Relational Corporate Governance Framework

Figure 2.8: The Relational Corporate Governance Framework

CHAPTER 3: GOVERNANCE VARIABLES IN PRACTICE

3.1 Purpose and Approach of Chapter Three

3.2 Operational Measures of the Relational Approach – Governance Factor ‘Coverage’ and ‘Relational Proximity Rating’

3.3 The Hypothesised Coverage Effect on Governance Factors by Individual Governance Variables

3.3.1 The Coverage Table

Table 3.3.1: Coverage Table

Hypothesised Significant Coverage Effect and Direction of Interrelationship between Governance Variables and Governance Factors

3.3.2 The Hypothesised Relative Importance of Governance Variables – The Relational Proximity Table

Table 3.3.2.1: Relational Proximity Table

Hypothesised Relative Importance of Governance Variables in the Sustainability of the Firm
# KEY FIELD NO. 1:
THE APPLICATION OF THE PRINCIPAL THEORIES
OF THE FIRM TO THE RELATIONAL APPROACH

## 4.1 Problems Arising from the Separation of Ownership from Management

## 4.2 The Nexus of Contracts Foundations of the Three Relational Axes of Good Governance and Governance Factors

### 4.2.1 'Neoclassical' Model Shortcomings are Unsuitable for the Relational Approach

### 4.2.2 Relational Approach is Aligned with Nexus of Contracts Theory

### 4.2.3 The Components of the Relational Approach and Agency Costs

### 4.2.4 Director Primacy Model Reflected in the Governance Factors

## 4.3 Application of the Shareholder Primacy and Stakeholder Models to the Relational Approach

### 4.3.1 The Relational Approach and the Shareholder Primacy Model

### 4.3.2 Shareholder Primacy - The Precedence of the Shareholders' Residual Claims are Reflected in the Governance Factors

## 4.4 The Influence of Stakeholder Theory in the Relational Approach

### 4.4.1 Shortcomings of the Shareholder Primacy Model

### 4.4.2 Perceived Problems and Suggested Solutions in Balancing Competing Stakeholder Interests

## 4.5 Concluding Remarks for Chapter 4
CHAPTER 5

KEY FIELD NO. 2:
‘AUTOPSIES’ OF THE ENRON AND HASTIE CORPORATE COLLAPSES

5.1 The Enron Governance Failure Abyss and the Hastie Group Collapse

5.1.1 Purpose, Scope and Methodology of Chapter 5 – Enron and Hastie Case Studies of the Behaviour of Governance Variables and Governance Factors

5.2 Failures in ‘Central’ or ‘Proximate’ Governance Variables

5.2.1 Agency Theory and the Shareholder Model

5.2.2 Board and Director Variables

5.2.3 Earnings Manipulation

5.2.4 External or Independent Audit

5.2.5 Inadequate Disclosure Affects the Transparency and Timing of Financial Reporting and Monitoring

5.3 Summary - Some Recurring Themes in the Enron and Hastie Group Corporate Collapses

5.3.1 The Nexus of Contracts and Agency Theory in the Enron and Hastie Failure Scenarios

5.3.2 Director Independence, Monitoring and Risk Management

5.3.3 Earnings Manipulation

5.3.4 External/Independent Audit

5.3.5 Concluding Remarks

CHAPTER 6

KEY FIELD NO. 3:
COMPARATIVE CORPORATE GOVERNANCE CODES

6.1 The Purpose, Scope and Function of Chapter 6

6.1.1 Exploring Relative Importance

6.1.2 The Function of Commonality – How to Use Chapter 6
6.1.3 Justification for Selection of Global and National Corporate Governance Codes

6.1.4 The Governance Codes Examined in Chapter 6

6.2 Global/Cross-Border Corporate Governance Codes

6.2.1 Selection of the Global Sector and OECD Principles

6.2.2 Principal Governance Variables in Global Corporate Governance

6.2.3 Global ‘Core’ Variables - Comparison and Commonality of Global/Cross-Border Corporate Governance Codes

6.3 National Corporate Governance Codes

6.3.1 Focus on US, UK and Australian National Codes

6.4 United States Corporate Governance Codes

6.4.1 SOX Effects on Securities Exchange Act and NYSE Final Rules in Appendix C2

6.4.2 US National Corporate Governance Codes

6.5 United Kingdom Corporate Governance Codes

6.5.1 UK National Corporate Governance Codes

6.6 Australian Corporate Governance Codes

6.6.1 ASX 2003 Best Practice Recommendations, ASX 2007-10 Revised Principles and IFSA Blue Book

6.7 ‘Core’ National Listed Governance Variables

6.7.1 Comparison of US, UK and Australian National Listed Corporate Governance Codes

6.8 Conclusion - Core Features and Aspects of Corporate Governance Codes

6.8.1 Core Features – Global and National Listed Governance Codes Combined
CHAPTER 7
KEY FIELD NO. 4 (PART 1):
NATIONAL SHAREHOLDER PROTECTION REGIME AND
BOARD FACTORS I

7.1 Aims and Purpose of Chapter 7  192
7.2 Structure and Approach of Chapter 7  194
7.3 Firm-Specific Effects of ‘Good’ Corporate Governance –
Firm Value and Operating Performance  195
   7.3.1 ‘Overall’ Governance Structure and the Level and
Strength of the National Shareholder Protection
Regime  196
   7.3.2 Board Factors I – ‘Independence’ and the Proportion
of Non-Executive/Independent Directors  214

CHAPTER 8
KEY FIELD NO. 4 (PART 2):
BOARD FACTORS II AND OTHER FIRM-SPECIFIC VARIABLES

8.1 Aims and Approach of Chapter 8.  230
8.2 Board Factors II - Board Size and Outside Board
Positions  231
   8.2.1 Determinants of Optimum Board Size  231
   8.2.2 The Relationship between Board Size and Firm
Operating Performance/Value is Inconclusive  233
   8.2.3 Do Board Positions of Outside Directors
Reduce Monitoring Quality?  236
8.3 Anti-Takeover Mechanisms and Market for Corporate
Control – ‘Whole’ Board and ‘Staggered’ Board
Elections  239
   8.3.1 Overview – Anti-Takeover Mechanisms May
Reduce the Effectiveness of the Market for
Corporate Control and May Reduce Firm Value  240
8.4 Audit Sub-Committee – Presence, Independence and
Expertise  245
   8.4.1 Effect of Audit Committee Independence and
Financial Expertise on Firm Value and Operating
Performance  246
8.4.2 [AudCom] (+) Variable Relational Effect Path


8.4.4 Likely Positive Effect between Accounting Financial Expertise and Firm Value and Operating Performance

8.5 ‘Block’ and Institutional Shareholdings

8.5.1 Governance Effects Both Positive and Negative

8.5.2 [BlockMon] (+) and [BlockCosts] (-) Variables Relational Effect Paths

8.6 Division in CEO/Chairperson Roles

8.6.1 Enhanced Firm Knowledge and ‘Trade-off’ with Board Control/monitoring

8.6.2 [DualTrade] (+/-) Variable Relational Effect Path

8.6.3 [DualDismiss] (-) and [DualStrat] (-) Variables Relational Effect Paths

8.7 Continuation of Empirical Studies Key Field No. 4 in Chapter 9

CHAPTER 9
EMPIRICAL STUDIES KEY FIELD NO. 4 (PART 3): BOARD AND AUDIT COMMITTEE FACTORS AND EARNINGS MANIPULATION

9.1 Earnings Manipulation and Purpose and Approach of Chapter 9

9.1.1 Principal Aim of Reporting – To Reduce Information Asymmetry and Agency Risk

9.1.2 Transparency and the ‘Trade-Off’ Effect on the Quality of Board and Market Monitoring

9.2 Earnings Manipulation and Board and Committee Structures
9.2.1 Board and Audit Committee Independence, Time, Financial Expertise and Duality of CEO/Chairperson

9.2.2 Board and Audit Committee Size and Earnings Management

9.2.3 Review of Auditors, Non-Audit Services and Earnings Management

9.2.4 Summary and Conclusion of Empirical Studies

Key Field No. 4 in Chapter 10.

CHAPTER 10
EMPIRICAL STUDIES KEY FIELD NO. 4 (PART 4): ‘GOOD’ CORPORATE GOVERNANCE AND DIRECTOR, CEO AND MANAGEMENT COMPENSATION

10.1 Overview of Governance Approaches and Purpose of Chapter 10

10.1.1 The Governance Issue - The Director/CEO Compensation Levels Variable: [DirCEO$] (+/-)

10.1.2 Approaches to Governance of Compensation

10.1.3 ‘Alignment’ of Performance, Option Compensation and the Purpose of Chapter 10

10.2 Compensation, the Level/Quality of Monitoring and Firm Value and Operating Performance

10.2.1 Proportion of Insider/Management Equity Ownership – ‘Incentive Alignment’ Effect Countered By ‘Entrenchment’ Effect

10.2.2 Studies Finding Positive Relationship Between Compensation and Firm Value and/or Operating Performance

10.2.3 Studies Finding No or Negative Relationship Between Compensation and Firm Value and/or Operating Performance for [DirCEO$]

10.2.4 Summary of Studies and Relational Effect Paths for [DirCEO$] (+/-), [EqOptIncent] (+) and [EqOptEntrch] (-)

10.2.5 Short-Term Options and the Risk of Earnings Manipulation
10.2.6 Possible Connection Between Director and CEO Compensation Level 312

10.3 Possible Connection Between Firm Size and Director/Executive Compensation 313

10.4 Compensation, Governance and Reputational Constraints 314

10.4.1 Reputational Constraints on Compensation are Dependent on Disclosure and Transparency 314

10.5 Concluding Remarks on the Recurring Themes and Tensions in Executive, CEO and Director Compensation 316

10.5.1 The Compensation ‘Trade-off’ 316

10.5.2 Compensation and the Level/Quality of Monitoring 316

10.5.3 Firm Operating Performance and Firm Value 317

10.5.4 Short-Term Options and Earnings Manipulation 318

10.5.5 Firm Size and Director/Executive Compensation 319

10.5.6 Compensation and Reputational Constraints 319

10.6 Conclusion of Empirical Studies Key Field No. 4 319

CHAPTER 11
RELATIONAL APPROACH CONCLUSIONS 321

11.1 Relational Approach Conclusions and Approach of Chapter 11 321

11.2 Key Aims and Developments of the Thesis from Chapter 1 323

11.2.1 To introduce a new definition of corporate governance 323

11.2.2 To create a simulated corporate governance environment which represents the ‘real world’ sphere of corporate governance 325

11.2.3 To identify, describe and map diagrammatically the interrelationships, themes and factors underpinning this environment 326
11.2.4 To create a comparative table or scheme system upon which to compare across sectors and over time the Governance Variables utilised in the major US, UK, Australian and global Governance Codes and schemes

11.2.5 As an over-arching aim, to propose an approach or tool for regulators and policy-makers to predict and measure the relative importance of Governance Variables in reducing (or increasing) agency costs and enhancing (or reducing) the long-term efficiency and sustainability of the for-profit firm

11.3 The Application of the Principal Theories of the Firm to the Relational Approach

11.4 Concluding Remarks for ‘Overall’ Governance and Board Factors I and II

11.4.1 ‘Overall’ or ‘Multi-Variable’ Governance

11.4.2 Board Factors I - ‘Independence’ and Proportion of Non-Executive/Independent Directors

11.4.3 Board Factors II - Board Size

11.4.4 Audit Sub-Committee – Presence, Independence and Expertise

11.4.5 Independence and Earnings Management

11.4.6 Executive, CEO and Director Compensation

11.5 Observations on the Explanatory Power of the Relational Approach and Future Research

11.6 Concluding Remarks for the Thesis
APPENDICIES

SECTION AND TITLE                      PAGE

APPENDIX A                                338

A1:  GLOSSARY OF RELATIONAL CORPORATE GOVERNANCE APPROACH TERMS AND COMPONENTS  338

A2:  GLOSSARY OF GOVERNANCE VARIABLES  345

APPENDIX B:                                352

ADDITIONAL REFERENCES FOR CHAPTERS 1 – 5

B1:  The Operation and Efficacy of Corporate Governance Variables in the 2008 Global Financial Crisis  352

B2:  Accounts of the Enron and Other Corporate Collapses  354

B3:  References on the Separation of Ownership from Management  357

B4:  Discussion of Models of the Firm and Corporate Governance Theories  359

APPENDIX C:                                360

ADDITIONAL REFERENCES AND TABLES FOR CHAPTERS 6 – 10

C1:  Harmonisation or Convergence of Global and National Corporate Governance  360

C2:  Summary of Content and Themes from SOX Reforms  362

SOX Summary Table: Summary of SOX Content and Themes  362

C3:  Evaluations of the SOX Reforms  371

C4:  Summary of Content and Themes from NYSE ‘Core’ Variables  373

NYSE Summary Table: NYSE ‘Core’ Variables and Themes  373
APPENDIX D1: 380

RECURRING THEMES AND TENSIONS IN EMPIRICAL STUDIES KEY FIELD NO. 4 (PARTS 1 AND 2)

Summary Table D1: Benefits and Effects from the National Shareholder Protection Regime and Board Factors I and II

APPENDIX D2: 392

RECURRING THEMES AND TENSIONS IN EMPIRICAL STUDIES KEY FIELD NO. 4 (PART 3)

Summary Table D2: Benefits and Effects from the Board and Audit Committee Factors and Earnings Manipulation

APPENDIX E: 400

ADDITIONAL REFERENCES FOR EMPIRICAL STUDIES KEY FIELD NO. 4 (PART 4)

E1: Additional References on Director, CEO and Management Compensation 400

E2: References on the Practice of “Backdating” Options 401

E3: Recurring Themes And Tensions In Empirical Studies Key Field No. 4 (Part 4)

Summary Table E3: Firm-Specific ‘Good’ Governance Variables and Director, CEO and Management Compensation 403
<table>
<thead>
<tr>
<th>SECTION AND TITLE</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>BIBLIOGRAPHY F1:</td>
<td>410</td>
</tr>
<tr>
<td>KEY FIELD NO. 1 – THE APPLICATION OF THE PRINCIPAL THEORIES OF THE FIRM TO THE RELATIONAL APPROACH</td>
<td></td>
</tr>
<tr>
<td>BIBLIOGRAPHY F2:</td>
<td>420</td>
</tr>
<tr>
<td>KEY FIELD NO. 2 - AUTOPSIES OF THE ENRON AND HASTIE CORPORATE COLLAPSES</td>
<td></td>
</tr>
<tr>
<td>BIBLIOGRAPHY F3:</td>
<td>433</td>
</tr>
<tr>
<td>KEY FIELD NO. 3 – COMPARATIVE CORPORATE GOVERNANCE CODES</td>
<td></td>
</tr>
<tr>
<td>BIBLIOGRAPHY F4:</td>
<td>442</td>
</tr>
<tr>
<td>KEY FIELD NO. 4 – EMPIRICAL STUDIES ON THE EFFECTIVENESS OF GOVERNANCE VARIABLES</td>
<td></td>
</tr>
</tbody>
</table>
CHAPTER 1:  
THE CHALLENGE OF CORPORATE GOVERNANCE

1.1 The Global Financial Crisis and Failures of Corporate Governance

The world-wide crisis in financial markets and, in particular, the repercussions on equities markets around the world consequent on the ‘credit crunch’ of 2008-9 and beyond has once again focused attention on corporate governance. Indeed, the fallout from the Global Financial Crisis (GFC) continues to have dramatic regulatory, social, economic and political effects around the world.¹

The crux of the GFC is widely acknowledged as a combination of failures in regulatory supervision, ‘gate-keeping’ by intermediaries, greed and fundamental failings of internal corporate governance.² Yet, pre-GFC corporate collapses such as those of Enron and WorldCom in the US³, HIH Insurance in Australia⁴ and collapses in other countries painted a similar picture.⁵ More recently, collapses such as that of the Hastie Group in Australia in 2012 – still playing out at the time of writing⁶ - prompt this thesis to examine what lessons from these collapses have failed to be learnt? And what measures could have been taken – prospectively – to avoid the abyss?

Flowing from this, the following questions are posed by the thesis:


² Black, ibid. For a discussion of the operation and efficacy of corporate Governance Variables during the 2008 financial crises, see, the references in Appendix B1, The Operation and Efficacy of Corporate Governance Variables in the 2008 Global Financial Crisis.

³ See the references in Appendix B2, Accounts of the Enron and Other Corporate Collapses. The Enron collapse is examined in detail in chapter 5.


⁵ For a discussion of other corporate collapses, see the references in Appendix B2, Accounts of the Enron and Other Corporate Collapses.

• What behaviours of corporate actors such as the individual directors, the CEO and management were present in these collapses and what are the consequences of these behaviours for firm survival or (in today’s parlance) sustainability?

• What is the regulatory corporate governance environment which applies to these companies and how do individual corporate governance measures, mechanisms and processes (called Governance Variables) operate in the real world to enhance or reduce the effects of these behaviours? In other words, what are the effects of Governance Variables such as independent directors, disclosure regimes, internal controls, external audit and performance-based compensation for directors, CEO and executives such as equity and option pay?

• What are the ‘core’ or ‘central’ failures in Governance Variables that arise in corporate collapses?

• How do these Governance Variables interact with each other, i.e., what are the relationships between Governance Variables?

• And which corporate Governance Variables are relatively more important – again, in the real world – in determining the survival or sustainability of the publicly-traded for-profit corporation?

These key questions at the heart of corporate governance discourse are the focus of this thesis. It proposes a diagnostic tool to prospectively analyse and assess the governance ‘health’ of individual companies and to predict firm survival. Such a tool is important for securities and exchange regulators, policy-makers, law reformers and the corporate actors themselves.

These key questions also stem from the phenomenon of the separation of ownership from management in the widely-dispersed shareholding public company. A number of theories have sought to explain this phenomenon including the ‘nexus of contracts’, agency theory, the shareholder (primacy) model, the stakeholder model and the director primacy model. The approach in this thesis adds explanatory power to these theories by providing a tool analysing how these theories - and the Governance Variables which flow from them - interact with corporate actors in the real world. So it is to the separation phenomenon that the thesis turns first to introduce the new approach.

1.2 Separation of Ownership from Management and the Role of Corporate Governance

1.2.1 The Balancing of Interests of ‘Insiders’ and ‘Outsiders’

The corporate governance sphere – indeed, on some views, the corporation itself - involves a balancing exercise between corporate ‘insiders’ such as the directors, CEO and management

---

7 The 39 Governance Variables examined in this thesis are set out in Table 2.4 of chapter 2.
8 These theories and models are examined in chapter 4.
9 For a detailed discussion, see the papers relating to the ‘nexus of contracts’ theory and the ‘anti-contractarian’ views of the firm from the symposium on contractual freedom in corporate law held on 9 and 10 December 1988 at Columbia Law School published at (1989) 89 Colum L Rev 1395.
with ‘outsiders’ such as shareholders or investors, employees, lenders, suppliers, regulators and, increasingly, social and environmental interests.

The insider and outsider designations flow from the traditional separation of ownership (shareholders) from management or control (directors) in publicly-traded companies. One of the most influential definitions of corporate governance by Sir Adrian Cadbury in 1992 emphasises this separation:

>c

corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders’ role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company’s strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board’s actions are subject to laws, regulations and the shareholders in general meeting.10

In another influential definition, written more than ten years later, the OECD explained the meaning and purpose of corporate governance in a manner which classifies Governance Variables as measures or mechanisms which seek to punish or deter management misconduct or which seek to align the interests of insiders with outside shareholders:

>[c]
corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring.11

For a long time now, various theories and models of the Anglo-American corporate firm, international and national corporate Governance Codes and an ever-increasing body of theoretical literature and empirical studies have sought to explain the interaction between these corporate insiders and outsiders. Again, the thesis begins with these theories and models.

---


1.2.2 Separation of Ownership, ‘Nexus of Contracts’, Agency Costs and the Shareholder Model

The well-known theories and models relating to the separation of ownership and management of the corporation are above - the ‘nexus of contracts’, agency theory, the shareholder (primacy) model (and its related shareholder wealth-maximisation principle), the stakeholder model and the director primacy model.

Statement of the Nexus Theory

Bainbridge explains the nexus of contracts theory as follows:

[n]exus of contracts theory visualizes the firm not as an entity, but as an aggregate of various inputs acting together to produce goods or services. Employees provide labor. Creditors provide debt capital. Shareholders initially provide equity capital and subsequently bear the risk of losses and monitor the performance of management. Management monitors the performance of employees and coordinates the activities of all the firm’s inputs. The firm is seen as simply a legal fiction representing the complex set of contractual relationships between these inputs.  

According to Easterbrook and Fischel and, separately, Bratton, the effect of the nexus of contracts theory is to discourage management misconduct in the publicly-owned and traded corporation. In short, welfare-reducing terms of the contract (or, more accurately, the various contracts or relationships) between the various actors cause a reduction in market price and, therefore, return on investment causing investors to seek more profitable investments. For publicly-traded firms, the ‘market for corporate control’ acts in conjunction with the nexus of contracts theory to further discourage management misconduct.

The market for corporate control operates as part of the efficient market hypothesis to punish management which engages in value- or performance-reducing behaviour. Cunningham explains that the efficient market hypothesis operates on the assumption that share prices can accurately reflect the corporation’s value so that a (lower) share price will reflect poor performance and, by proxy, poor management leaving the firm open to, among other things, hostile takeover and removal of management. The theory and ‘informational’ problems affecting the operation of the market for corporate control in this respect are discussed in

---

15 Easterbrook and Fischel, above n 13, 1430-1 and Cunningham, Ibid. In this article, Cunningham discusses the undermining of the efficient market hypothesis by ‘behavioural finance’ explanations for share prices and firm value.
chapter 4 below. Cunningham also notes that the market for corporate control is assisted by other governance measures - in particular, ‘reputational constraints’ (and consequences) relating to individual managers.

**Agency Theory**

Commentators such as Jensen and Meckling have sought to explain the separation effect in terms of agency (costs) theory. Examined in detail in chapter 4, this theory posits that, when making decisions, insiders or ‘agents’ should act on behalf of the outsiders or ‘principals’. However, the agent’s own self-interest in ‘shirking’, empire building, compensation, perks and other advantages may cause directors, CEOs and managers to deviate from what is in the shareholders’ best interests. As a result, the shareholders incur costs to ‘monitor’ and ‘bond’ with the directors/managers as well as other ‘residual’ costs.

Typically, shareholders (the owners) cannot interfere in the day-to-day decision-making of the company which, instead, is vested in the board of directors and management and this decision-making dichotomy is reinforced in many corporate law statutes such as, in the Australian context, section 198A of the Corporations Act. For Jensen and Meckling, thus, the for-profit corporation (and even a non-profit organisation) is effectively a nexus of contracts:

---

16 See discussion in section 4.2.2 of chapter 4.
17 Cunningham, above n 14, 3.
18 See discussion in section 4.2.3.1 of chapter 4.
21 See, for example in Australia, Corporations Act 2001 (Cth), s 198A (Replaceable Rule):

1. The business of a company is to be managed by or under the direction of the directors.
2. The directors may exercise all the powers of the company except any powers that this Act or the company's constitution (if any) requires the company to exercise in general meeting.

For further references on the separation of ownership from management of the firm, see the references in Appendix B3 References on the Separation of Ownership from Management.

22 Jensen and Meckling, above n 19, 8-9. For further discussion of the nexus of contracts theory of the firm and corporate law, see Bainbridge, “The Board of Directors as Nexus of Contracts: A Critique of Gulati, Klein & Zolt's
which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals. 23

Thus, the agency (cost) relationship between ‘insider-managers’ and ‘outsider-shareholders’ underpins the nexus model. In the shareholder (or shareholder primacy) model of corporate governance, the shareholders are the only residual claimants. 24 The nature of these shareholder claims is residual because, as Baums and Scott explain:

their [the stockholders’] claim comes not only last, but necessarily in no fixed amount; and thus their “contract” with the firm is highly “incomplete,” specifying neither a date for repayment of their investment nor a rate of dividend return. This would seem to leave them highly vulnerable to exploitation by those in control of the firm. 25

Thus, it is the residual nature of the shareholders’ position which defines the shareholder as the central element of the shareholder primacy model and its related shareholder wealth maximisation principle which follows.

1.2.3 The Shareholder-Wealth Maximisation Principle

For Roe, the interests of shareholders and managers are aligned in part by managerial ‘belief’ in the shareholder-wealth maximisation principle (which he calls a ‘soft control’). 26 In United States corporate (case) law, the origin of the shareholder-wealth maximisation principle is often said to arise from the following passage in *Dodge v Ford Motor Co*:


---

23 Jensen and Meckling, above n 19, 8-9.


[a] business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.\textsuperscript{27}

The correctness of this principle, at least as having been derived from \textit{Dodge v Ford Motor Co}, has been challenged.\textsuperscript{28} Despite this, the principle permeates much of US corporate law, including, as one example, the fiduciary duties of directors.\textsuperscript{29}

In the case of Australian law, a similar situation exists. Subsection 181(1)(a) of the \textit{Corporations Act} provides that a director’s powers and duties must be exercised “in good faith in the best interests of the \textit{corporation}.”\textsuperscript{30} While expressed to be owed to the corporation, it is well-known from the High Court’s decision in \textit{Walker v Wimborne}\textsuperscript{31} that this means, in the general case and apart from situations of insolvency or near insolvency of the corporation, that the duties must be exercised for the benefit of its shareholders as a whole.\textsuperscript{32}

1.3 ‘Core’ Areas of Corporate Governance and Corporate Failures

In chapter 6, the \textbf{relational approach} proposed by the thesis identifies a ‘model’ or comparative scheme in table-form which can be used as a benchmark in the comparison of all cross-border and national Governance Codes. The chapter assesses the position and relative importance of Governance Variables from this comparative scheme to identify - as a measure

\begin{itemize}
  \item \textsuperscript{27} \textit{Dodge v Ford Motor Co} (1919) 204 Mich 459, 507; 170 NW 668; 684 (per Ostrander J, Steere, Fellows, Stone and Brooke JJ concurring), available at \url{http://au.westlaw.com} (accessed 16 May 2008).
  \item \textsuperscript{28} Lynn A Stout, "Why We Should Stop Teaching Dodge v. Ford" (September 2007), UCLA School of Law, Law-Econ Research Paper No. 07-11, available at SSRN: \url{http://ssrn.com/abstract=1013744}.
  \item \textsuperscript{29} For a discussion and critique of the fiduciary duty of directors to act for the benefit of shareholders in the US context, see Douglas G Baird and M Todd Henderson, "Other People's Money" (2008) 60 \textit{Stanford Law Review} 1309, Symposium Issue, 2008, available at SSRN: \url{http://ssrn.com/abstract=1017615}.
  \item \textsuperscript{30} \textit{Corporations Act} 2001 (Cth), subsection 181(1)(a).
  \item \textsuperscript{31} \textit{Walker v Wimborne} [1976] HCA 7; (1976) 137 CLR 1 (3 March 1976).
  \item \textsuperscript{32} Ibid, (1976) 137 CLR 1, 7 (Per Mason J), (emphasis added):
\end{itemize}

\begin{quote}
 Indeed, the emphasis given by the primary judge to the circumstance that the group derived a benefit from the transaction tended to obscure the fundamental principles that each of the companies was a separate and independent legal entity, and that it was the duty of the directors of Asiatic to consult its interests and its interests alone in deciding whether payments should be made to other companies. In this respect it should be emphasized that the directors of a company in discharging their duty to the company must take account of the interest of its shareholders…
\end{quote}


For a discussion that shareholder primacy under various theoretical approaches disadvantages shareholders and thus will be replaced, see Lynn A Stout, “New Thinking on ‘Shareholder Primacy”, UCLA School of Law, Law-Econ Research Paper No. 11-04, (February 18, 2011), available at SSRN: \url{http://ssrn.com/abstract=1763944}.
of continuity and relative importance - a smaller ‘core’ set of Governance Variables for the international/cross-border sector and each of the national sectors of the US, UK and Australia. Looking ahead to chapter 6, these core Governance Variables are:

- Questions and voting in meetings;
- Interested or conflicted director disclosure;
- Employee/management/director incentive and participation schemes;
- Timely disclosure of material information including remuneration policies;
- Independent/external audit;
- Board functions and independence - compliance with statutory and legal duties on organisation/directors;
- Principal board responsibilities - corporate governance compliance;
- Principal board responsibilities - interested director or management conflicts or transactions;
- Independence from management - non-executive/independent directors; and
- Independence from management - responsibilities of board sub-committees delineated and disclosed.\textsuperscript{33}

These core Governance Variables are in turn used to construct the central elements of the relational approach in this thesis. For present purposes, however, it is illustrative for the separation of ownership from management to identify which of these Governance Variables are central to the pre- and post-GFC corporate collapses of Enron and the unfolding story of the Hastie Group. In other words, what are the ‘core’ failures in Governance Variables in these corporate collapses? The answer to this question is a vital first step if a diagnostic approach or tool for predicting firm survival or sustainability is to be proposed for use by regulators, policy makers, law reformers and the corporate actors themselves.

1.3.1 Multiple Failures in Core Governance Variables

In chapter 5, a detailed examination of the Enron corporate collapse is juxtaposed with that of the Hastie Group. But an overview of the Enron and Hastie facts is illustrative for introductory purposes of the challenges posed for any system of corporate governance.

The seventh largest US company at the time of its collapse, Enron is corporate governance’s own version of the \textit{RMS Titanic}. Indeed, Gordon observes that:

The Enron case has seemed particularly disturbing because the case represents a failed stress test for many of institutions of US shareholder capitalism, circa 1990s. As with most catastrophes, many

\textsuperscript{33} See discussion in section 6.8.1 of chapter 6.
separate systems simultaneously failed: auditing and accounting, executive compensation, internal monitoring by the board, and external monitoring by securities analysts.34

The Enron share price remained high despite the close attention of institutions and analysts.35 For Gordon, the complexity of the company’s structure and off-balance sheet transactions caused information asymmetry problems obscuring its true (and much lower) value.36 Each of Enron’s traders was a separate profit centre causing ‘phantom’ profits to be recorded.37 Off-balance sheet entities – in particular ‘Special purpose Entities’ (SPEs) – caused the valuation and solvency of those entities to be problematic.38

By contrast, danger signs for the Hastie Group were prominent. After listing on the ASX, Hastie Group Limited (‘HST’) acquired a number of businesses – many overseas - emerging with “7,000 employees, turnover in excess of $1.8b, construction work-in-progress (WIP) of $2.9 [billion] and assets employed of nearly $1 [billion].”39 The Group then experienced a dramatic decline in profitability which required five profit downgrades from November 2010 to May 2012.40 The company was required to enter a moratorium agreement with its bankers41 and then raised $158 million to repay debt.42 Large write-downs were made against its major assets including goodwill, receivables and work-in-progress totaling $254 million43 and trading in Hastie Group shares were suspended twice, the latter accompanied by accounting irregularities of $20 million.44 The Group was placed into Administration on 28 May 2012.45

Enron director independence was undermined by various factors. Branson is critical of high fees and consulting contracts for directors.46 But the equity holdings and share options issued to directors were also significant. These share and option holdings were argued to reduce the quality of monitoring as was Enron’s director compensation policy.48 While Hastie, too, involved a number of director personal share holdings49, the Administrator drew no conclusions.

35 See discussion in section 5.2.1.1 of chapter 5.
38 Ibid, 120-122.
39 Administrators’ Report, above n 6, section 2.5.1, p. 12 of 99.
40 Ibid, Timeline of Key Events Leading Up To the Administration of the Hastie Group, p. 17 of 99.
41 Ibid.
43 Ibid.
44 Ibid, section 2.1, p. 10 of 99.
48 Administrators’ Report, above n 6, sections 8.4 – 8.4.1, p 83 of 99.
Internal decision-making at Enron was typified by familiarity between board members and deference to management\(^{50}\) while the independence of committees was undermined by attendance of the Chairman and separate CEO at the executive, finance and audit committees.\(^{51}\) The ultra-competitive culture at Enron undermined risk-management controls by stifling dissent and driving misconduct in the pursuit of profit.\(^{52}\)

In the Hastie collapse, there were significant inadequacies in the Hastie audit committee, monitoring and control including that “the Audit and Risk Committee...was largely inactive”\(^{53}\) as well as inadequate operational management processes, reporting systems and interrogation and control by the board in relation to management.\(^{54}\) There was further poor management and monitoring of Hastie acquisitions leading the Administrators to conclude that the acquisition strategy resulted in high debt, subsidization of loss-making business by profitable businesses and inadequate financial reporting and consequent decision-making.\(^{55}\)

Hastie also involved inadequate risk assessment, oversight and control relating to Hastie’s Middle East projects which “significantly affected cash flow”.\(^{56}\) There were significant failures in relation to construction work-in-progress including poor project management, an “absence of project governance frameworks” and:

- a lack of honesty in the financial reporting
- a culture that may have led to hiding margin write-backs and losses [and]
- contract finalisation in the Middle East may have been deliberately avoided so that losses did not have to be taken to account.\(^{57}\)

The Enron collapse was typified by significant earnings manipulation\(^{58}\) again stemming from the use of off-balance sheet SPEs to hide debt and minimize tax.\(^{59}\) Enron entered into complex hedge transactions with these SPEs which meant “Enron effectively entered hedges with itself”\(^{60}\) and through which huge payments totaling some US$ 30 million were made to the CFO.\(^{61}\) CEO, executive and director compensation – particularly in the form of equity and share options – exacerbated earnings manipulation.\(^{62}\)

At Hastie too, the Administrators found significant culture problems in Hastie financial results and forecasts including that “there appears to have been a general culture of ignoring bad news...” and “the Board, prior to the appointment of the interim CEO...appeared not to have ‘an enquiring mind’ as to [the] reliability of financial statements and overall reporting”.\(^{63}\) The preparation of financial forecasts was highly criticized, the administrators having found “no

---

\(^{50}\) See discussion in section 5.2.2.2 of chapter 5.

\(^{51}\) Gillan and Martin, above n 47, 25.

\(^{52}\) See discussion in section 5.2.2.3.2 of chapter 5.

\(^{53}\) Administrators' Report, above n 6, section 2.5.3, p. 14 of 99.

\(^{54}\) Ibid. See also, section 7.9, p. 61 of 99 and section 7.9.5, p. 65 of 99.


\(^{57}\) Ibid, section 6.2.3, pp. 43-44 of 99 (bullet points in original).

\(^{58}\) See discussion in section 5.2.3 of chapter 5.

\(^{59}\) See discussion in section 5.2.3.1 of chapter 5.

\(^{60}\) Gillan and Martin, above n 47, 18.


\(^{62}\) See discussion in section 5.2.3.2.1 of chapter 5 and Bratton, ibid, 49.

\(^{63}\) Administrators' Report, above n 6, section 2.5.3, p. 14 of 99.
evidence that the Board reviewed the annual forecasts and compared them with actual results on a regular ongoing basis.64

Significant, too, in the Enron collapse was the undermining of external auditor independence leading to a massive audit failure by Enron’s auditors, Arthur Andersen. This was said to be principally on account of the significant amount of non-audit tax services65, Andersen’s role as both internal and external auditor66 and the practice of Enron hiring former Andersen employees.67 Beyond failure of the auditors, the conduct of other gatekeepers such as investment banks and analysts were called into question for recommending the purchase of Enron stock at the same time as providing finance to the company.68

The Administrators have also raised issues in relation to the Hastie Group audit querying the auditor’s compliance with a number of Australian Auditing Standards including not having:

- notified the Board of the underlying control and management issues within the Hastie Group [and]
- made appropriate recommendations regarding the write down of certain asset values.69

Even from this brief overview, there are important similarities and differences in the two collapses for drawing out themes and tensions for regulators, policy-makers, law reformers and corporate actors. These are examined in detail in chapter 5.

### 1.3.2 Key Fields and Research Questions in Firm Sustainability

In this thesis, there are four Key Fields which represent a simulation of the ‘real world’ sphere of corporate governance discourse. In other words, these are the four areas which will be examined in order to construct the relational approach to examining the governance health and sustainability of the corporation:

- **No. 1** Application of The Principal Theories of the Firm to the Relational Approach;
- **No. 2** Autopsies of the Enron and Hastie Corporate Collapses;
- **No. 3** Comparative Corporate Governance Codes; and
- **No. 4** Empirical Studies of the Effectiveness of Governance Variables.

### How Are the Key Fields Selected?

To simulate as accurately as possible the real world sphere of the operation and interrelationships between Governance Variables, the net has been cast as widely as possible. The four Key Fields are the most significant and influential areas of corporate governance

---

64 Ibid, section 7.13.4, p. 77 of 99.
65 See discussion in section 5.2.4.2 of chapter 5.
69 Administrators’ Report, above n 6, section 7.11, p. 67 of 99 (bullet points in original).
discourse measured by the number of articles and/or working papers. Thus it is important to explain how the four Key Fields were selected in order to substantiate the legitimacy of decisions taken regarding the identity of the Governance Variables examined in the thesis and the structure and components of the relational approach.

The Key Fields are selected from the single most current and voluminous collection of works in the very wide expanse of corporate governance - the e-library of the Social Science Research Network (SSRN). A search was undertaken in 2007 using the general “corporate governance” search term. Again to obtain a wide variety and expanse of works, the relational approach has not been to limit the analysis in this thesis to articles from refereed journals. Nor has it been to limit the examination to SSRN working papers which eventually enter such journals. This was to ensure that the most expansive examination of corporate governance discourse was undertaken.

Of course, it is not possible even in a work this size to discuss all these works. The works chosen were selected for relevance and impact. Thus a qualitative element was added to the selection process by discussing works that are important or representative in hypothesising the actual real world behaviour of Governance Variables. Because of considerations of scope and size, it was necessary to exclude from this initial collection on SSRN - and thereafter - works relating to the perceived effects of various areas of governance inquiry including, principally:

- accounting and auditing principles, standards and governing or regulatory bodies;
- governance of private firms and semi-government, non-profit or voluntary firms/organisations;
- the fiduciary duties of directors under the laws of equity or statute; and
- detailed theories, examinations and applications of principles of corporate social responsibility or CSR except interests that affect or influence the stakeholder model as described in chapter 4.

70 See http://www.ssrn.com. The SSRN website itself describes a huge collection of working papers intended for earlier dissemination of research:

Social Science Research Network (SSRN) is devoted to the rapid worldwide dissemination of social science research and is composed of a number of specialized research networks in each of the social sciences...

Each of SSRN's networks encourages the early distribution of research results by publishing Submitted abstracts and by soliciting abstracts of top quality research papers around the world. We now have hundreds of journals, publishers, and institutions in Partners in Publishing that provide working papers for distribution through SSRN's eLibrary and abstracts for publication in SSRN's electronic journals.

The SSRN eLibrary consists of two parts: an Abstract Database containing abstracts on over 480,900 scholarly working papers and forthcoming papers and an Electronic Paper Collection currently containing over 390,700 downloadable full text documents in Adobe Acrobat pdf format. The eLibrary also includes the research papers of a number of Fee Based Partner Publications.

References in this thesis to working papers from the SSRN website will bear the date of posting and/or revision of the papers as signified in the suggested citation by SSRN.
In 2012, the next stage of review of SSRN literature was undertaken to update the works within the four Key Fields. Again, the general “corporate governance” search term was used. The works chosen were selected for relevance and impact from a sample of 250 works with the highest download figures over the preceding 3 years, the lowest with approximately 395 downloads. The final stage of review of SSRN literature took place from 20 December 2013 to 6 January 2014 again using the “corporate governance” search term. Again, the works chosen were selected for relevance and impact from a sample of 200 works with the highest download figures spanning the previous 2 years with the lowest download figure of 277 downloads.

Ultimately, it is intended that the approach in this thesis will be constructed of a large number of modules. Each module – representing an individual Governance Variable – will be mathematically modeled and statistically tested. The aim of excluding works from the above areas was to construct the first module in a thesis this size.

The thesis now introduces each Key Field as the structural foundation of the relational approach. Each component of the relational approach – and the Governance Variables themselves – are identified after examination of one or more Key Fields. The examination of each Key Field demonstrates that the following questions for regulators, policy-makers, law reformers and corporate actors are central to any diagnosis of the governance health of the corporation.

1.3.2.1 Key Field No. 1 - Application of The Principal Theories of the Firm to the Relational Approach

Key Field No. 1 examines the application of the pre-eminent theories and models of the firm to the relational approach. Introduced above, these are the ‘nexus of contracts’, agency theory, the shareholder (primacy) model, the stakeholder model and the director primacy model.71 Key Field No. 1 demonstrates how the relational approach adds explanatory power to these theories. For example, Key Field No. 1 explains how particular components of the relational approach are theoretical and operational representations of nexus theory.

The key questions in section 1.1 asked what behaviours of the individual directors, CEO and management were present in corporate collapses and what are the consequences of these behaviours for firm sustainability? So this Key Field asks:

- How do the pre-eminent theories and models seek to balance the competing interests between corporate insiders and outsiders?
- And how does the relational approach help to explain the operation of these theories and models?

1.3.2.2 Key Field No. 2 – ‘Autopsies’ of the Enron and Hastie Corporate Collapses

The following Key Field No. 2 describes how these theories are undermined in the case of corporate collapses like Enron and Hastie. This Key Field provides a detailed examination of

---

71 These theories and models are examined in chapter 4.
the commentator views on the Enron corporate collapse as a pre-GFC example of corporate failure. Then juxtaposed is the thesis’ own comparison of the Hastie collapse from the post-GFC period. The key questions in section 1.1 seek the ‘core’ features of these collapses. Thus, the thesis asks:

- What are the structural features of the Enron and Hastie corporate collapses in pre- and post-GFC times and how did they operate at the relevant time?
- And what lessons do they provide for a diagnostic approach or tool for regulators, policy-makers, law reformers and corporate actors relating to the sustainability of the corporation?

1.3.2.3 **Key Field No. 3 – Comparative Corporate Governance Codes**

Two key questions in section 1.1 ask what is the regulatory corporate governance environment for corporations and which Governance Variables are relatively more important in determining the sustainability of the firm? Originally springing from a number of collapses last century including Enron, this Key Field examines the multitude of Governance Variables in the real world in which they operate. The Key Field examines codes for the international/cross-border sector and the US, UK and Australia including the OECD Principles, the UK Corporate Governance Code 2010-12, the NYSE Final Rules and the ASX 2007-10 Revised Principles.

Thus, Key Field No. 3 asks which Governance Variables have developed over time and across sectors (international/cross-border and national) to form the central planks of Governance Codes and schemes? Contained in chapter 6, this Key Field presents:

- a ‘model’ or comparative scheme in table-form which can be used as a benchmark in the comparison of all Governance Codes; and
- a smaller ‘core’ set of Governance Variables from these codes – introduced above - which are used to construct various components of the relational approach.

---

72 OECD Principles, above n 11.
1.3.2.4 Key Field No. 4 – Empirical Studies on the Effectiveness of Governance Variables

The thesis' key questions ask how individual Governance Variables operate in the real world to enhance or reduce the effects of corporate actors such as the board, individual directors, the CEO and management. Key Field No. 4 thus examines a wide range of empirical and other studies which examine the effects of Governance Variables on shareholder-wealth measures such as firm value/share price, firm operating performance/profit and the probability of earnings manipulation. The largest Key Field, it asks:

- What role does the national shareholder protection regime play in the operation of corporate Governance Variables?
- What is the effectiveness of individual corporate Governance Variables in affecting the long-term efficiency and sustainability of the corporation?
- What factors intervene to reduce the operation and effectiveness of these corporate Governance Variables?
- And what is the relative importance of individual corporate Governance Variables inter se in reducing (or increasing) agency costs and enhancing (or reducing) the long-term efficiency and sustainability of the for-profit firm?

1.4 Relational Corporate Governance

Based on the underlying interrelationships, themes and tensions in these four Key Fields, the approach proposed for regulators, policy-makers and law reformers in this thesis is called relational corporate governance. It is based on identifying, describing and predicting the nature, behaviour and interrelationships between corporate Governance Variables. It is critical to the understanding of Governance Variables that they do not operate in isolation but have a significant ‘zone of effect’. They affect the operation of other Governance Variables as well as other managerial and governance structures within the corporation.

The overarching purpose of relational corporate governance is to increase understanding of the interactive balancing processes of insiders and outsiders of the for-profit corporation. To do so, this thesis evaluates and in turn predicts the behaviour of 39 individual Governance Variables for the purpose of making hypotheses in relation to their relative importance in affecting agency costs and the long-term efficiency and sustainability of the corporation.

To do so, the key goals or aims of relational corporate governance drawn from the four Key Fields above are to:

(1) Introduce a new definition of corporate governance that weighs or balances the aims, behaviours and positional conflict of insiders and outsiders. This is known as the Three Relational Axes of Good Governance and is introduced in chapter 2\textsuperscript{76};

\textsuperscript{76} See the discussion in sections 2.3.1 – 2.3.3 of chapter 2.
(2) Create a **simulated corporate governance environment** which represents the ‘real world’ sphere of corporate governance. These are the four Key Fields introduced above;

(3) Identify, describe and map diagrammatically the interrelationships, themes and tensions underpinning these four Key Fields. These are the eight **Governance Factors** introduced below and the **Interrelationship Schemes** between these Factors presented in chapter 2. The Governance Factors and Interrelationship Schemes are combined to create a **relational effect path** for each Governance Variable;

(4) Create a **comparative table or scheme system** upon which to compare across sectors and over time the Governance Variables utilised in the major US, UK, Australian and international/cross-border for-profit corporate Governance Codes or schemes. These are the **Governance Code Tables** and **Commonality Tables** of chapter 6; and

(6) As an over-arching aim, to propose an approach or tool for regulators, policy-makers, law reformers and corporate actors to **predict and measure the relative importance of Governance Variables inter se** in reducing (or increasing) agency costs and enhancing (or reducing) the long-term efficiency and sustainability of the for-profit firm. In other words, to identify the optimal ‘mix’ or ‘core set’ of Governance Variables that maximises long-term efficiency and sustainability of the firm.

### 1.5 Agency Costs and Sustainability in this Thesis

A very good argument can be put that reducing agency costs *causes* the long-term efficiency and sustainability of the for-profit firm to be enhanced. If, as suggested by Jensen and Meckling, agency costs are reflected in the market price of shares, then reducing these costs on a long-term basis by the employment of Governance Variables could lead to long-term and sustained market value improvement.

Indeed, the express purpose of many of the empirical studies of the effectiveness of Governance Variables in the thesis is just this. For example, many of these studies seek to show that a collection of Governance Variables, or particular individual variables, enhance the monitoring of management and thus reduce agency costs. This, these studies argue, in turn enhances sustainability measures or proxies such as the firm’s cost of capital, firm value and firm operating performance. In other studies, the agency cost: sustainability relationship may not be the express purpose but is the underlying tenor of the study. Indeed, this is also one of the underlying assumptions of the relational approach proposed in this thesis.

Thus this thesis, being theoretical, will first *assume* in chapters 2 – 6 that hypotheses can be made about Governance Variables in reducing (or increasing) such agency costs and that, in turn, the long-term efficiency and survival or sustainability of the for-profit firm may be enhanced (or diminished). Then, in chapters 7 – 10, the thesis will examine empirical studies which reveal the real-world effects of Governance Variables on shareholder-wealth measures such as firm value/share price, firm operating performance/profit and the probability of earnings

---

77 See Figures 2.7.2A and 2.7.2B in chapter 2.
78 See discussion in section 4.2.3 of chapter 4.
manipulation. In future stages, the agency cost: sustainability relationship in this approach can be empirically tested.

### 1.6 Scope of the Thesis

To construct the first module of the relational approach in a thesis this size, it was necessary to narrow or exclude a number of areas of governance discourse.

First, the approach proposed in this thesis focuses on for-profit corporations. Ultimately, the approach will have substantial implications for non-profit firms as well but, at this time, such firms are excluded.

Second, the discussion of international and national corporate Governance Codes and schemes – and the variables to which they give rise – will be limited to for-profit firms where there is a separation between ownership and management in a dense financial market typified by a large number of widely-dispersed shareholders and companies with unitary boards. Thus, the discussion will focus on the English-origin corporate governance regimes of the United States, United Kingdom and Australia.

Third, the fiduciary duties imposed on directors of corporations under the laws of equity and statute are an important source of legally binding ‘good governance’ directives to which claimants and regulatory authorities often have first recourse in the case of director misfeasance and nonfeasance. However, a detailed discussion of the nature, content and operation of those equitable and statutory duties is beyond the scope of this thesis.

Finally, a detailed examination of the principles of Corporate Social Responsibility or CSR *per se* is beyond the scope of this relational approach thesis.

### 1.7 Overview of Thesis

#### 1.7.1 Overview of Relational Corporate Governance Approach

The approach for regulators, policy-makers, law reformers and corporate actors presented in this thesis aims to evaluate and map on a ‘first principles’ basis the insider and outsider forces on the corporation and the nature, behaviour, effect and, consequently, relative importance of 39 corporate Governance Variables which arise in international and national corporate governance best practice and discourse.

The relational approach is a tool which complements and enhances the explanatory power of the existing principal ‘law and economics’ theories and models of the firm. It maps the effectiveness of corporate Governance Variables in use in corporate Governance Codes and laws around the world and assesses reform proposals in the field. The approach can be used by regulators, policy-makers, law reformers and corporate actors as a diagnostic tool to analyse the governance health of individual companies and the governance actions required to remedy sub-optimal governance and management arrangements.
1.7.2 Introduction to Thesis Chapters

Chapter 2 constructs the principal components of the relational approach and introduces the 39 Governance Variables. It begins with an overview of the argued micro- and macro-economic benefits of ‘good’ corporate governance. Then follows detailed analysis and justification for the four components. The Three Relational Axes of Good Governance – the theoretical weighing mechanism - are presented in descriptive and diagram form. These act as a set of scales to weigh the objectives, behaviours and positional conflict of insiders versus outsiders. The eight Governance Factors are the ‘backbone’ of the relational approach. They represent the most significant and recurring themes or aims underpinning the four Key Fields and, therefore, the 39 Governance Variables drawn from those Fields. The third component - the two Interrelationship Schemes – represents the hypothesized interrelationships between the eight Governance Factors. These Schemes are used later in the thesis to construct the fourth component - a relational effect path for each Governance Variable. This path depicts the number and identity of Governance Factors affected by each Governance Variable and the direction of the effect. The chapter culminates with a diagram of the overall relational corporate governance approach in Figure 2.10.

The hypothesized interrelationships between the Governance Variables and Governance Factors depicted in the relational effect paths are summarised early in the thesis in Chapter 3. This is so that examples, analysis and interpretation of the results can be undertaken throughout the later chapters depicting the four Key Fields. The results are presented in two theoretical tables. The Coverage Table in section 3.3.1 depicts the ‘coverage’ of a Governance Factor - a summary of the relational effect path for each of the 39 Governance Variables. This table displays the number and identity of each Governance Factor affected by a Governance Variable and the direction of the effect. The coverage of the 39 Governance Variables is then summarised in the Relational Proximity Table in section 3.3.2.1. This Table arranges the 39 Governance Variables in order or groups of descending relative importance (known as relational proximity) in affecting agency costs and the long-term efficiency and sustainability of the firm.

Chapters 4 – 10 cover a vast territory. They examine the four significant areas that simulate ‘real-world’ corporate governance discourse – the four Key Fields. Chapter 4 contains an analysis and application of the principal theories and models of the firm explained in terms of the relational approach. The chapter shows that the relational approach adds explanatory power, components and examples to the currently pre-eminent theories of the firm - the ‘nexus of contracts’, agency theory, the shareholder (primacy) model, the stakeholder model and the director primacy model. Agency costs theory and the shareholder (primacy) model, on one view predominating current firm theory, receive particular focus with the chapter explaining how these are represented in the components of the relational approach.

In Chapter 5, the theory in the preceding chapter is translated into a real world case study of the behaviour of Governance Variables in one of the largest corporate collapses ever – the pre-GFC corporate collapse of Enron. Juxtaposed with this is the thesis’ own analysis of the post-GFC collapse of the Hastie Group. This chapter seeks to show 3 things. First, to extract the themes and tensions of the Enron collapse to support the identification, structure and articulation of the eight Governance Factors. For comparison, the collapse of the Hastie Group is analysed. Second, to identify the intervening factors or problems which reduced the generalisability of the Enron collapse. Third, to identify the specific factors at the Hastie Group which supported the occurrence of the collapse. The chapter begins by reviewing the findings of the pre-GFC collapse of Enron as a means to support the methodological approach and to substantiate the significance of the collapse. The chapter then examines the pre-GFC collapse of Enron in detail, the contextual factors, the behaviour of the Governance Variables, the key decisions and the collapse, the post-crisis events. The chapter also examines the post-GFC collapse of the Hastie Group in detail, the contextual factors, the behaviour of the Governance Variables, the key decisions and the collapse, the post-crisis events.
effectiveness of the Governance Variables examined in the thesis. Finally, to show how these Governance Variables behaved in the multitude of governance failures of the Enron and Hastie corporate collapses. This chapter will be a precursor to showing the development of ‘core’ features in the Governance Codes and schemes in chapter 6.

The Enron corporate collapse (and others) spawned a large number of corporate Governance Codes of ‘best-practice’. Chapter 6 is thus a comparative analysis of these and subsequent international and national corporate Governance Codes. The aim of chapter 6 is two-fold. First, to produce a ‘model’ or comparative scheme in table-form which can be used as a benchmark or comparison for all Governance Codes. Second, to identify a smaller ‘core’ set of variables from international and national codes for justifying the selection of the themes and tensions in the Three Relational Axes of Good Governance and the Governance Factors.

There follows the first of four parts on the Empirical Studies Key Field No. 4. In chapter 7, the Governance Variables are examined to determine their effectiveness in reducing agency costs and increasing the long-term efficiency and sustainability of the firm. This is the first chapter which presents a relational effect path for each Governance Variable - this path sets out the number and identity of Governance Factors affected by the relevant Governance Variable and the direction of the effect. The relational effect paths are critical for two reasons:

• First, they are an interpretation/translation of the empirical studies into the components of the relational approach; and

• Second, for the explanatory power of the relational approach - to determine the relative importance of a Governance Variable vis-a-vis other Governance Variables in reducing (increasing) agency costs and enhancing (reducing) the long term efficiency and sustainability of the firm. The greater the number of Governance Factors affected by a Governance Variable, the greater is that variable's relative importance relative to other variables.

Thus, chapter 7 examines ‘overall’ governance (as a function of multiple Governance Variables), the strength of the national shareholder protection regime and ‘Board Factors I’ - director independence and the proportion of non-executive/independent directors. Then, for chapter 8, the Governance Variables examined are:

• ‘Board Factors II’ - board size and outside board positions of independent directors; and

• Other firm-specific variables - anti-takeover mechanisms such as staggered board elections, audit subcommittee presence, independence and expertise, ‘block’ and institutional shareholdings and division in the CEO/Chairperson roles.

Again, a relational effect path is presented for each Governance Variable and firm efficiency and sustainability is measured by firm operating performance and firm value.

Part three of the Empirical Studies Key Field No. 4 is contained in chapter 9. In chapters 7 and 8, the thesis’ over-arching purpose to reduce agency costs and enhance firm long-term efficiency and sustainability was examined by proxies relating to firm operating performance/profit and firm value/share price. In this chapter 9, the proxy for long-term efficiency and sustainability is earnings manipulation or management. Increases in earnings
management represent increases in the agency costs of outside shareholders and therefore a fall in firm sustainability. The Governance Variables examined include many identified previously - but now assessed against the probability of earnings management/manipulation.

The purpose of chapter 10 is to present the fourth and final part of the Empirical Studies Key Field No. 4. The corporate governance effects of director, CEO and management compensation are examined with respect to Governance Variables which include:

- compensation effects on the level/quality of monitoring and firm value and operating performance;
- the connection between firm size and director/CEO/executive compensation; and
- compensation effects on governance through reputational constraints.

The approach running through the chapter is to revisit the effects of compensation issues - including equity payments and options - on the independence, monitoring quality and risk management functions of the directors from the Enron and Hastie collapses. The chapter then identifies empirical and other studies in the literature to support the Enron and Hastie analysis. From this review, the chapter constructs the relational effect paths for the compensation-related Governance Variables including director/CEO pay levels, equity/option holdings of directors and management and short-term options for directors and outside directors on the audit committee.

The relational approach concludes in chapter 11 with observations and analysis relating to the interrelationships and relational proximity of the 39 Governance Variables. Links are drawn in relation to the themes and tensions underpinning the four Key Fields. Comparisons of the thesis’ findings on the relational proximity Rating of Governance Variables are made against the current state of research in those Fields. Chapter 11 concludes with observations on the structure, explanatory power and scope of the thesis as well as areas for future research.
CHAPTER 2:
THE FRAMEWORK OF THE RELATIONAL CORPORATE GOVERNANCE APPROACH

2.1 Approach to the Relational Corporate Governance Framework

The purpose of this chapter is to show how the relational corporate governance approach and its constituent components determine the relational proximity of Governance Variables. To do so, the additional purpose of this chapter is to construct the principal components of the relational approach and to introduce the 39 Governance Variables. This includes the following theoretical components introduced in the previous chapter:

• the Three Relational Axes of Good Governance – the theoretical weighing mechanism which weighs the objectives, behaviours and positional conflict of insiders versus outsiders;

• the eight Governance Factors – the most significant and recurring themes and tensions underpinning the four Key Fields; and

• the two Interrelationship Schemes which represent the hypothesised relationships between the Governance Factors under the shareholder primacy model and the stakeholder model of corporate governance – these are used to construct a relational effect path for each Governance Variable.

To assist with the meaning of terms and components, defined terms of the relational approach appear in bold text when first appearing in the chapter and are defined in Appendix A1. Governance Variables are defined in Appendix A2. These components are used together to determine the relative importance of Governance Variables in affecting agency costs and the sustainability of the firm. In short, each relational effect path depicts the number and identity of the Governance Factors affected by each Governance Variable and the direction of the effect. The more Governance Factors affected by a Governance Variable, then the greater is its relational proximity relative to other Governance Variables in affecting agency costs (in either direction) and the long-term efficiency and sustainability of the firm.

The relational approach seeks to add to the relevant literature on the operation of economic actors in Anglo-American firms where there is a separation between ownership and management. These firms operate in a dense financial market typified by a large number of widely-dispersed shareholders. The firms have unitary boards such as those operating in the United States, United Kingdom and Australia.

---

1 See Appendix A1, Glossary of Relational Corporate Governance Approach Terms and Components and Appendix A2, Glossary of Governance Variables.

Using the Relational Corporate Governance Approach in Figure 2.1

A walk-through the following Figure 2.1 sets out how the relational approach works from the perspective of the reader and sets out how the components are combined to predict the relational proximity (relative effect) of Governance Variables on the sustainability of the firm.


Figure 2.1: Relational Corporate Governance Approach

The Four Key Fields

The Eight Governance Factors and the 39 Governance Variables

Weighing Mechanism to Weigh Governance Factors Affected by a Governance Variable

‘Coverage’ and ‘Relational Proximity’ Results

No. 1: Application of Firm Theories to the Relational Approach (Chapter 4)

No. 2: Autopsies of the Enron and Hastie Corporate Collapses (Chapter 5)

No. 3: Comparative Corporate Governance Codes (Chapter 6)

No. 4: Empirical Studies of the Effectiveness of Governance Variables (Chapters 7 – 10)

Eight Governance Factors:

No.1: Reporting
No. 2: Compliance
No. 3: Alignment
No. 4: Compensation
No. 5 Monitoring & Audit
No. 6: Stakeholders
No. 7: Decision-making
No. 8: Responsibility (Sections 2.6.1 – 2.6.8)

39 Governance Variables (Table 2.4)

Three Relational Axes of Good Governance (Sections 2.3.1 - 3):

1. Profit and Value Max vs Assessment, Reporting and Value Preservation
2. Innovation and Risk vs Management, Control and Accountability
3. Internal Stakeholders vs External Stakeholders

The 2 Interrelationship Schemes:

- These show the Hypothesised Interrelationships between Governance Factors:
  - Shareholder Primacy Interrelationship Scheme (Figure 2.7.2A)
  - Stakeholder Model Interrelationship Scheme (Figure 2.7.2.B)

Coverage Table 3.3.1

Displays the Identity, Number and Direction of Governance Factors Affected by a Governance Variable

Relational Proximity Table 3.3.2.1

Rating Governance Variables in Order of Relative Importance in Reducing Agency Costs and Enhancing Firm Sustainability

Relational Effect Path for each Governance Variable
Figure 2.1 depicts how the components and tables which comprise the relational approach are constructed. As can be seen from the Figure, all these components and tables originate from an examination of the four Key Fields on the left-hand side of the diagram. The four Key Fields simulate the ‘real world’ sphere of corporate governance available to the reader in the relational approach. They are:

No. 1 Application of The Principal Theories of the Firm to the Relational Approach;
No. 2 Autopsies of the Enron and Hastie Corporate Collapses;
No. 3 Comparative Corporate Governance Codes; and
No. 4 Empirical Studies of the Effectiveness of Governance Variables.

The articles, working-papers and other works comprising these Key Fields are drawn from the SSRN platform. These four Key Fields contain the 39 Governance Variables which are examined in the thesis. These are the 39 governance and management structures, mechanisms, processes and protocols which seek to deter or punish management misconduct or which align the interests of the management with those of the outside dispersed shareholders.

As the relational approach is based on predicting the interrelationships between these 39 Governance Variables, the aim at this point is to identify what those interrelationships are. These interrelationships are represented by the eight Governance Factors. So the works in the four Key Fields have been examined to extract these Governance Factors. These are the eight most significant recurring themes and tensions underpinning the works in the four Key Fields and, therefore, the 39 Governance Variables to which the Key Fields give rise. The process of extracting these Governance Factors from the Key Fields is undertaken in this chapter. Themes and considerations from each of the four Key Fields are brought forward from the later chapters to construct each Governance Factor. In other words, the section devoted to each Governance Factor collects under its heading the themes and considerations which the thesis has used to select the identity, nature and articulation of that Governance Factor:

No. 1 Reporting - Transparency, Timing and Integrity of Financial and Other Reports;
No. 2 Compliance - Corporate Governance and Legal Compliance;
No. 3 Alignment - Alignment of Management and Shareholder Interests;
No. 4 Compensation - Board, CEO and Management Compensation and Incentives;
No. 5 Monitoring & Audit - Internal and External/Audit Monitoring Quality;

5 These Governance Variables are set out in Table 2.4 of this chapter.
6 See discussion in section 1.2.1 of chapter 1.
7 See discussion in sections 2.6.1 – 2.6.8 of this chapter.
No. 6 **Stakeholders** - Identification, Participation and Protection of Stakeholder Interests;

No. 7 **Decision-making** - Quality of Board, CEO and Management Decision-making and

No. 8 **Responsibility** - Delineation and Disclosure of Powers, Duties and Lines of Responsibility.

Thus, at this point, the relational approach has produced 39 Governance Variables and the eight recurring themes and tensions which underpin the whole group of these Governance Variables – the Governance Factors. They provide the factors, themes or considerations which are relevant to any decision to employ individual Governance Variables. The legitimacy of observations and conclusions derived from the relational approach are dependent on the Governance Factors.

The aim now is to determine – by hypothesis - how these 39 Governance Variables affect each other. This aim is achieved by proxy. The interrelationships between the 39 Governance Variables must be the interrelationships between the eight Governance Factors which underpin those Governance Variables. To determine the interrelationships between the Governance Factors, the relational approach uses the weighing mechanism of the Three Relational Axes of Good Governance also constructed in this chapter. These Three Relational Axes weigh the Governance Factors (i.e., the themes and tensions represented by each Governance Variable) in a hypothetical sense only - by identifying the aims/objectives, behaviours and positional conflict of the corporate actors and then examining each Governance Factor in light of these Axes. In other words, what does each Axis predict about the behaviour of each Governance Factor in affecting each other Governance Factor? Again, by proxy, this weighing process must represent how the 39 Governance Variables underpinned by these Governance Factors affect each other. The interrelationships produced by this weighing are already calculated and presented for the reader – these are the two Interrelationship Schemes.

The examination of the individual Governance Factors then moves to the construction of these two Interrelationship Schemes. These two Schemes are diagrams setting out the hypothesised interrelationships between all of the eight Governance Factors. There are two Schemes – one based on the shareholder primacy model and the other based on the stakeholder model of corporate governance.

Next to be determined is how the employment (or omission) of each Governance Variable affects each other Governance Variable. The relational approach recognises at this time the pre-eminence of the shareholder primacy model of corporate governance. Thus, the Shareholder Primacy Interrelationship Scheme diagram is the basis of a relational effect path produced for each Governance Variable in chapters 7 – 10. These paths depict the identity, number and direction of the Governance Factors affected by each of the 39 Governance Variables. In short, the greater the number of Governance Factors affected by a Governance Variable – in the manner set out in the Shareholder Primacy Interrelationship Scheme – then

---

8 See discussion in sections 2.3.1 – 2.3.3 of this chapter 2.
9 See Figure 2.7.2A of this chapter 2.
10 See Figure 2.7.2B of this chapter 2.
11 See discussion in section 4.3.2 of chapter 4.
the greater is that Governance Variable’s relative importance compared to other Governance Variables in reducing agency costs and enhancing the long-term efficiency and sustainability of the firm. The process can be undertaken for any form of Governance Variable whether derived from the common law or equity (such as the directors’ duties), statute or a Governance Code of best practice.

The final step is to present the results of the relational effect path for each Governance Variable. Each of the 39 relational effect paths are summarised in the Coverage Table 3.3.1. This Table shows in summary form the identity and number of Governance Factors affected by each Governance Variable and the direction of the effect. This summary information is then transferred to the Relational Proximity Table 3.3.2.1 where the Governance Variables are ranked and grouped in order of descending relative importance in affecting the Governance Factors and, thus, the long-term efficiency and sustainability of the firm. This relative importance is known as the relational proximity of that Governance Variable and is measured on a scale of +/- 100 units abbreviated as ‘rprox’.

**The Benefits of ‘Good’ Corporate Governance**

Having presented the challenge for corporate governance in chapter 1, chapter 2 of the thesis begins with an overview of the most observable force in terms of governance phenomena – the argued benefits of ‘good’ corporate governance.

These benefits are based largely on the findings of empirical field studies of the effectiveness of Governance Variables in the for-profit sphere. The benefits of good governance introduced below focus on reducing agency costs and firm cost of capital and enhancing firm value (share price) and firm operating performance (profit). In turn, these measures are then used as proxies for long-term firm efficiency and the sustainability of the for-profit firm.

The chapter culminates with the combination of all the theoretical components and resultant benefits of the relational approach depicted in a single diagram. This is the pyramid-like structure of the Relational Corporate Governance Framework in Figure 2.8.

### 2.2 Overview of the Firm-Specific (Micro) and Macro-Economic Benefits or Effects of ‘Good’ Corporate Governance

Here, the principal firm-specific benefits of the adoption of good Governance Variables are summarised as:

- Reducing firm cost of capital;
- Increasing firm value and operating performance; and
- Stakeholder interest identification, participation and protection.

These reflect the research of Claessens (writing on behalf of The World Bank and the OECD) who summarised the developmental effects of good governance for businesses (in other words, the employment of Governance Variables) as including improved access to capital,
reduced capital costs, managerial improvement (with consequent improvement in results) and enhanced stakeholder relationships.\textsuperscript{12}

Claessens identifies increased investment, growth and employment as some of the \textit{macro-economic} benefits flowing from the firm-specific benefits.\textsuperscript{13} These macro-economic benefits or effects represent the cumulative effects that are said to arise from the adoption of firm-specific Governance Variables. In other words, the research posits that the sum of those governance and management structures, mechanisms, processes and protocols operate, in practice and after any negative effects, in an overall beneficial manner.

Support for this research can also be found in various other statements of the firm-specific and macro-economic aims and consequential effects of the adoption of good Governance Variables in the for-profit sphere. The OECD sees corporate governance as essential for various reasons largely related to market confidence, efficiency and development resulting in a lower cost of capital:

\begin{quote}
the presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper
\end{quote}

\begin{flushleft}
\textsuperscript{13} Claessens, ibid.
\end{flushleft}

More recently, in 2012, Claessens and Yurtoglu confirm this analysis and conclude (at 30):

At the level of the firm, the importance of corporate governance for access to financing, cost of capital, valuation, and performance has been documented for many countries and using various methodologies. Better corporate governance leads to higher returns on equity and greater efficiency. Across countries, the important role of institutions aimed at contractual and legal enforcement, including corporate governance, has been underscored by the law and finance literature. At the country level, papers have documented differences in institutional features. Across countries, relationships between institutional features and development of financial markets, relative corporate sector valuations, efficiency of investment allocation, and economic growth have been shown. Using firm-level data, relationships have been documented between countries’ corporate governance frameworks on the one hand, and performance, valuation, cost of capital, and access to external financing on the other.

There are some caveats relating to causality (also at 30):

While the general importance of corporate governance has been established, knowledge on specific issues or channels is still weak. An important general caveat to the literature is that it has some way to go to address causality. This also applies to the following three areas: ownership structures and the relationship with performance and governance mechanisms; corporate governance and stakeholders’ roles; and enforcement, both public and private, and related changes in the corporate governance environment.

functioning of a market economy. As a result, the cost of capital is lower and firms are encouraged to use resources more efficiently, thereby underpinning growth.14

Related to this in terms of global movements, the OECD also recognised the importance of ‘internationally accepted principles’ of good governance in attracting long-term foreign investment.15 The Commonwealth Association for Corporate Governance (CACG) similarly identified enhanced profits and efficiency for organisations, sustained competitiveness for national economies and organisations and market ‘stability’ and ‘credibility’ as related to good governance.16

2.3 The Components of the Relational Approach

As depicted above, the theoretical weighing mechanism of the relational approach and its results are comprised of four components - the Three Relational Axes of Good Governance, the eight Governance Factors, the two Interrelationship Schemes and the relational effect path for each Governance Variable.

The Three Relational Axes of Good Governance are like a set of scales for weighing the objectives (Axis No. 1), behaviours (Axis No. 2) and positional conflict (Axis No. 3) of the insiders and outsiders.17

The eight Governance Factors are the ‘backbone’ of the relational approach and so are critical to the theoretical components and the operational tables.18 The Governance Factors represent the most significant recurring themes or aims underpinning the four Key Fields and thus the 39 Governance Variables to which the Fields give rise. Critical then, in theoretical terms, the components of the relational approach depict the theoretical weighing process between the often-competing interests of insiders and outsiders of the corporation.

The hypothesised or predicted interrelationships between the eight Governance Factors are set out in the Interrelationship Schemes. The number of, and manner and direction in which, these Factors are affected or influenced by the Governance Variables are depicted in relational effect paths. These paths determine the relative importance - known as relational proximity - of those variables in affecting the shareholder-wealth measures. Chapter 2 now turns to examine in detail the theoretical components.

17 See Figures 2.3.2A and 2.3.2B of this chapter 2. See also Appendix A1, Glossary of Relational Corporate Governance Approach Terms and Components for the definitions of Objectives Axis No. 1, Behaviours Axis No. 2 and Positional Conflict Axis No. 3.
18 See the Coverage Table in section 3.3.1 and the Relational Proximity Table in section 3.3.2.1 of chapter 3.
2.3.1 The Three Relational Axes of Good Governance

Drawing on the definitions of corporate governance from the Cadbury Report and OECD described in chapter 1\textsuperscript{19}, the definition of relational corporate governance seeks to balance the competing aims, behaviours and interests of insiders such as the directors, CEO and management with traditional outsiders such as shareholders and other wider stakeholders:

1. **Objectives Axis**

On one axis, the freedom of a company’s management to pursue (profit-maximising) objectives (value enhancement) at one end is balanced against the interests of the shareholders (owners) in monitoring management’s performance (performance assessment and reporting) and seeing that a company’s resources are not dissipated (value preservation).

2. **Behaviours Axis**

On another axis, “entrepreneurism” and “innovation” (risk-taking) are balanced against risk management, “control” and “accountability” (responsibility).

3. **Positional Conflict Axis**

Lastly, the interests of those ‘within’ the company such as the board, CEO and executives/management (internal stakeholders) are balanced against the interests of those ‘outside’ the company such as shareholders/investors, employees, lenders, suppliers, government legislators and regulators and social interests including the environment and the general public (external stakeholders).

2.3.2 The Purpose and Interrelationship of the Three Relational Axes

The Three Relational Axes of Good Governance, while represented separately in the above definition, are employed simultaneously in balancing or weighing the Governance Factors in the relational approach. The Three Relational Axes are represented separately because each has a separate purpose. But while the Three Relational Axes are employed simultaneously, they do not all operate in the same manner or – in terms of three-dimensional space - on the same plane.

**Objectives Axis No. 1 and Behaviours Axis No. 2**

Relational Axes Nos. 1 and 2 do operate on the same plane. They have a functional purpose because they are primarily concerned with operational functions or activities. While there is clearly some overlap between these Axes, they are not identical. On the one hand, the Objectives Axis No. 1 is cast in terms of functional objectives – for example, profit

\textsuperscript{19} See discussion in section 1.2.1 of chapter 1. For an earlier working paper version of the Three Relational Axes of Good Governance devised by de Zwart, see de Zwart (90% author) and Gilligan, above n 12, 7-8.
maximisation, value enhancement and value preservation. On the other hand, the Behaviours Axis No. 2 denotes functional behaviours such as innovation, risk-taking, risk management and control:

Figure 2.3.2A:
The Functional Purpose – Objectives Axis No. 1 and Behaviours Axis No. 2

Axes 1(a) and 2(a) represent the aim/objective and behavioural drivers of firm profitability and value and, therefore, long-term efficiency and sustainability. By contrast – and this is not meant in a negative sense - Axes 1(b) and 2(b) represent the checks and balances which are equally necessary to attain or enhance these efficiency and sustainability outcomes.

Positional Conflict Axis No. 3

The third Axis is quite different. It is known as the Positional Conflict Axis No. 3. It is not concerned with functions or activities. Instead, it represents the positional conflict between different stakeholders - insiders and outsiders - and, in addition, between the insiders and outsiders inter se. Thus, again represented three-dimensionally, this Axis ‘hovers’ above Axes Nos. 1 and 2 for the purpose of demarcating or delineating the parties or interests to be protected by those Axes. This is depicted in the following Figure 2.3.2B:
2.3.3 The Weighing Process of the Three Relational Axes

The Three Relational Axes are not the product of the weighing process of the relational approach. Instead, they are a conceptual means of describing the three-dimensional scales where the weighing process in relation to the eight Governance Factors must take place.

The Three Relational Axes determine the manner in which the Governance Factors are weighed in the relational approach and their Coverage by an individual Governance Variable is determined. In more practical terms, the Three Relational Axes act like scales in which users of the relational approach weigh the Governance Factors and individual Governance Variables in order to determine whether a particular Governance Variable (significantly and in which direction) affects or influences the attainment or enhancement of one or more particular Governance Factors.

The weighing process is akin to the weighing of factors that takes place in the breach of duty stage of negligence law. As is well-known, the standard of care under negligence law principles (under the common law and statutes such as the Corporations Act 2001) requires a director to exercise reasonable care to avoid foreseeable harm in the management of all aspects of the corporation. In negligence law, the precautions a ‘reasonable’ director must take to protect the company from foreseeable harm are determined by the ‘calculus of negligence’. This is a combination of considerations/factors including the probability of the

---

20 See the Coverage Table in section 3.3.1 of chapter 3.
harm occurring, its likely seriousness or gravity, the burden of taking precautions and any competing social justifications for the impugned conduct. These factors – both legally and in an economic sense – determine the relative importance of the various areas of external foreseeable harm facing the corporation.

The relational approach is akin to treating management misconduct as merely a type of foreseeable harm – in this case internal – facing the company. But instead of weighing three factors, the relational approach weighs eight Governance Factors to determine the relative importance of Governance Variables in counteracting agency costs and enhancing the long-term sustainability of the firm.

In relation to the type of internal harm that the relational approach adopts as foreseeable, Jensen and Meckling’s seminal agency theory principle introduced in chapter 1 is again adopted. The most influential theory in modern corporations law, it posits that rational managers will seek to maximise their own interests at the expense of shareholders by engaging in value-reducing behaviours such as ‘shirking’, ‘empire building’, over-compensation and (over) perquisites.

The relational approach is that the precautions to avoid or reduce agency costs are the Governance Variables themselves. These are the structures, mechanisms, processes and protocols in Governance Codes like those of the New York Stock Exchange and Australian Securities Exchange that deter and punish director, CEO and management misconduct or which align the interests of those insiders with the interests of outside shareholders. It is to the Governance Variables that the thesis now turns.

2.4 Introduction to the Governance Variables

The 39 Governance Variables are the governance and management structures which seek to punish or deter director, CEO and management misconduct or which align the interests of those insiders with the interests of outside shareholders. They are critical to the relational approach because the approach is constructed on the basis that the Governance Variables affect one another – the operation of each Governance Variable is affected by the ‘zone of effect’ of each other Governance Variable. This zone of effect is represented by the relational effect path of that Governance Variable. The strength or otherwise of a Governance Variable’s zone of effect is thus measured by its relational proximity – its relative importance compared to other Governance Variables.

These relational effect paths are constructed in chapters 7 – 10 of the thesis. These chapters examine empirical studies relating to the effectiveness of Governance Variables measured by

---


22 See discussion in section 1.2.2 of chapter 1.


24 ASX 2007-10 Revised Principles, above n 15.
the firm’s cost of capital, firm value and firm operating performance. These measures are proxies for reducing agency costs and enhancing the long-term efficiency and sustainability of the corporation.

The 39 Governance Variables are defined in Appendix A2, Glossary of Governance Variables. They are displayed and identified by name and designated abbreviation in the following Table 2.4. This page is tabbed for convenience to the reader for on-going reference in the thesis. Section references for the analysis of empirical studies and the relational effect path for each Governance Variable is set out in the right-hand column of the Table. Relational effect path references are in bold type.

**Table 2.4: Summary of Governance Variables**

<table>
<thead>
<tr>
<th>No</th>
<th>Governance Variable</th>
<th>Abbreviation (Alphabetical)</th>
<th>Section Ref.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Audit Committee – Accounting Expertise – Earnings Manipulation Reduction Effect</td>
<td>AudAccEarn</td>
<td>9.2.1.1.1, 9.2.1.1.2</td>
</tr>
<tr>
<td>2.</td>
<td>Audit Committee - Presence, Operation and Frequency</td>
<td>AudCom</td>
<td>5.2.2.2, 8.4.2, 8.4.3.1</td>
</tr>
<tr>
<td>3.</td>
<td>Audit Committee - Financial Expertise (Accounting)</td>
<td>AudExpAcc</td>
<td>8.4.4</td>
</tr>
<tr>
<td>4.</td>
<td>Audit Committee - Non-Accounting Expertise - ‘Free Rider’ Effect</td>
<td>AudFree</td>
<td>9.2.1.1.2</td>
</tr>
<tr>
<td>5.</td>
<td>Audit Committee – Independence in Combination with Frequency of Meeting – Reduction in Earnings Manipulation Effect</td>
<td>AudIndFreq</td>
<td>6.2.3.1.2, 9.2.1</td>
</tr>
<tr>
<td>6.</td>
<td>Audit Committee - Independence - Information Flow and Decision Quality ‘Trade-off’</td>
<td>AudIndInfo</td>
<td>6.2.3.1.2, 8.4.3</td>
</tr>
<tr>
<td>7.</td>
<td>Audit Committee - Independence – Monitoring Effect</td>
<td>AudIndMon</td>
<td>5.2.2.2, 6.2.3.1.2, 6.2.3.1.4, 8.4.3</td>
</tr>
<tr>
<td>8.</td>
<td>Audit Committee – Short Term Options Granted to Outside Directors – Reduction in Monitoring Effect</td>
<td>AudShortOpts</td>
<td>5.2.2.1, 5.2.3.2.1, 6.2.3.1.4, 10.2.5.1</td>
</tr>
<tr>
<td>9.</td>
<td>Block Shareholding – Other Shareholder Agency Costs</td>
<td>BlockCosts</td>
<td>8.5.1-2</td>
</tr>
<tr>
<td>10.</td>
<td>Block Shareholding – Monitoring Effect</td>
<td>BlockMon</td>
<td>8.5.1-2</td>
</tr>
<tr>
<td>11.</td>
<td>Board – Attendance Level (High)</td>
<td>BrdAttend</td>
<td>7.3.1.2, 7.3.2.1.2</td>
</tr>
<tr>
<td></td>
<td>Description</td>
<td>Code</td>
<td>Section(s)</td>
</tr>
<tr>
<td>---</td>
<td>------------------------------------------------------------------------------</td>
<td>---------</td>
<td>---------------------</td>
</tr>
<tr>
<td>12.</td>
<td>Board and Committee (Non-Audit) Size – Earnings Manipulation Effect</td>
<td>BrdCmEarn</td>
<td>5.2.3 (9.2.2)</td>
</tr>
<tr>
<td>13.</td>
<td>Board and Committee Size</td>
<td>BrdCmSize</td>
<td>8.2.2.2</td>
</tr>
<tr>
<td>14.</td>
<td>Board Independent Director: Executive Director Proportion – Information Flow and Decision Quality ‘Trade-off’</td>
<td>BrdIndInfo</td>
<td>6.2.3.1.2 (7.3.2.1.3)</td>
</tr>
<tr>
<td>15.</td>
<td>Board Independent Director: Executive Director Proportion – Monitoring Effect</td>
<td>BrdIndMon</td>
<td>5.2.2.1 (6.2.3.1.2 (6.2.3.1.4 (7.3.2.1.1-2)</td>
</tr>
<tr>
<td>16.</td>
<td>Board – Annual Review</td>
<td>BrdReview</td>
<td>7.3.2.1.2</td>
</tr>
<tr>
<td>17.</td>
<td>Board – Director Skills ‘Mix’</td>
<td>BrdSkills</td>
<td>7.3.1.2.1</td>
</tr>
<tr>
<td>18.</td>
<td>Compensation Committee - Presence, Operation and Frequency</td>
<td>CompCom</td>
<td>5.2.2.2 (10.2.4.1)</td>
</tr>
<tr>
<td>19.</td>
<td>Director/CEO Compensation Levels</td>
<td>DirCEOS</td>
<td>5.2.2.1.1 (5.2.3.2 (6.2.3.1.4 (10.2.4)</td>
</tr>
<tr>
<td>20.</td>
<td>Duality of CEO/Chair Positions – CEO Dismissal Probability</td>
<td>DualDismiss</td>
<td>8.6.3</td>
</tr>
<tr>
<td>21.</td>
<td>Duality of CEO/Chair Positions – Probability of Earnings Manipulation</td>
<td>DualEarn</td>
<td>9.2.1.1.3</td>
</tr>
<tr>
<td>22.</td>
<td>Duality of CEO/Chair Positions – Effect on Strategic Decision-making</td>
<td>DualStrat</td>
<td>8.6.3</td>
</tr>
<tr>
<td>24.</td>
<td>Equity/Option Plans and Holdings of Directors/Executives – Incentive/‘Alignment’ Effect (excludes short-term options)</td>
<td>EqOptIncent</td>
<td>5.2.2.1 (5.2.3.2.1 (6.2.3.1.4 (10.2.4)</td>
</tr>
<tr>
<td>25.</td>
<td>Equity/Option Plans and Holdings of Directors/Executives – ‘Entrenchment’ Effect (excludes short-term options)</td>
<td>EqOptEntrch</td>
<td>5.2.2.1 (5.2.3.2.1 (6.2.3.1.4 (10.2.4)</td>
</tr>
<tr>
<td>26.</td>
<td>External/Independent Audit Function</td>
<td>ExtAudEarn</td>
<td>5.2.4 (9.2.3.3)</td>
</tr>
<tr>
<td>27.</td>
<td>National Governance/Shareholder Protection Regime</td>
<td>NationGov</td>
<td>5.2.1.1 (6.3.1 (7.3.1.3 (7.3.1.3.3)</td>
</tr>
<tr>
<td>28.</td>
<td>Nominating Committee - Presence, Operation and Frequency</td>
<td>NomCom</td>
<td>5.2.2.2 (7.3.1.2.2)</td>
</tr>
</tbody>
</table>
|   | Nominating Committee – Independence Proportion | NomInd | 5.2.2.2  
|   |                                           |       | 6.2.3.1.2  
|   |                                           |       | 7.3.1.2.2  
| 30. | Non-Audit Services of External Auditor | NonAuditS | 5.2.4.2  
|   |                                           |       | 9.2.3.2-3  
| 31. | Other Anti-Takeover Mechanisms (excludes staggered board elections) | OtherATMs | 5.2.1.1  
|   |                                           |       | 8.3.1  
|   |                                           |       | 8.3.1.1  
| 32. | Outside Board Positions of Independent Directors | OutBrdPos | 6.2.3.1.2  
|   |                                           |       | 8.2.3.1  
| 33. | Outside/External Board Advisers | OutBrdAdv | 7.3.2.1.2  
| 34. | Reputational Constraints – ‘Disclosure Standards’ | ReputDiscl | 5.2.5.1  
|   |                                           |       | 6.2.3.1.4  
|   |                                           |       | 10.4.1  
| 35. | Reputational Constraints – ‘Transparent Reporting’ | ReputRep | 5.2.5.1  
|   |                                           |       | 6.2.3.1.4  
|   |                                           |       | 10.4.1  
| 36. | Staggered Board Elections | StagBrdElect | 8.3.1  
|   |                                           |       | 8.3.1.1  
| 37. | Short-Term Option Holdings/Plans of Directors and Executives | ShortTOpts | 5.2.2.1  
|   |                                           |       | 5.2.3.2.1  
|   |                                           |       | 6.2.3.1.4  
|   |                                           |       | 10.2.5.1  
| 38. | Transparency and Timing of Reporting – Monitoring Effect | TransTimeMon | 5.2.1.1  
|   |                                           |       | 5.2.3  
|   |                                           |       | 5.2.5.1  
|   |                                           |       | 6.2.3.1.3  
|   |                                           |       | 9.1.2.1  
|   |                                           |       | 5.2.5.1  
|   |                                           |       | 6.2.3.1.3  
|   |                                           |       | 9.1.2.1  

|2.5| **Principal Considerations in the Selection of the Governance Factors** |

|2.5.1| **The Governance Factors are Drawn from the Key Fields** |

The Governance Factors represent the eight principal themes or factors that underpin the four Key Fields and thus the 39 individual Governance Variables to which these Fields give rise. In other words, the eight Governance Factors represent the considerations which are drawn from - and link - each of these four Key Fields.

In turn, the interrelationships between the Governance Factors are brought together and summarised in the Interrelationship Schemes depicted in Figures 2.7.2A and 2.7.2B. These
Schemes are then used to construct for each Governance Variable an individual relational effect path showing the identity, number and direction of Governance Factors affected by each Governance Variable.

A summary of these relational effect paths is contained in the Coverage Table 3.3.1 and the ultimate Relational Proximity Table 3.3.2.1. Thus, the Governance Factors are critical to the integrity and explanatory power of the entire relational approach.

In this chapter 2, the thesis justifies the principal considerations that have been adopted in the identification, structure and articulation of the Governance Factors. This is achieved by examining each of the Key Fields to draw out the themes recurring in one or more Fields. In turn, these recurring themes must also be the considerations common to all the Governance Variables which are drawn out from the Key Fields.

### 2.5.2 What is a Governance Factor?

As noted above, a Governance Factor is an underlying and recurring theme derived from within the four Key Fields. In other words, it is, *in itself*, an object, purpose or end of ‘good governance’. It may also be considered to be an intermediate step or combination of steps to achieve such an object, purpose or end or to avoid harming good governance outcomes. For example, improving the quality of board, CEO and management decision-making (*Decision-making Factor No. 7*) is clearly an object, purpose or end of good governance. That end is also assisted by improving the transparency, timing and integrity of financial and other reports (*Reporting Factor No. 1*) and the delineation and disclosure of powers, duties and lines of responsibility (*Responsibility Factor No. 8*). Similarly, alignment of management and shareholder interests (*Alignment Factor No. 3*) is another end of good governance. It can be achieved, in one way, by the design of board, CEO and management compensation and incentives (*Compensation Factor No. 4*).

But in the determination of what precisely constitutes a Governance Factor, it is important to articulate just what is an ‘underlying theme’ of the Key Fields. The themes selected to be Governance Factors must be drawn from within the four Key Fields and not merely be an influence on those Fields. For example, the effect of ‘globalisation’ factors or considerations (such as the cross-border competition between capital markets\(^{25}\) or the ‘importation’ of variables from non-English-origin shareholder-protection regimes and *vice versa*\(^{26}\)) in the convergence or divergence of national governance schemes is a current and rich vein of literature in governance discourse.\(^{27}\) Indeed, this theme is represented in of the pyramid-like structure of the Relational Corporate Governance Framework in Figure 2.8. It is shown as influencing the composition of the Comparative Corporate Governance Codes Key Field No. 3 and the Empirical Studies Key Field No. 4. Even apart from this, globalisation or ‘harmonisation’\(^{28}\) of corporate Governance Codes may enhance the attainment of one of the over-arching purposes of the relational approach – the long-term efficiency and sustainability

---


26 Ibid.

27 See, for example, Cunningham, above n 25. See, also, the references in Appendix C1, *Harmonisation or Convergence of Global and National Corporate Governance*.

28 See discussion in subsection 6.1.3 of chapter 6.
of for-profit corporations. This is achieved by enhancing access to (for example, less expensive) overseas capital markets.29

But, as Figure 2.8 describes, globalisation is a force shaping these two Key Fields and, thus, the national shareholder-protection regimes, corporate Governance Codes and Governance Variables to which they give rise. It is not, this thesis submits, a theme to which the Key Fields and Governance Variables give rise per se.

2.5.3 Governance Factors Must Be Distinguished From Governance Variables

In selecting the Governance Factors, it is important not to mistake for a Governance Factor what is really a Governance Variable. For example, some would submit that the independence of directors from management is a ‘theme’ of contemporary corporate governance. It certainly is a focus. This is reflected in chapter 6’s demonstration that “independence from management” including “non-executive/independent directors” is a ‘core’ feature of global/cross-border and national (US, UK and Australian) corporate Governance Codes.30 But such independence is not, in itself, an object, purpose or end of ‘good governance’.

Instead, director independence (or the proportion of independent directors) serves as an argued means to affect, attain or enhance some (or all) of the themes constituting the Governance Factors themselves. Examples include the Alignment Factor No. 331, the Monitoring & Audit Factor No. 532 and the Decision-making Factor No. 7.33

2.6 The Governance Factors are Recurring Themes and Tensions from the Key Fields

The principal considerations in the selection of the eight Governance Factors are now presented in numerical order. The order is not a reflection of the relative importance of the Factor. For some of the Factors, a table is presented to describe the Key Field from which the theme is taken and the source of the theme within that Key Field. The aim of the tables is to demonstrate that the Governance Factors are recurring or universal themes throughout one or more of the Key Fields.

2.6.1 Reporting Factor No. 1: Transparency, Timing and Integrity of Financial and Other Reports

Intuitively, the Reporting Factor No. 1 is, or should be, a critical component of virtually all corporate governance regimes as it provides or constitutes the means by which any meaningful assessment of (inside) managerial performance may be undertaken by (outside) shareholders or other stakeholders. For example, in terms of the Comparative Corporate Governance Codes Key Field No. 3, chapter 6 will demonstrate that ‘timely disclosure of

29 Cunningham, above n 25, 12.
30 See discussion in section 6.8.1 of chapter 6.
31 Alignment of Management and Shareholder Interests. See discussion in section 2.6.3 of this chapter 2.
32 Internal and External/Audit Monitoring Quality. See discussion in section 2.6.5 of this chapter 2.
33 Quality of Board, CEO and Management Decision-making. See discussion in section 2.6.7 of this chapter 2.
material information” is a core feature of the nature, operation, continuity (both temporally and developmentally) and centrality of such codes. The following Table 2.6.1 sets out the considerations drawn from the Key Fields supporting the identity, structure and articulation of the Reporting Factor No. 1:

Table 2.6.1: Reporting Factor No. 1

<table>
<thead>
<tr>
<th>No.</th>
<th>Source of Theme, Consideration or Factor</th>
<th>Description</th>
<th>Section</th>
</tr>
</thead>
<tbody>
<tr>
<td>Key Field No. 1 – Application of the Principal Theories of the Firm to the Relational Approach</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.</td>
<td>The market for corporate control operates as part of the efficient market hypothesis to remove management which engages in value or performance-reducing behaviour.</td>
<td>• The efficient market hypothesis itself assumes that share prices reflect all publicly available information.</td>
<td>4.2.2</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Problems of imperfect knowledge (or information asymmetry), bounded rationality of investors and the timing (lag) of market adjustments can disrupt this management-disciplining mechanism.</td>
<td>4.2.2</td>
</tr>
<tr>
<td>Key Field No. 2 – Autopsies of the Enron and Hastie Corporate Collapses</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.</td>
<td>• Enron Off-balance sheet ‘Special Purpose Entities’ or ‘SPEs’</td>
<td>• failure of both timely and adequate information to the market.</td>
<td>5.2.1.1</td>
</tr>
<tr>
<td></td>
<td>• Concealment of Enron debt and ‘self-hedging’ arrangements</td>
<td>• undermining of the market for corporate control and efficient market hypothesis.</td>
<td>5.2.1.1</td>
</tr>
<tr>
<td></td>
<td>• Recognition of income in trading between Enron-owned entities</td>
<td></td>
<td>5.2.3</td>
</tr>
<tr>
<td></td>
<td>• Other Enron earnings management arrangements</td>
<td></td>
<td>5.2.3</td>
</tr>
</tbody>
</table>

34 See discussion in section 6.8.1 of chapter 6.
35 See discussion in section 1.2.2 of chapter 1.
38 Dent, ibid.
39 Ibid, 19.
40 See discussion in section 5.2.1.1 of chapter 5.
• By contrast, Hastie group danger signs were prominent including standstill arrangements with bankers, equity raising of $A158 million, large write-downs to goodwill, trade and other receivables and charges against EBIT of $A 55 million increased to $A 88 million and shares suspended on two occasions\(^{42}\).

• But the Hastie Board was criticised by the Administrators over its financial reporting suggesting Hastie’s books and records were deficient and did not accurately explain the Group’s financial position and performance and may have been materially misstated.\(^{43}\).

---

### Key Field No. 3 – Comparative Corporate Governance Codes

<table>
<thead>
<tr>
<th>1. International/cross-border and national (US, UK and Australian) corporate Governance Codes examined in chapter 6</th>
<th>5.2.1.1</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Core feature of “timely disclosure of material information.”</td>
<td>6.8.1</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2. OECD Principles(^{44})</th>
<th>5.2.5.1</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Entire Principle V devoted to Reporting Factor No 1.(^{45})</td>
<td>6.2.2</td>
</tr>
<tr>
<td>• Principle V, C includes reference to the Monitoring &amp; Audit Factor No. 5’s independent audit.(^{46})</td>
<td>6.2.2</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>3. ASX 2007-10 Revised Principles(^{47}):</th>
<th>6.6.1</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Revised Principle 4</td>
<td>6.6.1</td>
</tr>
<tr>
<td>• Revised Principle 5</td>
<td>6.6.1</td>
</tr>
<tr>
<td>• Requirement to “Safeguard integrity in financial reporting”(^{48})</td>
<td>6.6.1</td>
</tr>
<tr>
<td>• Requirement to “[m]ake timely and balanced disclosure” of “all material matters concerning the company”.(^{49})</td>
<td>6.6.1</td>
</tr>
</tbody>
</table>

---

\(^{41}\) See discussion in section 5.2.2.3 of chapter 5.


\(^{44}\) OECD Principles, above n 14.

\(^{45}\) Ibid, Principle V, p 22

\(^{46}\) Ibid, Principle V.C., p 22.

\(^{47}\) ASX 2007-10 Revised Principles, above n 15.

\(^{48}\) Ibid, Revised Principle 4, p 26.

\(^{49}\) Ibid, Revised Principle 5, p 29.
40

Disclosure requirements not limited to financial reporting but extend to "performance, ownership and governance" and "operations and activities".

This is the basis of the ASX (and other relevant jurisdiction) Listing Rule continuous disclosure obligations.

4. SOX Reform Provisions

2. 'Transparency and Timing' (SOX Reporting II – sections 401, 402, 403, 408 and 409).
3. Provisions designed to reduce the incidence of earnings manipulation – see SOX Earnings Manipulation in SOX Summary Table in Appendix C2.

No. 3 - Empirical Studies of the Effectiveness of Governance Variables

1. Empirical Studies:
   - Ashbaugh-Skaife, Collins and LaFond and Patel and Dallas
   - Hermalin and Weisbach

   Transparency and timeliness of reporting principally remedies the 'information asymmetry' problem arising in agency theory which creates 'agency risk' for shareholders.

   Agency risk and the cost of equity capital reduces with increased transparency and timeliness of financial reporting and

   Corporate governance effects of increasing transparency is a higher quality of board monitoring (which must be balanced against the costs of exposing management to greater scrutiny)

---

50 Ibid.
54 Internal Controls and Finance Code of Ethics.
55 Auditors and Non-Audit Services.
Thus, the themes represented in the Reporting Factor No. 1 are properly to be considered recurring in all four of the Key Fields and so significant in the relational approach.

This significance is also reflected in the Three Relational Axes of Good Governance. There, the Objectives Axis 1(b) (Performance Assessment and Reporting and Value Preservation) and the Behaviours Axis 2(b) (Risk Management, Control, Accountability and Responsibility) represent the checks and balances contemplated in the weighing process of the Governance Factors. As the above discussion demonstrates, the considerations represented in the Reporting Factor No. 1 are thus a fundamental (theoretical) condition for the effective operation of those two Axes.

2.6.2 Compliance Factor No. 2: Corporate Governance and Legal Compliance

Corporate governance and legal compliance are critical as an overriding requirement of all other Governance Factors. Thus all Governance Variables utilised by a company must be consistent with the rule of law. The overriding nature of the Compliance Factor is represented in the following Figure 2.6.2:

![Figure 2.6.2: Compliance Factor No. 2 Interrelationships](image)

The overriding nature of the Compliance Factor No. 2 over other Governance Factors may be demonstrated by a real-world example.

Consider the Stakeholders Factor No. 6. It would not be permissible to enhance or satisfy a non-shareholder interest represented by this Factor if it is at the expense of, or contrary to, a

---

59 Ashbaugh Skaife, Collins and LaFond, above n 56, 2-3.
fiduciary duty such as the duty to act in the interests of the corporation. This duty is generally interpreted in Australian law to mean that, at least where no question of insolvency or near insolvency of the company is concerned, that the directors must act for the benefit of the shareholders as a whole.

The following Table 2.6.2 demonstrates that the Compliance Factor No. 2 is a significant theme arising from the Key Fields:

**Table 2.6.2: Compliance factor No. 2**

<table>
<thead>
<tr>
<th>No.</th>
<th>Source of Theme, Consideration or Factor</th>
<th>Description</th>
<th>Section</th>
</tr>
</thead>
<tbody>
<tr>
<td>Key Field No. 1: Application of Principal Theories of the Firm to the Relational Approach</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.</td>
<td>• Tension between the shareholder primacy model and the associated shareholder wealth maximisation principle vis-à-vis stakeholder model of corporate governance.</td>
<td>• Compliance Factor requires that shareholder primacy is currently the pre-eminent or overriding theory in Australia on account of the Australian High Court decision in <em>Walker v Wimborne</em> and section 181(1)(a) <em>Corporations Act 2001</em> (Cth).</td>
<td>1.2.3</td>
</tr>
<tr>
<td>Key Field No. 2 – Autopsies of the Enron and Hastie Corporate Collapses</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.</td>
<td>• US legally-mandated accounting standards and rules relating to Enron</td>
<td>• Significant failures in corporate governance and legal compliance • Argued that standards and rules were adequate but Enron’s non-compliance was central to the relevant accounting fraud and earnings manipulation (Catanach and Rhoades).62</td>
<td>5.2.3</td>
</tr>
<tr>
<td></td>
<td>• Australian Accounting Standards and Rules relating to the Hastie Group</td>
<td>• Hastie Board was criticised by the Administrators over its financial reporting suggesting Hastie’s books and records were deficient and did not accurately explain the Group’s financial position and performance and may have been materially misstated.63</td>
<td>5.2.5.1</td>
</tr>
<tr>
<td>Key Field No. 3 – Comparative Corporate Governance Codes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.</td>
<td>• <em>Corporations Act 2001</em> (Cth) and &quot;Imported&quot; into relational approach by</td>
<td></td>
<td>2.6.2</td>
</tr>
</tbody>
</table>

---

60 See *Corporations Act 2001* (Cth), sub-section 181(1)(a).
61 *Walker v Wimborne* [1976] HCA 7; (1976) 137 CLR 1, 7 (per Mason J as he then was). While this equitable and statutory fiduciary duty could be argued to merely be a manifestation of the shareholder primacy principle, it nonetheless represents a specific legal obligation beyond the theoretical relational approach.
2. Common law, equitable and statutory duty of directors.

- Comparative Corporate Governance Codes Key Field No. 3 including the OECD Principles, NYSE Final Rules, the UK Corporate Governance Code 2010-12 and ASX 2007-10 Revised Principles

- Core features are the principal board functions and responsibilities of both “compliance with statutory and legal duties” and “corporate governance compliance”.65

Key Field No. 4: Empirical Studies of the Effectiveness of Governance Variables

1. Studies of the ‘strength’ of the national shareholder protection and governance regime

- Increases in the level of national shareholder protection and governance regime (to a certain point) improve firm performance

- Common law regimes appear to provide the highest level of protection vis-à-vis civil code countries.

Thus, the themes represented in the Compliance Factor No. 2 are properly to be considered recurring in all four of the Key Fields and so are classified as a Governance Factor.

2.6.3 Alignment Factor No. 3: Alignment of Management and Shareholder Interests

The Alignment Factor No. 3 is a prominent theme in the entirety of the Key Field No.1 – the application of the principal theories of the firm to the relational approach. The alignment of management and shareholder interests is one of the principal aims underlying two of the four main theories and models of the firm and corporate governance examined in chapter 4 – agency theory66 and the shareholder primacy model.67

The seminal work of Fama and Jensen is the key consideration in the adoption of the Alignment Factor No. 3. The authors characterise the key feature of the dispersed shareholding public company to be a separation of ownership from management of the firm.68

---

65 See discussion in section 6.8.1 of chapter 6.
66 See discussion in sections 4.2.3 and 4.2.3.1-2 of chapter 4.
67 See discussion in sections 4.3.1 – 4.3.2.1 of chapter 4.
As introduced in Chapter 1, Jensen and Meckling’s separation model posits that there exists an agency relationship between inside managers who act on behalf of outside shareholders, the costs (agency costs) of which relationship determine the ownership structure of the firm. In this respect, for Jensen and Meckling, the agency costs include monitoring costs on behalf of the shareholder:

\[
\text{[i]f both parties to the relationship are utility maximizers, there is good reason to believe that the agent will not always act in the best interests of the principal. The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent.}
\]

Thus, the alignment of management and shareholder interests – whether by way of incentive, monitoring or disciplinary devices - is a key feature of agency cost theory. If we assume that shareholders are the only ‘residual claimants’ of the corporation, then the Alignment Factor No. 3 is also a key feature of the shareholder primacy model of corporate governance.

This can be demonstrated by a number of examples. First, the Shareholder Primacy Interrelationship Scheme depicted in Figure 2.7.2A below displays the Alignment Factor No. 3 as an ‘umbrella’ or ‘guiding principle’ over all other Governance Factors except the Compliance Factor No. 2. This is depicted in the following Figure 2.6.3A:

---

69 See discussion in section 1.2.2 of chapter 1.
71 Jensen and Meckling, above n 70, 5-6.
72 Ibid, 5 (emphasis in original).
73 See discussion in section 4.3.2 of chapter 4.
74 See discussion in section 2.6.2 of this chapter 2.
A real-world example of this diagram relates to the ongoing debate relating to director, CEO and management compensation. Hill and Yablon explain that the 'alignment' principle encapsulated in the Alignment Factor No. 3 serves as one of several theoretical approaches upon which such compensation and incentives should be designed.\(^{75}\)

Yet the Enron corporate collapse demonstrates, as one aspect of that failure, the misalignment of management and shareholder interests in a number of areas. First, in the link between earnings manipulation and the short-term nature of CEO, executive and director compensation.\(^{76}\) Contributing to this misalignment was the lack of both director\(^{77}\) and auditor\(^{78}\)

---


76 See discussion in section 5.2.3.2 of chapter 5.

77 See discussion in sections 5.2.2.1 – 5.2.2.3 of chapter 5.

78 See discussion in section 5.2.4 of chapter 5.
independence with the consequent reduction in the quality of board monitoring on behalf of shareholders. One remedial response to the collapse was the SOX reforms. These reforms sought to enhance the alignment of directors and management with outside shareholders in provisions relating to both directors and management\textsuperscript{79} and earnings manipulation.\textsuperscript{80}

### 2.6.4 Compensation Factor No. 4: Board, CEO and Management Compensation and Incentives

Representing one of the longest-running themes in corporate governance discourse, and a focus of media interest, Compensation Factor No. 4 remains significant in the climate of the GFC, particularly as US and other governments turned at that time to taxpayer money to bail-out failing financial institutions and markets.\textsuperscript{81} As explained by Jensen and Meckling in the preceding section, managerial compensation and incentive devices play a critical role in the firm theories contained in Key Field No.1 as one of the principal mechanisms to reduce agency costs.\textsuperscript{82}

A prominent example of the significance of the Compensation Factor No. 4 comes from the Enron and Hastie Collapses Key Field No. 2. That collapse demonstrates the argued link between earnings manipulation and the short-term nature of CEO, executive and director compensation.\textsuperscript{83} Gillan and Martin explain that, at Enron, the proportion of outside directors was ‘notionally’ 86% (12 out of 14) with a large number of subcommittees including audit, compensation and nomination (and corporate governance) on which all directors were outsiders.\textsuperscript{84} The authors note substantial shareholdings amongst directors as well as option holdings by all but one outside director.\textsuperscript{85} In addition, financial arrangements with directors – consulting fees, related entity transactions and donations – resulted in a ‘true’ independence proportion closer to 43%.\textsuperscript{86} For Gillan and Martin, these arrangements and the share and option holdings of directors “may have attenuated any inclination to aggressively monitor management’s practices”.\textsuperscript{87}

In the case of share options, Gordon explains that, while such options may enhance the Alignment Factor No. 3, they may also inhibit directors in their monitoring function of making

\textsuperscript{79} See discussion in SOX Summary Table in Appendix C2 and US Governance Code Table 6.4.2 in section 6.4.2 of chapter 6.
\textsuperscript{80} Ibid.
\textsuperscript{81} For a detailed discussion of director and executive compensation, see the articles by Professor Hill, Professor Bebchuk and others in the footnotes of section 10.1 of chapter 10 and the references in Appendix E1. See also, Technical Committee Of The International Organization Of Securities Commissions (OICV-IOSCO), Board Independence Of Listed Companies, Final Report, March 2007, p. 26, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD238.pdf (accessed 03/02/09).
\textsuperscript{82} Jensen and Meckling, above n 70, 5.
\textsuperscript{83} See discussion in section 5.2.3.2 of chapter 5.
\textsuperscript{85} Ibid, 22.
\textsuperscript{86} Ibid, 23-24.
necessary enquiries of management due to “ambivalence about uncovering embarrassing facts that will reduce the share price”. Bratton suggests that the form of executive compensation in the Enron collapse – the granting of share options – contributed to the behaviour which resulted in earnings manipulation:

[o]ption holding dulls the actor’s sensitivity to degrees of distress on the downside, and at the same time gives the actor an incentive to generate chances for upside gains of high magnitude. Thus directed, a group of managers certainly would be more disposed to high risk strategies.

The Comparative Corporate Governance Codes Key Field No. 3 also demonstrates the importance of the Compensation Factor No. 4. Many of the Governance Codes in this Field were developed in response to the Enron and other collapses. Not surprisingly, chapter 6 identifies “employee/management/director incentive and participation schemes” as a core feature of global/cross-border and national (US, UK and Australian) corporate Governance Codes. In addition, the “timely disclosure of material information including remuneration policies” is also identified as a core Governance Code feature in that chapter.

Finally, compensation and incentives of board members, CEOs and management figure prominently in Part 4 of the Empirical Studies Key Field No. 4. These empirical studies are analysed in the entirety of chapter 10 which includes:

• approaches to the governance of compensation;
• the maintenance of director independence;
• compensation and the level/quality of monitoring and firm value and operating performance;
• remuneration in the form of equity holdings and share options; and
• say-on-pay shareholder voting.

2.6.5 Monitoring & Audit Factor No. 5: Internal and External/Audit Monitoring Quality

Internal and external audit monitoring quality is a wide concept in the relational approach. As its terms indicate, it includes, on the one hand, notions of internal audit and, on the other hand, third-party 'independent' audit. But the Monitoring & Audit Factor No. 5 is not limited to internal

---

90 See discussion in section 6.1.3.2 of chapter 6.
91 See discussion in section 6.8.1 of chapter 6.
92 See discussion in section 10.1.2 of chapter 10.
93 See discussion in section 10.2 of chapter 10.
94 See discussion in section 10.2.4 of chapter 10.
95 See discussion in section 10.2.3.1 of chapter 10.
and external audit. Its terms deliberately extend to consider matters including financial and
other internal controls, risk assessment, reporting and management procedures, governance
and ethical codes of conduct or guidelines (as control devices). Critically, the Monitoring &
Audit Factor No. 5 extends to the nature, operation and quality (strength) of the board and
management’s inquiry, supervisory and monitoring duties. And this in turn extends to all
aspects of the firm’s financial, operational and governance activities and obligations.

The Monitoring & Audit Factor No. 5 is a significant theme emerging from all four Key Fields as
set out in the following Table 2.6.5:
## Table 2.6.5: Monitoring & Audit Factor No. 5

<table>
<thead>
<tr>
<th>No.</th>
<th>Source of Theme, Consideration or Factor</th>
<th>Description</th>
<th>Section</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><strong>Key Field No. 1: Application of Principal Theories of the Firm to the Relational Approach</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.</td>
<td>• Agency theory</td>
<td>• Agency costs of the principal-agent relationship include <strong>monitoring costs</strong> on behalf of the shareholder (Jensen and Meckling(^98)) which are &quot;designed to limit the aberrant activities of the agent&quot; (Jensen and Meckling(^99))</td>
<td>4.2.3 – 4.2.3.2</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Effective decision-making structure which reduces agency costs divides decision “initiation” and “implementation” (“decision management”) from “ratification” and “monitoring” (“decision control”)(^100) the latter function being undertaken of behalf of the shareholders by a board of directors (Fama and Jensen(^101))</td>
<td>4.2.3.2</td>
</tr>
<tr>
<td></td>
<td><strong>Key Field No. 2 – Autopsies of the Enron and Hastie Corporate Collapses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.</td>
<td>• Audit failure by the auditing firm of Arthur Andersen.</td>
<td>• Coffee considers the Enron collapse to be, primarily, a failure of the relevant auditors(^102)</td>
<td>5.2.4.1-5.2.4.2</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• End of one of the world’s largest and most reputable accounting firms, Arthur Andersen (Barrett)(^103)</td>
<td></td>
</tr>
<tr>
<td>2.</td>
<td>• Non-audit services of the audit firm</td>
<td>• Chapter 5 examines the effect of non-audit services on the quality of monitoring</td>
<td>5.2.4.2</td>
</tr>
<tr>
<td></td>
<td><strong>Key Field No. 3 – Comparative Corporate Governance Codes</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.</td>
<td>• International/cross-border and national (US, UK and Australian)</td>
<td>• External and independent audit is a core feature of practically every modern</td>
<td>6.8.1</td>
</tr>
</tbody>
</table>

---

98 Jensen and Meckling, above n 70, 5-6.
99 Ibid, 5 (emphasis in original).
100 Fama and Jensen, above n 68, 4-5 and 9.
101 Ibid, 14 and 16.
<table>
<thead>
<tr>
<th>Governance Codes</th>
<th>international/cross-border and national (US, UK and Australian) corporate Governance Code104</th>
<th>SOX Summary Table Appendix C2</th>
</tr>
</thead>
<tbody>
<tr>
<td>• US’ SOX105 reforms and, flowing from this, the NYSE Final Rules106 both devote considerable attention to the external audit.107</td>
<td>US Governance Code Table 6.4.2</td>
<td>US Governance Code Table 6.4.2</td>
</tr>
<tr>
<td></td>
<td>NYSE Summary Table Appendix C4</td>
<td>NYSE Summary Table Appendix C4</td>
</tr>
</tbody>
</table>

**Key Field No. 4: Empirical Studies of the Effectiveness of Governance Variables**

1. • Independent audit function  
   • Independence or freedom from influence of the third-party auditor is a continuing theme in governance study and discourse.108  
   | 9.2.3.1-3 |

2. • Independence of directors or the proportion of independent directors  
   • Studies examine whether increased independence enhances monitoring quality and, in turn, firm profitability and firm value  
   | 7.3.2.1- 7.3.2.1.7 |

3. • Proportion of insider/management equity ownership  
   • Board skills ‘mix’  
   • Board size  
   • Outside board positions of independent directors  
   • Anti-takeover mechanisms  
   • The market for corporate control  
   • Presence, independence (proportion), time and financial expertise of the audit sub-committee  
   • Empirical studies examine whether these variables enhance monitoring quality and decision-making and, in turn, firm profitability and firm value  
   | 7.3.2.1.5  7.3.1.2- 7.3.1.2.1  8.2.1 – 8.2.2  8.2.3  8.3  8.3.1  9.2.1 – 9.2.2 |

---

104 See discussion in section 6.8.1 of chapter 6.
105 See above n 53.
106 See above n 23.
107 See SOX, above n 53, Title II - Auditor Independence, sections 201-209 and NYSE Final Rules, above n 23, sections 303A.06 (Audit Committee) and 303A.07 (Audit Committee Additional Requirements).
The Interrelationship between the Monitoring & Audit Factor No. 5 and the Reporting Factor No. 1

Significantly, the interrelationship between the Monitoring & Audit Factor No. 5 and the Reporting Factor No. 1 is reflexive. In other words, these two Factors inform or affect each other in a continuous cycle. Thus, in practical terms of the weighing process of the relational approach, Governance Variables which affect one of these Factors will be very likely to affect the other. Other reflexive relationships in the Shareholder Primacy Interrelationship Scheme Figure 2.7.2A include the following. These involve, in particular, the Decision-making Factor No. 7:

- Responsibility Factor No. 8 and Decision-making Factor No. 7;
- Monitoring & Audit Factor No. 5 and Decision-making Factor No. 7;
- Alignment Factor No. 3 and Decision-making Factor No. 7; and
- Compensation Factor No. 4 and Decision-making Factor No. 7

Thus, the themes encapsulated in the Monitoring & Audit Factor No. 5 are drawn from all four Key Fields and this is reflected in elements of the Objectives Axis 1(b) (Performance Assessment and Reporting and Value Preservation) and the Behaviours Axis 2(b) (Risk Management, Control, Accountability and Responsibility) of the Three Relational Axes of Good Governance.

2.6.6 Stakeholders Factor No. 6: Identification, Participation and Protection of Stakeholder Interests

The themes encapsulated in the Stakeholders Factor No. 6 are the ‘other side of the coin’ to those of the Alignment Factor No. 3 - Alignment of Management and Shareholder Interests. The Stakeholders Factor No. 6 is among the most rapidly expanding areas of new-millennium and current governance discourse.109

The following Table 2.6.6 sets out the principal considerations and real world examples which illustrate the significance of the Stakeholders Factor No. 6. These considerations are drawn principally from Key Field No. 1 (Application of Principal Theories of the Firm to the Relational Approach) and Key Field No. 3 (Comparative Corporate Governance Codes).

---

109 See discussion in sections 4.4 – 4.4.2.3 of chapter 4.
Table 2.6.6: Stakeholders Factor No. 6

<table>
<thead>
<tr>
<th>No.</th>
<th>Source of Theme, Consideration or Factor</th>
<th>Description</th>
<th>Section</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Key Field No. 1 – Application of Principal Theories of the Firm to the Relational Approach</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.</td>
<td>• Tensions between the principal and rival models – the shareholder primacy model vis-à-vis the stakeholder model.(^{110})</td>
<td>• Perceived shortcomings in the shareholder model form the basis of the stakeholder model.(^{112})</td>
<td>4.4.1</td>
</tr>
<tr>
<td></td>
<td>• Stakeholder model requires &quot;that managers should make decisions that take account of the interests of all the stakeholders in a firm&quot; (Jensen)(^{111})</td>
<td>• Licht explains that the shareholder model’s assumption of a single residual claimant (i.e., the shareholder) is flawed and ‘unrealistic’(^{113})</td>
<td>4.4.1</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Satisfying a wide range of stakeholder needs is argued to be necessary to enhance the long-term survival or sustainability of the for-profit corporation(^{114})</td>
<td>4.4.1.1</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Relationships with stakeholders are ‘intangible assets’ of the firm which are beyond the firm’s ‘direct control’(^{115}) and preservation of these intangible assets is dependent on addressing and satisfying such stakeholder interests (Capasso)(^{116})</td>
<td>4.4.1.1</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Key Field No. 3 – Comparative Corporate Governance Codes</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.</td>
<td>• OECD Principles(^{117})</td>
<td>• These devote an entire Principle to the factor of Stakeholder Participation.(^{118})</td>
<td>6.2.2</td>
</tr>
</tbody>
</table>

\(^{110}\) Ibid.
\(^{114}\) See discussion in section 4.5.1.2 of chapter 4.
\(^{116}\) Ibid, 9.
\(^{117}\) OECD Principles, above n 14.
\(^{118}\) Ibid, Principle IV, p. 21.
2. • Principle 3 of the ASX 2003 Best Practice Recommendations\textsuperscript{119} was amended in the ASX 2007-10 Revised Principles\textsuperscript{120} • Principle 3 was amended in the ASX 2007-10 Revised Principles to provide for acknowledgement of stakeholder interests.\textsuperscript{121} • This writer argues that the ASX 2007-10 Revised Principles now constitute a composite shareholder-stakeholder governance model. 4.4.1.3 and 6.6.1

3. • Australian Government’s Corporations and Markets Advisory Committee (“CAMAC”) Report issued in December 2006 entitled \textit{The Social Responsibility of Corporations}\textsuperscript{122} • Aspects of the Report examine the relevance of stakeholder interests in enhancing the long-term efficiency and survival/sustainability of the for-profit corporation. 4.4.1.1

\textbf{Key Field No. 4 – Empirical Studies of the Effectiveness of Governance Variables}

| 1. | National regime and firm-specific governance variable empirical studies | Growing number of studies on influence of stakeholder interests\textsuperscript{123} |

Thus, the Stakeholders Factor No. 6 is significant in terms of the theoretical underpinnings of the relational approach. This finds traction in the Three Relational Axes of Good Governance, in particular, Positional Conflict Axis No 3.\textsuperscript{124} The underlying tension in the Positional Conflict Axes 3(a) and 3(b) is a weighing of the interests of internal and external stakeholders.

\textbf{2.6.7 Decision-making Factor No. 7: Quality of Board, CEO and Management Decision-making}

The Decision-making Factor No. 7 is a fundamental theme both underpinning and arising from Key Field No. 1 (\textit{Application of the Theories of the Firm to the Relational Approach}) and, indeed, the nature of the for-profit corporation.\textsuperscript{125} This is depicted in the following Table 2.6.7.

As a real world example, Table 2.6.7 also demonstrates the extensive variety of factors which commentators in the autopsies of the Enron and Hastie corporate collapses (\textit{Key Field No. 2})

\textsuperscript{119} ASX 2003 Best Practice Recommendations, above n 15.
\textsuperscript{120} ASX 2007-10 Revised Principles, above n 15.
\textsuperscript{121} Ibid, Revised Principle 3, p 22.
\textsuperscript{124} See discussion in section 2.3.1 – 2.3.3 of this chapter 2.
\textsuperscript{125} For a detailed discussion, see the papers relating to the nexus of contracts theory and the anti-contractarian views of the firm from the symposium on contractual freedom in corporate law held on 9 and 10 December 1988 at Columbia Law School published at (1989) 89 \textit{Colum L Rev} 1395.
have examined in relation to the (diminished) quality of decision-making which contributed to those collapses. These are examined in detail in chapter 5.

Table 2.6.7: Decision-Making Factor No. 7

<table>
<thead>
<tr>
<th>No.</th>
<th>Source of Theme, Consideration or Factor</th>
<th>Description</th>
<th>Section</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Key feature of the dispersed shareholding public company¹²⁶</td>
<td>• Separation of ownership from management of the firm (Fama and Jensen)¹²⁷</td>
<td>1.2.2</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Agency relationship between inside managers who act on behalf of outside shareholders giving rise to agency costs (Jensen and Meckling).¹²⁸</td>
<td>1.2.2</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Shareholders (the owners) cannot interfere in the day-to-day decision-making of the company which is vested in the board of directors and management (Bainbridge).¹²⁹</td>
<td>1.2.2</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Effective decision-making structure which reduces agency costs divides decision “initiation” and “implementation” (“decision management”) from “ratification” and “monitoring” (“decision control”)¹³⁰ the latter function being undertaken on behalf of the shareholders by a board of directors (Fama and Jensen¹³¹)</td>
<td>4.2.3.2</td>
</tr>
</tbody>
</table>

¹²⁶ Ibid.
¹²⁷ Fama and Jensen, above n 68.
¹²⁸ Jensen and Meckling, above n 70, 5-6.
### Key Field No. 2 – Autopsies of the Enron and Hastie Corporate Collapses

| 1. | • Director independence  |
|    | • Share and option holdings  |
|    | • Board member familiarity and deference  |
|    | • The independence of committees  |
|    | • Risk management and the (in)adequacy of reports  |
|    | • The effects on risk management of the risk-taking culture at Enron  |
| 2. | Poor management and monitoring of Hastie acquisitions  |

Commentators examine whether these variables enhance or reduce the quality of decision-making in the Enron collapse thus contributing to Enron's failure.

Administrators concluded that the acquisition strategy resulted in a number of effects including:
- inaccurate and inadequate financial reporting and consequently poor decision-making by the Board.  

### Key Field No. 3: Comparative Corporate Governance Codes

| 1. | • Section 198A of the Corporations Act.  |
|    | • Reinforces decision-making division between shareholders (owners) and directors (controllers)  |


130 Fama and Jensen, above n 68, 4-5 and 9.  
131 Ibid, 14 and 16.  
133 See, for example in Australia, Corporations Act 2001 (Cth), s 198A (Replaceable Rule):

1. The business of a company is to be managed by or under the direction of the directors.  
2. The directors may exercise all the powers of the company except any powers that this Act or the company's constitution (if any) requires the company to exercise in general meeting.

In practical terms, the Decision-making Factor No. 7 is closely aligned to the Monitoring & Audit Factor No. 5. In other words, these themes should normatively inform and shape each other. Thus, in real world terms, as the monitoring process within the corporation identifies that some action is required, so then is the decision-making process engaged. In turn, decision-making action should again normatively engage the monitoring and evaluation/assessment functions in a continuous cycle.

### 2.6.8 Responsibility Factor No. 8: Delineation and Disclosure of Powers, Duties and Lines of Responsibility

The Responsibility Factor No. 8 is represented in the Three Relational Axes of Good Governance. It provides the legal, constitutional (in the company law sense) and organisational/operational authority for the actions of individuals within, and organs (such as the board and subcommittees) of, the corporation. The themes encapsulated in the Responsibility Factor No. 8 are critical to the effectiveness and efficiency of many of the other Governance Factors – in particular, the Decision-making Factor No. 7, the Monitoring & Audit Factor No. 5 and, through the interrelationships discussed above in relation to both those Factors, the Reporting Factor No. 1.

---

134 ASX 2007-10 Revised Principles, above n 15.
135 Ibid, Revised Principle 3.
For example, to operate effectively, the decision-making powers and responsibilities within
different organs of the company - such as the board and subcommittees - and different levels
of management or individual office-holders must be delineated (constitutionally or otherwise).
Thus, in practice, the Decision-making Factor No. 7 is closely aligned with the Responsibility
Factor No. 8 and these Factors inform each other reflexively. Equally, the delineation and
disclosure of particular powers, duties and lines of responsibility are integral to the
effectiveness of any monitoring system within the corporation. Therefore, the Responsibility
Factor No. 8 is an important element of the Monitoring & Audit Factor No. 5. Support for this
argument is provided by a conceptual analysis of ‘accountability’ in multi-level governance in
the public and democratic sphere by Bovens.136 Bovens defines ‘accountability’ in terms also
relevant to the corporate context:

[a]ccountability is a relationship between an actor and a forum, in which the actor has an obligation to
explain and to justify his or her conduct, the forum can pose questions and pass judgement, and the
actor may face consequences.137

Bovens’ concept is important to the weighing process contemplated by the Three Relational
Axes of Good Governance. That is, that there is an ‘actor’ who has an ‘obligation’. Without
the ability to effectively attribute an ‘obligation’ (or alternatively in terms of the Behaviours Axis
2(b), ‘responsibility’) for a particular duty, power or function to an actor (whether, for example,
individual officeholder, executive, key-position employee, board or sub-committee), there is no
accountability or responsibility. Thus, for example, if there is no accountability or
responsibility, the Decision-making Factor No. 7 and the Monitoring & Audit Factor No. 5 and,
in turn, the Reporting Factor No. 1 would be critically undermined.

Thus, on the basis of this analysis, the Responsibility Factor No. 8’s interrelationships with the
Decision-making Factor No. 7 and Monitoring & Audit Factor No. 5 and, again in turn, the
Reporting Factor No. 1 are represented in the following Figure 2.6.8:

137 Ibid, 450 (emphasis in original).
Other theoretical considerations and real world examples in the adoption of the Responsibility Factor No. 8 are set out in the following Table 2.6.8. Of particular relevance is the importance of the Responsibility Factor No. 8 in Key Field No. 1 (*Application of the Principal Theories of the Firm to the Relational Approach*). In theoretical terms, the Responsibility Factor No. 8 is closely aligned with agency (costs) theory.

In practical terms, Table 2.6.8 also demonstrates the importance of the Responsibility Factor No. 8 in real world international and national Governance Codes comprising the Comparative Corporate Governance Codes Key Field No. 3.
<table>
<thead>
<tr>
<th>No.</th>
<th>Source of Theme, Consideration or Factor</th>
<th>Description</th>
<th>Section</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Key Field No. 1: Application of the Principal Theories of the Firm to the Relational Approach</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| 1. | • Separation of widely-dispersed shareholders from management of the corporation | • An effective decision-making structure to reduce agency costs typically divides decision ‘initiation’ and ‘implementation’ (‘decision management’) from ‘ratification’ and ‘monitoring’ (‘decision control’) (Fama and Jensen)\(^{138}\)  
• Latter function is undertaken on behalf of shareholders by a board of directors (Fama and Jensen)\(^{139}\) | 4.2.3.2 |
| **Key Field No. 2: Autopsies of the Enron and Hastie Corporate Collapses** | | | |
| 1. | • Attendance of the Chairman and separate CEO at Enron committees including ‘executive’, ‘finance’ and ‘audit’ | • Undermining of Enron board’s monitoring function (Gillan and Martin)\(^{140}\) | 5.2.2.2 |
| **Key Field No. 3: Comparative Corporate Governance Codes** | | | |
| 1. | • International (OECD, ICGN and CACG) and National (US, UK, and Australian) Governance Codes | • Core feature is that “responsibilities of board sub-committees [be] delineated and disclosed”. | 6.8.1 |
| 2. | • SOX reforms relating to directors and management and earnings manipulation\(^{141}\) including:  
  o Section 301 | • Enhances lines of responsibility in relation to auditor appointment, compensation and oversight\(^{142}\) and conduct of the audit\(^{143}\) | SOX Summary Table Appendix C2 |

\(^{140}\) Gillan and Martin, above n 84, 25.  
\(^{141}\) See discussion in section 6.4.2 of chapter 6.  
\(^{142}\) See discussion in SOX Summary Table of Appendix C2 – No 1, SOX Audit Sub-Committee and Financial Experts.  
\(^{143}\) Ibid
• Section 302
  • Delineates responsibility in relation to the certification of annual and quarterly reports by the CEO and CFO. 144

• Section 304
  • Enhances lines of responsibility by requiring that the CEO or CFO reimburse the company for bonuses, incentive payments and trading profits on an accounting restatement. 145

• Section 404
  • Enhances lines of responsibility by requiring that an internal control report be included in the company’s annual report including management’s responsibility for the establishment and maintenance of internal controls and management assessment of the effectiveness of these controls. 146

Key Field No. 4 – Empirical Studies of the Effectiveness of Governance Variables

1. • Division in CEO and Chairperson roles
  • Available studies find no significant effect on firm value in dividing these roles (Weir, Laing and McKnight) 147 and (Larcker, Ormazabal and Taylor) 148
  • Dividing these roles “is significantly positively correlated with better contemporaneous and subsequent operating performance” (Bhagat and Bolton) 149

Thus, the Responsibility Factor No. 8 is a recurring theme as it is integral to the effective operation of other Governance Factors - in particular, the Decision-making Factor No. 7, the Monitoring & Audit Factor No. 5 and the Reporting Factor No. 1.

144 See discussion in SOX Summary Table of Appendix C2 – No 2, SOX Reporting I – Responsibility for Accuracy of Financial Reports.
145 Ibid.
146 See discussion in SOX Summary Table of Appendix C2 – No 4, SOX Earning Manipulation I – Internal Controls and Finance Code of Ethics.
2.7 **Interrelationships between Governance Factors – The Interrelationship Schemes**

2.7.1 **The Two Interrelationship Schemes**

The Interrelationship Schemes are a synthesis of the individual interrelationships examined in the preceding sections 2.6.1 – 2.6.8 of this chapter. In practical terms, the Interrelationship Schemes are a diagrammatic representation of possible or hypothesised interrelationships identified between the eight Governance Factors. Again, there are two Interrelationship Schemes – one based on the shareholder primacy model and one based on the stakeholder model of corporate governance.

**Shareholder Primacy Interrelationship Scheme**

The tensions between the shareholder primacy principle and the stakeholder model are reflected in the Alignment Factor No. 3 and the Stakeholders Factor No. 6. Indeed, as explained in section 2.6.3, the Alignment Factor No. 3 is an ‘umbrella’ or ‘guiding’ principle over all other Governance Factors – except the Compliance Factor No. 2. In such a case, the Interrelationship Scheme represents the shareholder primacy model as reflected by the Alignment Factor No.’s ‘guiding principle’ role.

**Stakeholder Interrelationship Scheme**

Where, by contrast, the Interrelationship Scheme is to reflect the stakeholder model, then the reverse will be the case. The Stakeholders Factor No. 6 will then constitute the ‘umbrella’ or ‘guiding principle’ in the design and implementation of Governance Variables over the other Governance Factors. This is again with the exception of the Compliance Factor No. 2 and, this time, the Alignment Factor No. 3 so that ‘other’ stakeholder interests do not necessarily rank over those of the shareholder-stakeholders.

2.7.2 **The Direction of the ‘Effect’ in the Interrelationship Schemes**

An arrow connecting two (or more) Governance Factors in Figures 2.7.2A and 2.7.2B below depict an hypothesised interrelationship between the relevant Governance Factors. In practical terms, this represents a hypothesis that one Governance Factor affects another Governance Factor in the direction of the arrow. A ‘two-way’ arrow hypothesises that the relevant Governance Factors affect each other. Again, such an interrelationship is described as reflexive.

---

150 See discussion in section 2.6.3 of this chapter 2. See also, Gerard J Charreaux, "Corporate Governance Theories: From Micro Theories to National Systems Theories", (January 2004), Universite de Bourgogne Fargo Working Paper No. 1040101, available at SSRN: http://ssrn.com/abstract=486522, 6 (emphasis added), who explains that governance structures and mechanisms have a ‘disciplinary perspective’ – again, in terms of the shareholder model - which:

...constitute a means of forcing the managers to “maximize” the shareholder value. This perspective has particularly dominated the studies relating to the board of directors, the annual shareholder’s meeting, the remuneration systems for managers, the legal and accounting regulations and takeovers as well.
It is significant to note that the arrows in the Interrelationship Schemes do not mean that, once a hypothesised effect on a particular Governance Factor by a particular Governance Variable is identified, all the other Governance Factors linked to that first Factor will automatically be affected. The hypothesised effect on each particular Governance Factor by a Governance Variable must be identified, determined and evaluated separately. The Interrelationship Schemes in Figures 2.7.2A and 2.7.2B merely represent possible effects that may conceivably arise. In other words, the Interrelationship Schemes represent possible pathways that must be considered or investigated in the determination or evaluation of whether a Governance Factor is affected.

This is for two principal reasons. First, consistent with reality, it is not possible – in isolation - to determine the Governance Factor ‘first’ affected by a particular Governance Variable. Take, for example, the Board skills ‘mix’ variable – [BrdSkills] (+).151 The [BrdSkills] (+) variable’s relational effect path is positive (+) and is presented as beginning with the Monitoring & Audit Factor No. 5 and the Decision-making Factor No. 7. Each of these Governance Factors has a reflexive relationship with the other.152 Here, it is not possible to identify which Governance Factor is affected first. But the relational effect path of the [BrdSkills] (+) variable could equally begin with the reflexive relationship between:

- the Reporting Factor No. 1 and the Monitoring & Audit Factor No. 5;
- the Monitoring & Audit Factor No. 5 and the Responsibilities Factor No. 8;
- the Compensation Factor No. 4 and the Decision-making Factor No. 7;
- the Alignment Factor No. 3 and the Decision-making Factor No. 7; or
- the Responsibilities Factor No. 8 and the Decision-making Factor No. 7.

Equally, the relational effect path for the [BrdSkills] (+) variable could begin with one or more of the single-direction relationships. And a particular Governance Variable may affect Governance Factors simultaneously, sequentially or in some combination of the two.

Secondly, while a particular Governance Variable may impact a particular Governance Factor significantly, the flow-on or ‘ripple-effect’153 of that Governance Variable may not be of the same order, magnitude or direction (positive or negative).

Thus, in the identification of the ‘start’ of a relational effect path for a Governance Variable, the thesis will begin with the Governance Factor(s) and direction of effect identified by the relevant empirical studies relating to that Governance Variable. Continuing with the [BrdSkills] (+) variable, the studies link the director skills mix most directly with the monitoring function (raising the Monitoring & Audit Factor No. 5) and the quality of decision making (raising the Decision-making Factor No. 7). The direction of effect is positive as the relevant empirical studies link the [BrdSkills] (+) variable with the enhancement of both those Governance Factors.

151 Board – Director Skills ‘Mix’ - see discussion in section 7.3.1.2.1 of chapter 7.
152 See Figure 7.3.1.2.1B of chapter 7.
153 This term is taken from the term used by Professor Jane Stapleton to describe the flow-on effects of negligently inflicted ‘pure’ economic loss in the tort of negligence. See Jane Stapleton, “Duty of Care and Economic Loss: A Wider Agenda” (1991) 107 Law Quarterly Review 249, 255.
Then, the Interrelationship Schemes are used in chapters 7 – 10 to construct the remaining portion of the relational effect path showing the identity, number and direction of Governance Factors affected by each Governance Variable. A relational effect path represents an hypothesised interrelationship between a Governance Variable and one or more Governance Factors and, thus in turn, other Governance Variables.

The Shareholder Primacy Interrelationship Scheme - based on the pre-eminent theory of corporate law - is therefore tabbed for the convenience of the reader for on-going reference throughout the thesis.
Figure 2.7.2A: Shareholder Primacy Interrelationship Scheme

Compliance Factor No. 2: Corporate Governance and Legal Compliance

Alignment Factor No. 3: Alignment of Management and Shareholder Interests

Stakeholders Factor No. 6: Identification, Participation and Protection of Stakeholder Interests

Compensation Factor No. 4: Board, CEO and Management Compensation and Incentives

Reporting Factor No. 1: Transparency, Timing and Integrity of Financial and Other Reports

Monitoring & Audit Factor No. 5: Internal and External/Audit Monitoring Quality

Responsibility Factor No. 8: Delineation and Disclosure of Powers, Duties and Lines of Responsibility

Decision-Making Factor No. 7: Quality of Board, CEO and Management Decision-making

Alignment Factor No. 3: Alignment of Management and Shareholder Interests

Stakeholders Factor No. 6: Identification, Participation and Protection of Stakeholder Interests
Reporting Factor No. 1: Transparency, Timing and Integrity of Financial and Other Reports

Monitoring & Audit Factor No. 5: Internal and External/Audit Monitoring Quality

Responsibility Factor No. 8: Delineation and Disclosure of Powers, Duties and Lines of Responsibility

Decision-Making Factor No. 7: Quality of Board, CEO and Management Decision-making

Alignment Factor No. 3: Alignment of Management and Shareholder Interests

Compensation Factor No. 4: Board, CEO and Management Compensation and Incentives

Stakeholders Factor No. 6: Identification, Participation and Protection of Stakeholder Interests

Compliance Factor No. 2: Corporate Governance and Legal Compliance

Figure 2.7.2B: Stakeholder Model Interrelationship Scheme
2.8 Conclusion - The Relational Corporate Governance Framework

The Relational Corporate Governance Framework of the approach in this thesis is depicted in the following Figure 2.8. The Framework brings together all the theoretical components introduced in chapters 1 and 2. As shown in the diagram, all the components of the relational approach are ultimately drawn from the four Key Fields that form the base of the pyramid-like structure of the Framework.

In the next chapter, the thesis presents the Governance Variables in practice – the results of the empirical studies of the effectiveness of Governance Variables comprising Key Field No. 4. These studies are used to construct a relational effect path for each Governance Variable in chapters 7 – 10. Each relational effect path is summarised in the Coverage Table 3.3.1. In the Relational Proximity Table 3.3.2.1, this ‘Coverage’ is converted to a measure of the relative importance of each Governance Variable in affecting agency costs and the long-term efficiency and survival of the firm. These operational results tables are presented in chapter 3.
Figure 2.8: The Relational Corporate Governance Framework

Macro-Economic Benefits (section 2.2)

Long-Term Firm Efficiency, Survival and Sustainability (sections 1.5 and 2.2)

Firm-Specific Aims/Benefits of Corporate Governance (section 2.2)

(Reducing) Firm Cost of Capital

(Increasing) Firm Value and Operating Performance

Stakeholder Interest Identification, Participation and Protection

Three Relational Axes of Good Governance (Figures 2.3.2A and 2.3.2B and sections 2.3.1 – 2.3.3)

Objectives Axis No. 1

1(a). Profit Maximisation and Value Enhancement

1(b). Performance Assessment and Reporting and Value Preservation

Behaviours Axis No. 2

2(a). Entrepreneurism, Innovation and Risk-Taking

2(b). Risk Management, Control, Accountability and Responsibility

Positional Conflict Axis No. 3

3(a). Internal Stakeholders – Board, CEO, M’ment

3(b). External Stakeholders – Shareholders, Employees, Lenders, Suppliers, Government and Social Interests
Interrelationship Schemes (2) (Figures 2.7.2A and 2.7.2B)

Governance Factors (8) (section 1.7.1 and sections 2.6.1 – 2.6.8)

1. Reporting: Transparency, Timing and Integrity of Financial and Other Reports
2. Compliance: Corporate Governance and Legal Compliance
3. Alignment: Alignment of Board, CEO, Management and Shareholder Interests
4. Compensation: Board, CEO and Management Compensation and Incentives
5. Monitoring & Audit: Internal and External (Audit) Monitoring Quality
6. Stakeholders: Identification, Participation and Protection of Stakeholder Interests
7. Decision-making: Quality of Board, CEO and Management Decision-making

Individual Governance Variables (39) (Table 2.4)

Key Fields (4) (section 1.7.1)

1. Application of Firm Theories to Relational Approach (Ch 4)
2. Autopsies of the Enron and Hastie Corporate Collapses (Ch 5)
3. Comparative Corporate Governance Codes (Ch 6)
4. Empirical Studies of the Effectiveness of Governance Variables: (Chs 7 – 19)

Neoclassical Model
Agency Costs
Nexus of Contracts
Shareholder Primacy
Director Primacy
Stakeholder Model
Corporate Social Responsibility (CSR)

Strength of National Regime Studies (Ch 7)
Grouped Variables or ‘Overall’ Governance (Ch 7)
Individual Governance Variable Studies (Chs 7 – 10)

Globalisation Factors: Harmonisation/Convergence (s. 6.1.3.5)
International (s. 6.2)
United States (s. 6.4)
UK (s. 6.5)
Australia (s. 6.6)
CHAPTER 3:
GOVERNANCE VARIABLES IN PRACTICE

3.1 Purpose and Approach of Chapter Three

In the previous chapter, the thesis presented the principal components of the relational approach. These included the Three Relational Axes of Good Governance which is the theoretical weighing mechanism which weights the objectives, behaviours and positional conflict of insiders versus outsiders. The eight Governance Factors are the recurring themes and tensions underpinning the four Key Fields and represent the objects, purposes and ends of ‘good governance’. Finally, the Shareholder Primacy Interrelationship Scheme – on account of its pre-eminence in corporate law - is used to construct a relational effect path for each Governance Variable.

This chapter presents the results of the empirical studies of the effectiveness of Governance Variables comprising Key Field No. 4 and examined in chapters 7 - 10 of the thesis. Those chapters combine the results of these empirical studies with the Shareholder Primacy Interrelationship Scheme to present a relational effect path for each Governance Variable. This path depicts the identity and number of the Governance Factors affected by a Governance Variable and the direction of the effect. Similarly, the results Tables in this chapter are also presented in advance of the other Key Fields:

- No. 1: Application of the Principal Theories of the Firm to the Relational Approach (chapter 4);
- No. 2: Autopsies of the Enron and Hastie Corporate Collapses (chapter 5); and
- No. 3: Comparative Corporate Governance Codes (chapter 6).

The approach is to present the results of the 39 relational effect paths at this initial stage of the thesis so that observations and examples relating to the relative importance of Governance Variables may be made and given context in advance of the analysis of the detailed studies comprising the four Key Fields. This is particularly in light of the fact that many Governance Variables will be examined in multiple Key Fields. For example, the monitoring effect of the director independence variable, \([\text{BrdIndMon}] (+)\)¹, is examined in three separate chapters.² The strength of the national shareholder protection regime, \([\text{NationGov}] (+)\)³, similarly appears in three chapters⁴ as does the \([\text{DirCEOS}] (+/-)\)⁵ variable.⁶ Thus, the results of the relational effect path for each Governance Variable are presented ahead of the Key Fields to add explanation and analysis to those Fields.

The results of the relational approach are contained in two operational Tables - the Coverage Table⁷ and, ultimately, the Relational Proximity Table.⁸ The aim of these Tables is to

---

¹ Board Independent Director: Executive Director Proportion – Monitoring Effect.
² See the section references noted in Table 2.4, Item 15, for the \([\text{BrdIndMon}] (+)\) variable.
³ National Governance/Shareholder Protection Regime.
⁴ See the section references noted in Table 2.4, Item 27, for the \([\text{NationGov}] (+)\) variable.
⁵ Director/CEO Compensation Levels.
⁶ See the section references noted in Table 2.4, Item 19, for the \([\text{DirCEOS}] (+/-)\) variable.
⁷ See the Coverage Table in section 3.3.1 of this chapter 3.
⁸ See the Relational Proximity Table in section 3.3.2.1 of this chapter 3.
present the results of the assessment of the relative importance or relational proximity of individual Governance Variables in reducing (or increasing) agency costs and enhancing (or reducing) the long-term efficiency and survival or sustainability of the for-profit firm in a transparent manner. Similarly visible is the thesis’ assessment of the interrelationships between individual Governance Factors and, in turn, the 39 Governance Variables in achieving these ends.

### 3.2 Operational Measures of the Relational Approach – Governance Factor ‘Coverage’ and ‘Relational Proximity Rating’

Generally speaking, the empirical studies of Governance Variables in chapters 7 – 10 have been conducted in a manner suitable to the means and ends of the particular authors. These studies are not generally configured in a manner directed to ascertaining the effect of those variables on all eight Governance Factors. In many cases, the effect of the variables in the studies is directed to only one or two themes within the Governance Factors - such as the quality of board monitoring, the quality of decision-making or the risk of earnings manipulation. Indeed, even when these studies are directed to particular Governance Factors, there are often conflicting or statistically insignificant results. So the starting points for the 39 relational effect paths are the empirical studies presented in chapters 7 – 10. And the interrelationships between Governance Variables and Governance Factors beyond the bounds of the particular studies are hypothesised relationships.

The way in which these hypothesised relationships are constructed was explained in Figure 2.1 in chapter 2. In short, the interrelationships between the Governance Factors are already calculated and presented for the reader - these are the two Interrelationship Schemes in Figures 2.7.2A and 2.7.2B. The pre-eminence of the shareholder primacy model of corporate governance dictates that the Shareholder Primacy Interrelationship Scheme in Figure 2.7.2A be used to construct the relational effect paths. The Interrelationship Scheme sets out the way in which Governance Factors are linked to one or more other Governance Factors. The Interrelationship Scheme ‘start’ point is nominated by the thesis. This is a Factor suggested by the empirical study relating to the effectiveness of the relevant Governance Variable in chapters 7 – 10. This empirical study also suggests the direction of the effect (+/-) on the Governance Factors. Thus, a relational effect path for each Governance Variable depicts the identity and number of the Governance Factors affected by a Governance Variable and the direction of the effect.

The hypothesised effect of a Governance Variable on a Governance Factor set out in a relational effect path is known as Governance Factor ‘Coverage’. In other words, this Coverage is represented diagrammatically in the relational effect path of a Governance Variable. As the name suggests, this path is summarised and displayed in the Coverage Table 3.3.1.

---

9 See discussion in section 2.7.2 of chapter 2.  
10 Ibid.  
11 Thus the foundation of the hypotheses is the detailed Shareholder Primacy Interrelationship Scheme presented in Figure 2.7.2A and the individual interrelationships represented in that Interrelationship Scheme and examined in sections 2.6.1 – 2.6.8 of chapter 2. Using that Interrelationship Scheme, a relational effect path is presented in chapters 7 – 10 for each Governance Variable depicting a hypothesised interrelationship with relevant Governance Factors. It is that relational effect path that is summarised in the Coverage Table.
The Coverage of Governance Factors summarised in the Coverage Table is then converted into a measure of relative importance in affecting agency costs and firm sustainability. That measure is known as the relational proximity of a Governance Variable and is depicted on a scale from +/- 100.00 to 0.00 \( r_{prox} \) units in the Relational Proximity Table 3.3.2.1. The relational proximity of a Governance Variable is calculated by starting with the Coverage of Governance Factors (measured from +/- 1 up to +/- 8) produced by that Governance Variable and then dividing by the total number of Governance Factors (i.e., again 8). Finally, that resultant figure is expressed as a percentage by multiplying by 100. The ultimate Relational Proximity Table then groups the 39 Governance Variables in descending order of relational proximity in affecting agency costs and the long-term efficiency and sustainability of the firm.

3.3 The Hypothesised Coverage Effect on Governance Factors by Individual Governance Variables

3.3.1 The Coverage Table

The following Coverage Table 3.3.1 displays the Governance Factors affected (and the direction of that effect) by the operation of individual Governance Variables. In this way, the interrelationships between individual agency cost-reducing (or increasing) Governance Variables is depicted in table-form by identifying multiple Governance Factors hypothesised to be affected by a relevant Governance Variable.

Table 3.3.1: Coverage Table

<table>
<thead>
<tr>
<th>No.</th>
<th>Governance Variable (Table 2.4)</th>
<th>Relational Effect Path Reference</th>
<th>Direction of Effect (+) (+/-) (-)</th>
<th>Governance Factor (Sections 1.7.1 and 2.6.1 - 2.6.8)</th>
<th>Total Governance Factor Coverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>AudAccEarn 9.2.1.1.2</td>
<td>+</td>
<td>● ● ● ● ● ● ●</td>
<td>1 2 3 4 5 6 7 8</td>
<td>+6</td>
</tr>
<tr>
<td>2.</td>
<td>AudCom 8.4.2</td>
<td>+</td>
<td>● ● ● ● ● ● ●</td>
<td>1 2 3 4 5 6 7 8</td>
<td>+6</td>
</tr>
<tr>
<td>3.</td>
<td>AudExpAcc 8.4.4</td>
<td>+</td>
<td>● ● ● ● ● ● ●</td>
<td>1 2 3 4 5 6 7 8</td>
<td>+6</td>
</tr>
<tr>
<td>4.</td>
<td>AudFree 9.2.1.1.2</td>
<td>-</td>
<td>● ● ● ● ● ● ●</td>
<td>1 2 3 4 5 6 7 8</td>
<td>-6</td>
</tr>
<tr>
<td>5.</td>
<td>AudIndFreq 9.2.1</td>
<td>+</td>
<td>● ● ● ● ● ● ●</td>
<td>1 2 3 4 5 6 7 8</td>
<td>+7</td>
</tr>
<tr>
<td>6.</td>
<td>AudIndInfo 8.4.3</td>
<td>-</td>
<td>● ● ● ● ● ● ●</td>
<td>1 2 3 4 5 6 7 8</td>
<td>-4</td>
</tr>
<tr>
<td>7.</td>
<td>AudIndMon 8.4.3</td>
<td>+</td>
<td>● ● ● ● ● ● ●</td>
<td>1 2 3 4 5 6 7 8</td>
<td>+7</td>
</tr>
<tr>
<td>8.</td>
<td>AudShortOpts 10.2.5.1</td>
<td>-</td>
<td>● ● ● ● ● ● ●</td>
<td>1 2 3 4 5 6 7 8</td>
<td>-7</td>
</tr>
<tr>
<td></td>
<td>Description</td>
<td>Section</td>
<td>Change</td>
<td></td>
<td></td>
</tr>
<tr>
<td>---</td>
<td>--------------------</td>
<td>---------</td>
<td>--------</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>BlockCosts</td>
<td>8.5.1-2</td>
<td>-6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>BlockMon</td>
<td>8.5.1-2</td>
<td>+6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>BrdAttend</td>
<td>7.3.2.1.2</td>
<td>+7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>BrdCmEarn</td>
<td>9.2.2</td>
<td>+/-6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>BrdCmSize</td>
<td>8.2.2.2</td>
<td>+/-6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>BrdIndInfo</td>
<td>7.3.2.1.3</td>
<td>-4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>BrdIndMon</td>
<td>7.3.2.1.1-2</td>
<td>+7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>BrdReview</td>
<td>7.3.2.1.2</td>
<td>+7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>BrdSkills</td>
<td>7.3.1.2.1</td>
<td>+7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>CompCom</td>
<td>10.2.4.1</td>
<td>+/-7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>DirCEO$</td>
<td>10.2.4</td>
<td>+/-7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>DualDismiss</td>
<td>8.6.3</td>
<td>-7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>21</td>
<td>DualEarn</td>
<td>9.2.1.1.3</td>
<td>-7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>22</td>
<td>DualStrat</td>
<td>8.6.3</td>
<td>-4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>23</td>
<td>DualTrade</td>
<td>8.6.1-2</td>
<td>+/-7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>EqOptnIncent</td>
<td>10.2.4</td>
<td>+7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>25</td>
<td>EqOptEntrch</td>
<td>10.2.4</td>
<td>-7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>26</td>
<td>ExtAudEarn</td>
<td>9.2.3.3</td>
<td>+7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>27</td>
<td>NationGov</td>
<td>7.3.1.3.3</td>
<td>+8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>28</td>
<td>NomCom</td>
<td>7.3.1.2.2</td>
<td>+/-7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>29</td>
<td>NomInd</td>
<td>7.3.1.2.2</td>
<td>+7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>30</td>
<td>NonAuditS</td>
<td>9.2.3.2-3</td>
<td>-7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31</td>
<td>OtherATMs</td>
<td>8.3.1.1</td>
<td>-8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>32</td>
<td>OutBrdPos</td>
<td>8.2.3.1</td>
<td>-6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>33</td>
<td>OutBrdAdv</td>
<td>7.3.2.1.2</td>
<td>+7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>34</td>
<td>ReputDiscl</td>
<td>10.4.1</td>
<td>+8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>35</td>
<td>ReputRep</td>
<td>10.4.1</td>
<td>+8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>36</td>
<td>StagBrdElect</td>
<td>8.3.1.1</td>
<td>-8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>37</td>
<td>ShortTOpts</td>
<td>10.2.5.1</td>
<td>-7</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
3.3.1.1 **Operation of the Coverage Table**

A dot marking (●) in any column representing a Governance Factor in the Coverage Table denotes some significant hypothesised effect on that Governance Factor by an individual Governance Variable. In addition, the effect on a Governance Factor which is displayed in the Coverage Table can be direct or indirect. It may be indirect because that Governance Variable affects – as an intermediate step - other Governance Variables or Governance Factors as displayed in the relational effect paths in chapters 7 – 10.

By contrast, the absence of such a dot marking indicates that there is no effect on that Governance Factor. Again, a dot marking will be absent where the effect of a particular Governance Variable on a Governance Factor is so insignificant that it may properly be ignored. Otherwise, the relative importance of such a Governance Variable will be skewed towards the upper end of the rating scale. Possible refinements of this aspect of the relational approach – dependent on empirical testing – are discussed in section 3.3.1.3 below and chapter 11.

3.3.1.2 **Direction of Effect and ‘Dual Direction’ Governance Variables**

A positive direction or relationship (+) signifies that the particular Governance Variable enhances the attainment of the particular Governance Factor and, consequently, results in a hypothesised reduction in agency costs between insiders and outsiders of the corporation. By contrast, a negative directional marker or relationship (-) denotes a hypothesised diminution in the attainment of that Governance Factor or an increase in such agency costs.

For example, the relational effect path of the [BrdIndMon] (+) variable, like the [BrdSkills] (+) variable, begins with the reflexive relationship between the Monitoring & Audit Factor No. 5 and the Decision-making Factor No. 7. This is depicted in the Shareholder Primacy Interrelationship Scheme in Figure 2.7.2A. The variables both have a positive direction marker. This indicates that they both enhance the attainment of the themes in the relevant Governance Factors which they effect or ‘Cover’ as shown in the Interrelationship Scheme:

- The Reporting Factor No. 1;
- The Alignment Factor No. 3;
- The Compensation Factor No. 4;
- The Monitoring & Audit Factor No. 5

---

12 Board Independent Director: Executive Director Proportion – Monitoring Effect. See the relational effect path in sections 7.3.2.1.1-2 of chapter 7.
13 Board – Director Skills ‘Mix’ – see discussion in section 7.3.1.2.1 of chapter 7.
• The Stakeholders Factor No. 6;
• The Decision-making Factor No. 7; and
• The Responsibilities Factor No. 8.

Therefore, the [BrdIndMon] (+) variable and the [BrdSkills] (+) variable are hypothesised to affect or cover all Governance Factors except the overriding Compliance Factor No. 2. 14 This equates to a Coverage/Rating for both variables of +7/87.50 prox in the Coverage Table and the Relational Proximity Table. Thus, by extension, in the case of the long-term efficiency and survival/sustainability of the firm, a positive marker denotes hypothesised enhancement of these objectives (while a negative marker denotes a hypothesised diminution of this aim). In short, these are the long-term effects of enhancing (or reducing) the themes in the above seven Governance Factors in a positive (or negative) direction.

Some hypothesised relationships between Governance Variables and Governance Factors are displayed as both positive and negative ('+/−'). This denotes a relationship whose direction, all other things being equal, cannot be determined (even hypothetically) in isolation but which depends on the presence or absence of other structural determinants. These determinants are described in this thesis as intervening or confounding variables.

Take, for example, the [BrdCmSize] (+/-) Governance Variable – the size of the board and committees. As demonstrated in chapter 7 16, some theoretical and empirical literature suggests that the size of the board up to a certain point may increase the effectiveness of the board Decision-making Factor No. 7. 17 Consequently, other Governance Factors will also be enhanced. This includes, for example, the Monitoring & Audit Factor No. 5 and, in turn, the integrity of the Reporting Factor No. 1 and the Alignment Factor No. 3.

The size of the board is, however, argued to be dependent on other structural factors including:

• the compatibility of insider and outside shareholder interests18;
• the practicability of external verification or monitoring19;
• the size of the firm20;
• national/statutory Governance Code or regime requirements21; and

14 See discussion in section 7.3.1.2.1 of chapter 7.
15 Board and Committee Size – see discussion in section 8.2.2.2 of chapter 8.
16 See discussion in section 8.2.2.2 of chapter 8.
19 Ibid.
the level of firm diversification or complexity and debt.\textsuperscript{22}

An increase in any of these structural factors is likely to increase the difficulty of internal monitoring of the firm with consequential (demands for) increases in board, CEO and management compensation (Compensation Factor No. 4).\textsuperscript{23} However, after the ‘optimal’ board size is reached, the effectiveness of board decision-making is likely to fall\textsuperscript{24} with consequential effects on other Governance Factors. So the direction of the effect of the \([\text{BrdCmSize}]^{(+/\)}\) variable will be dependent on the structural factors particular to individual firms and must be considered on a case-by-case basis.

One consequence of denoting a Governance Variable as ‘+/−’ may be to reduce the explanatory and predictive power of the relational approach. But this also reflects the reality of the complexity of the interrelationships between Governance Factors and therefore needs to be reflected in the relational approach. Even so, only five Governance Variables have a ‘dual’ directional marker:

- Board and Committee Size: \([\text{BrdCmSize}]^{(+/\)}\);\textsuperscript{25}
- Compensation Committee – Presence, Operation and Frequency: \([\text{CompCom}]^{(+/\)}\);\textsuperscript{26}
- Director/CEO Compensation Levels: \([\text{DirCEO}]^{(+/\)}\);\textsuperscript{27}
- Duality of CEO/Chair Positions – Monitoring and Decision-Quality ‘Trade-off’: \([\text{DualTrade}]^{(+/\)}\);\textsuperscript{28} and
- Nominating Committee – Presence, Operation and Frequency: \([\text{NomCom}]^{(+/\)}\).\textsuperscript{29}

To reduce the incidence of ‘dual-direction’ Governance Variables, the thesis has where practicable separated ‘dual-direction’ individual Governance Variables into their positive and negative aspects resulting in two separate Governance Variables. For example, in the case of independent outside directors, there is a suggested positive effect (i.e., a reduction in agency costs) on account of the monitoring quality\textsuperscript{30} of such directors. Thus, the \([\text{BrdIndMon}]^{(+/\)}\)

\textsuperscript{21} Linck, Netter and Yang, ibid, 2.
\textsuperscript{23} See discussion in section 10.3 of chapter 10.
\textsuperscript{24} Mak and Kusnadi, above n 17.
\textsuperscript{25} See discussion in section 8.2.2.2 of chapter 8.
\textsuperscript{26} See discussion in section 10.2.4.1 of chapter 10.
\textsuperscript{27} See discussion in section 10.2.4 of chapter 10.
\textsuperscript{28} See discussion in sections 8.6.1-2 of chapter 8.
\textsuperscript{29} See discussion in section 7.3.1.2.2 of chapter 7.
variable is positive (+).\textsuperscript{31} This effect is separated from the argued negative effect (i.e., an increase in agency costs) of a reduction in the quality of the ‘manager-specific’ and ‘firm-specific’ information flow to the board.\textsuperscript{32} Thus, the [BrdIndInfo] variable is negative (-).\textsuperscript{33} The Governance Factor Coverage of each such Governance Variable is then assessed separately with a consequential improvement in explanatory and predictive power.

### 3.3.1.3 Partial Coverage of Governance Factors

The relational approach in its present form cannot differentiate between, on the one hand, a significant hypothesised effect and, on the other hand, a small (but not negligible) hypothesised effect. In the absence of empirical testing, the relational approach cannot accurately reflect the partial Coverage of (or effect on) a Governance Factor by a Governance Variable. In other words, all dot markings have been assigned the value of one (1) Coverage unit in the relational approach. There is, without empirical testing, no theoretical basis upon which to ‘split’ a dot marking or unit. However, to hypothesise that a particular Governance Variable’s effect on a Governance Factor is some fraction of a dot marking or unit would certainly increase explanatory and predictive power. In that case, there would be a greater degree of - and capacity for - differentiation between Governance Variables.

An alternative method to improve the descriptive and predictive accuracy of the relational approach would be to accord a different weighting to individual Governance Factors based on empirical testing. This is further discussed in the improvements to the relational approach in chapter 11.

### 3.3.2 The Hypothesised Relative Importance of Governance Variables – The Relational Proximity Table

#### 3.3.2.1 Hypotheses in relation to the Relational Proximity of Governance Variables

In the following Relational Proximity Table 3.3.2.1, the total Coverage of Governance Factors by a Governance Variable is used to make a hypothesis of the relative importance of that Governance Variable in affecting agency costs and firm sustainability. This is known as relational proximity and is expressed as a numerical rating from +/-100.00 $r_{prox}$ to (conceivably) 0.00 $r_{prox}$.

The higher the total Governance Factor Coverage and therefore relational proximity Rating of a particular Governance Variable, the greater is the hypothesised effect of that Governance Variable in reducing (or increasing) total agency costs between insiders and outsiders of the for-profit firm. And, in turn, the greater is the effect of that Governance Variable in enhancing (or reducing) the long-term efficiency and survival/sustainability of such firms. Observations and analysis of the results and interrelationships displayed in the Relational Proximity Table 3.3.2.1 are set out in the following chapters relating to the Key Fields.

\textsuperscript{31} See discussion in sections 7.3.2.1.1-2 of chapter 7.

\textsuperscript{32} See discussion in section 7.3.2.1.3 of chapter 7.

\textsuperscript{33} Ibid.
In the following chapter 4, the thesis examines the application of the principal theories and models of the firm to the relational approach. The purpose is to show how the relational approach adds explanatory power and components to these principal theories – the ‘nexus of contracts’, agency theory, the shareholder (primacy) model, the stakeholder model and the director primacy model. Importantly, the weighing mechanism of the relational approach is shown to be a theoretical representation of the nexus.
Table 3.3.2.1: Relational Proximity Table

Hypothesised Relative Importance of Governance Variables in the Sustainability of the Firm

<table>
<thead>
<tr>
<th>Relational Proximity Groups</th>
<th>Relational Proximity Group 8</th>
<th>Relational Proximity Group 7</th>
<th>Relational Proximity Group 6</th>
<th>Relational Proximity Group 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Governance Factor Coverage (Table 3.3.1)</td>
<td>+ 8</td>
<td>+/- 8</td>
<td>- 8</td>
<td>+ 7</td>
</tr>
<tr>
<td>Relational Proximity Rating*</td>
<td>+ 100.00</td>
<td>+/-100.00</td>
<td>- 100.00</td>
<td>+ 87.50</td>
</tr>
<tr>
<td>TransTimeMon</td>
<td>OtherATMs</td>
<td>AudIndFreq</td>
<td>DualTrade</td>
<td>DualDismiss</td>
</tr>
<tr>
<td>NationGov</td>
<td>StagBrdElect</td>
<td>AudIndMon</td>
<td>NomCom</td>
<td>DualEarn</td>
</tr>
<tr>
<td>ReputDiscI</td>
<td>BrdAttend</td>
<td>CompCom</td>
<td>NonAuditS</td>
<td>AudExpAcc</td>
</tr>
<tr>
<td>ReputRep</td>
<td>BrdIndMon</td>
<td>DirCEO$</td>
<td>AudShortOpts</td>
<td>BlockMon</td>
</tr>
<tr>
<td>BrdReview</td>
<td>EqOptEntrch</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BrdSkills</td>
<td>ShortTOpts</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ExtAudEarn</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NomInd</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>OutBrdAdv</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EqOptIncent</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Table 3.3.2.1: Relational Proximity Table (Continued)

Hypothesised Relative Importance of Governance Variables in the Sustainability of the Firm

<table>
<thead>
<tr>
<th>Relational Proximity Groups</th>
<th>Relational Proximity Group 4</th>
<th>Relational Proximity Group 3</th>
<th>Relational Proximity Group 2</th>
<th>Relational Proximity Group 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Governance Factor Coverage (Table 3.3.1)</td>
<td>+ 4</td>
<td>+/- 4</td>
<td>- 4</td>
<td>+ 2</td>
</tr>
<tr>
<td>Relational Proximity Rating*</td>
<td>+ 50.00</td>
<td>+/- 50.00</td>
<td>- 50.00</td>
<td>+ 37.50</td>
</tr>
<tr>
<td></td>
<td>AudIndInfo</td>
<td></td>
<td></td>
<td>BrandInfo</td>
</tr>
</tbody>
</table>

* Calculated by ('Total Governance Factor Coverage') divided by (total number of Governance Factors = 8) x 100.00
CHAPTER 4
KEY FIELD NO. 1:
THE APPLICATION OF THE PRINCIPAL THEORIES OF THE FIRM TO THE RELATIONAL APPROACH

4.1 Problems Arising from the Separation of Ownership from Management

In chapter 3, the relational approach’s conclusions were presented in the form of the Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1. The Coverage Table contains a summary of the relational effect path of each of the 39 Governance Variables. This path is constructed in chapters 7 – 10 and sets out the number and identity of Governance Factors affected by each Governance Variable and the direction of the effect. The summary of each relation effect path is known as a Governance Variable’s ‘Coverage’ of Governance Factors. In the Relational Proximity Table, this Coverage figure is converted into a measure of the relative importance of that Governance Variable in reducing (or increasing) agency costs and enhancing (or reducing) the long-term efficiency and survival of the firm. These results Tables constitute the relational approach’s operational representation of the intersection of the voluntary obligations which comprise the nexus of contracts.

This chapter 4 examines Key Field No. 1 – the Application of the Principal Theories of the Firm to the Relational Approach. More particularly, the chapter examines the theoretical basis of the relational approach and, in particular, the governance theory or model underpinnings of the Weighing Mechanism introduced in chapters 1 and 2 comprising:

- The Three Relational Axes of Good Governance;
- The eight Governance Factors; and
- The two Interrelationship Schemes.

This chapter 4 will demonstrate that the Weighing Mechanism or process constitutes the relational approach’s theoretical representation of the nexus.

---

1 See discussion in sections 2.3.1 – 2.3.3 of chapter 2.
2 See discussion in section 1.7.1 of chapter 1 for the eight Governance Factors:

<table>
<thead>
<tr>
<th>No.</th>
<th>Factor</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. 1</td>
<td>Reporting Factor</td>
<td>- Transparency, Timing and Integrity of Financial and Other Reports;</td>
</tr>
<tr>
<td>No. 2</td>
<td>Compliance Factor</td>
<td>- Corporate Governance and Legal Compliance:</td>
</tr>
<tr>
<td>No. 3</td>
<td>Alignment Factor</td>
<td>- Alignment of Management and Shareholder Interests;</td>
</tr>
<tr>
<td>No. 4</td>
<td>Compensation Factor</td>
<td>- Board, CEO and Management Compensation and Incentives;</td>
</tr>
<tr>
<td>No. 5</td>
<td>Monitoring &amp; Audit Factor</td>
<td>- Internal and External/Audit Monitoring Quality;</td>
</tr>
<tr>
<td>No. 6</td>
<td>Stakeholders Factor</td>
<td>- Identification, Participation and Protection of Stakeholder Interests;</td>
</tr>
<tr>
<td>No. 7</td>
<td>Decision-making Factor</td>
<td>- Quality of Board, CEO and Management Decision-making; and</td>
</tr>
<tr>
<td>No. 8</td>
<td>Responsibility Factor</td>
<td>- Delineation and Disclosure of Powers, Duties and Lines of Responsibility.</td>
</tr>
</tbody>
</table>

3 See Figures 2.7.2A and 2.7.2B of chapter 2.
Key Research Questions for Regulators, Policy-Makers, Law Reformers and Corporate Actors

Two of the key goals of the thesis are, firstly, to introduce a new definition of corporate governance that weighs the aims, behaviours and positional conflict of insiders and outsiders. Second is to propose an approach for regulators, policy-makers, law reformers and corporate actors to predict and measure the relative importance of Governance Variables in reducing (or increasing) agency costs and enhancing (or reducing) the long-term efficiency and survival of the for-profit firm.

As part of the weighing of insider and outsider interests, the relational approach seeks to complement and add explanatory power to five of the existing principal ‘law and economics’ theories and models of the firm – the nexus of contracts, agency theory, the shareholder primacy model, the stakeholder model and the director primacy model. As noted in chapter 1, the four Key Fields are the four most significant and influential areas of corporate governance discourse measured by the number of articles and/or working papers on the SSRN. These five theories of the firm are termed the ‘principal’ theories by this thesis because, among the articles and working papers of the SSRN comprising Key Field No. 1, they are again the most examined or numerous. These principal theories and their interrelationship with the Weighing Mechanism of the Three Relational Axes of Good Governance, the eight Governance Factors (i.e., the eight recurring or underpinning aims or purposes which ‘good governance’ seeks to achieve drawn from the four Key Fields) and the two Interrelationship Schemes will thus be examined here.

Separation Theories and Agency Costs

As part of this purpose, this chapter examines the separation of ownership from management in the paradigm dispersed-shareholding public corporation and the consequent competing interests of inside and outside corporate actors as the basis of problems which give rise to agency costs. These agency costs (which include monitoring costs), in turn, call for the

---

4 See discussion in section 1.3.3 of chapter 1.
5 The 39 Governance Variables are listed in Table 2.4 of chapter 2.
6 See discussion in section 1.3.3 of chapter 1.
7 See discussion in section 1.4 of chapter 1.
8 See the discussion of the four Key Fields introduced in sections 1.3.2 – 1.3.2.4 of chapter 1:

- No. 1 Application of the Principal Theories of the Firm to the Relational Approach;
- No. 2 Autopsies of the Enron and Hastie Corporate Collapses;
- No. 3 Comparative Corporate Governance Codes; and
- No. 4 Empirical Studies of the Effectiveness of Governance Variables.


10 Jensen and Meckling, ibid, 5-6.
application of countervailing Governance Variables as incentive devices which monitor, limit and punish management misconduct.11

This thesis does not intend to examine in detail all theories of the firm or the effects of the separation of ownership from management within those models. This has been done, and continues to be done, by other commentators.12 Again, the five principal theories of the firm have been selected because they are the most examined or numerous in the SSRN collection of literature.

The second purpose of this chapter is to demonstrate that this thesis’ relational approach adds explanatory power to the principal theories of the firm comprising Key Field No. 1. This is achieved using both theoretical analysis and diagrammatic representation. As an important part of this, this thesis will show in this chapter 4 that the Weighing Mechanism is a theoretical representation of the ‘intersection’ of the voluntary obligations said to comprise the nexus of contracts.

Thirdly, the chapter will demonstrate that the relational approach is aligned with the nexus of contracts theory in terms of seeking to avoid or minimise welfare or value-reducing charter (constitution) terms or management behaviour which – under that theory - in the long-term, is both inefficient and harmful to the survival or sustainability of the corporation.

Fourthly and critically, the chapter considers arguments that maximising stakeholder interests is critical for the sustainability of the corporation. As part of this, the chapter examines problems arising from the identity and priority of stakeholder interests inter se and against the shareholder wealth-maximisation principle. The relational approach assists in answering some of these questions by applying its own overriding goal – to minimise long-term agency costs to facilitate continual survival of the firm.

4.2 The Nexus of Contracts Foundations of the Three Relational Axes of Good Governance and Governance Factors

The following Figure 4.2 is a diagram of the Weighing Mechanism of the relational approach. This chapter hypothesises that this Weighing Mechanism is a theoretical representation of the voluntary contracts or obligations comprising the nexus of contracts theory. This theory characterises the corporation as an intersection of voluntary obligations (or contracts or relationships) between the various corporate actors, in particular outside shareholders inter se and between such shareholders and inside managers.13

11 Ibid, 5.
12 For a detailed discussion of various models of the firm and corporate governance theories, see the references in Appendix B4, Discussion of Models of the Firm and Corporate Governance Theories.
The Three Relational Axes of Good Governance represent in turn the objectives, behaviours and positional conflict of the insiders and outsiders. The Governance Factors represent the eight most significant recurring themes or aims underpinning the four Key Fields and thus the 39 Governance Variables to which the Fields give rise. In this way, the Weighing Mechanism or process constitutes the relational approach’s *theoretical* representation of the intersection of the voluntary obligations comprising the nexus.
As noted above, the relational approach’s conclusions were presented in the form of the Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1. These results Tables constitute the relational approach’s operational representation of the intersection of this nexus.

This thesis submits that, complementary to the nexus of contracts theory, the relational approach enhances the explanatory and predictive power of this theory by identifying and weighing the inter-relational themes (i.e., the Three Relational Axes of Good Governance and the eight Governance Factors) that underpin the voluntary obligations among corporate actors. These voluntary obligations are typified by the corporation’s charter or constitution14 as well as the ‘off-the-rack’ set of ‘contractual’ terms supplied by the ‘default’ rules of corporate law (such as the duties of directors) supplied by the legislature and the courts.15

4.2.1 ‘Neoclassical’ Model Shortcomings are Unsuitable for the Relational Approach

Hart explains that the ‘neoclassical’ model treats a firm as comprising:

...a set of feasible production plans. A manager presides over this production set, buying and selling inputs and outputs in a spot market and choosing the plan that maximizes owners’ welfare. Welfare is usually represented by profit, or, if profit is uncertain so that profit-maximization is not well defined, by expected net present value of future profit (possibly discounted for risk) or by market value.16

However, the neoclassical model is of limited utility to the relational approach. Hart explains that the neoclassical model cannot resolve issues of competing interests among corporate actors, i.e., that it does not address issues of structure — the size, extent or boundaries of the firm — nor how conflicts of interest between suppliers of equity, management and employees are resolved.17. Important in this respect is the relational approach’s purpose – to weigh the competing interests of corporate actors to achieve long-term efficiency and/or survival or sustainability of the corporation.

4.2.2 Relational Approach is Aligned with Nexus of Contracts Theory

Bainbridge’s explanation of the nexus of contracts theory emphasised it as “a legal fiction representing the complex set of contractual relationships between” input providers such as employees, creditors, shareholders and management.18 The market for corporate control acts

---

14 See Easterbrook and Fischel, above n 13.
18 Bainbridge, “In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green”, above n 13, 1426-7 (footnote omitted).

together with the nexus of contracts to punish management misconduct which reduces firm value. The market for corporate control itself assumes that markets are efficient and that the share price reflects all public information relating to the firm. Management misconduct causes the share price to fall. At this time, the theory posits, an external hostile takeover will be launched which will remove the incumbent management. In practice, asymmetric information problems reduce the effectiveness of this mechanism.

**The Combined Effect of the Efficient Market Hypothesis and ‘Reputational Constraints’**

As introduced above, the market for corporate control is a component of the efficient market hypothesis to discipline insider-managers that engage in value or performance-reducing

---

I will argue that nexus-of-contracts scholar’s claims to Coase’s lineage are based on a misapplication of Coase’s central insights and the pursuit of a very different research project than underlay *The Nature of the Firm.* I suggest that Coase’s insights must be understood as an extension of Frank Knight’s grand opus—*Risk, Uncertainty and Profit*—and as an extension of Knight’s theory of the entrepreneur. So understood, Coase’s theory of the firm, properly understood, supports a very different contractarian account of the corporation than the currently dominant nexus-of-contracts version, and a very different research agenda. Properly interpreted, the firm has boundaries and a center. Properly understood, the corporation and the firm are different phenomenon. Properly understood, the corporation and corporation law must be seen as serving the purpose of providing the corporation with a substitute for the entrepreneur who owns and directs the classic firm.


19 Opportunistic behaviour arises due to information asymmetry problems. For example, Ashbaugh-Skaife, Collins and LaFond explain the managerial misbehaviour problems associated with separation of ownership from management in terms of ‘information asymmetry’ that creates ‘agency risk’ for shareholders:

[s]elf-interested managerial behavior can take several forms including shirking, consumption of perquisites, over compensation, and empire building, all of which increase agency risk... Imperfect information on the quality of management and the economic value of the firm results in greater agency risk being imposed on the shareholder. Rational investors demand a premium for bearing agency risk, effectively raising the firm’s cost of equity capital.


When the firm gets into financial distress, two important questions emerge. First, are managers responsible and properly penalized for poor firm performance that wipes out shareholder wealth? Second, what is the optimal way to incentivize the incumbent or new management so as to facilitate distress resolution and rehabilitation of the distressed firm?

The authors conclude (at 46-47):

Overall, the literature shows that no matter what causes a firm’s financial distress, significant changes in the firm’s management, incentive mechanisms, and governance and control structure are a crucial part of the financial distress resolution. This suggests that managerial incompetence is often not the only issue in failed firms. Poorly designed incentives and ineffective monitoring of managers are central issues that need to be well addressed to facilitate the rehabilitation of distressed firms.
behaviour. As a theme already introduced above, an underpinning assumption of the efficient market hypothesis is that a corporation’s value is accurately reflected in the stock price with low stock prices reflecting underperforming stock (and management) thus inviting hostile takeover. As Zeitoun and Osterloh explain, this use of hostile takeovers gives management an incentive to act in favour of outside shareholders lest the management be replaced when the stock price falls:

[...] the threat for a managerial team to be replaced increases when stock prices are low (Manne, 1965). Since outside shareholders are not loyal to the incumbent management, they simply sell their shares to investors who aim at taking over the firm and installing a more efficient managerial team (Jensen & Ruback, 1983). The takeover market, which is commonly called the market for corporate control, thus prevents managers from losing their focus on the maximization of shareholder wealth.

While the efficient market hypothesis assumes that share prices reflect all publically available information relating to the firm (or perfect knowledge), it is not, however, without difficulties. Dent describes two important problems that arise in reality. The first is an ‘information problem’ which casts doubt on the accuracy of all information released to the market and, compounding this, the problem that:

[...] even if public information is accurate, investors have limited capacity to process it. Investors act with bounded rationality; that is, they expend resources to analyze information only to the point where it seems that the profits from analysis exceed the costs.

Thus, Dent argues, companies tend to have corporate governance arrangements (such as constitutions) that are “familiar to institutional investors, that facilitate[d] pricing relative to other companies, that [are] backed by a developed body of precedents and judges familiar with the arrangement” with little variance. This flows from the fact that market participants have considerable reliance on ratings agencies and advisors to assess corporate governance arrangements.

---


21 Cunningham, ibid. In this article, Cunningham discusses the undermining of the efficient market hypothesis by “behavioural finance” explanations for share prices and firm value.


24 Ibid, 19 of 72 (footnotes omitted). For a discussion of the role of ratings agencies and other financial market intermediaries in the Enron corporate collapse, see section 5.2.4.3.3 of chapter 5.
The second problem identified by Dent is that ‘markets take time’ – that “[t]he investor’s difficulty escalates when the correction of the mispricing of a stock may take a long time.”

Putting these problems aside, Cunningham also notes that the efficient market hypothesis is assisted by other governance measures. In particular, Cunningham identifies reputational constraints (and consequences) relating to individual managers as significant. Indeed, the reputational constraints on outside directors are emphasised by Fama and Jensen as an important aspect of the recommended division between ‘decision management’ and ‘decision control’ discussed below:

![Equation]

To this end, the relational approach includes the individual Governance Variables of [ReputDisc] (Reputational Constraints – ‘Disclosure Standards’, +100.00 rprox) and [ReputRep] (Reputational Constraints – ‘Transparent Reporting’, +100.00 rprox). These Governance Variables divide the reputational constraints concept into constituent components that reflect Singh’s proposition that the reputational constraints aspect of the market for corporate control in turn depends on two elements - ‘disclosure standards’ and ‘transparent reporting’.

4.2.2.1 Market for Corporate Control Reflected in Governance Factors and Governance Variables

Thus, to reflect an important condition of the operation of nexus theory, the relational approach reproduces as Governance Factors and Governance Variables individual components of the market for corporate control.

For example, Governance Factors such as the Reporting Factor No. 1, the Compliance Factor No. 2, the Alignment Factor No. 3, the Monitoring & Audit Factor No. 5 and the Responsibility Factor No. 8 assist in maintaining the functioning of the market for corporate control by reducing information asymmetry.

In the case of the 39 Governance Variables examined in this relational approach, the market for corporate control is represented by Governance Variables also seeking to reduce information asymmetry. For example, the variables [NationGov] (National Governance/Shareholder Protection Regime – see discussion in section 7.3.1.3.3 of chapter 7).
[ReputRep] (+)\textsuperscript{34} and [TransTimeMon] (+)\textsuperscript{35} together account for all of the four variables accorded the highest positive Coverage/Rating of +8/+100.00 rprox.

In addition, the information asymmetry-countervailing Governance Variables of [AudIndFreq] (+)\textsuperscript{36}, [AudIndMon] (+)\textsuperscript{37}, [BrdAttend] (+)\textsuperscript{38}, [BrdIndMon] (+)\textsuperscript{39} and [ExtAudEarn] (+)\textsuperscript{40} account for five out of a total of ten Governance Variables accorded the next highest positive Coverage/Rating of +7/+87.50 rprox.

On the negative side, the market for corporate control may also be adversely affected by Governance Variables such as [StagBrdElect] (-)\textsuperscript{41} and [Other ATMs] (-)\textsuperscript{42} which each has a Coverage/Rating of -8/-100.00 rprox.

The significance of the positive +100.00 rprox scores is that insider actions which reduce or adversely affect the transparency and timing of information ([TransTimeMon] (+)) or the effectiveness of the management-disciplining mechanism of the market for corporate control will significantly increase agency costs and significantly reduce the long-term efficiency and sustainability of the for-profit corporation.

Also, taking the negative -100.00 rprox scores of the [StagBrdElect] (-) and [OtherATMs] (-) Governance Variables, insider actions which again reduce the effectiveness of the market for corporate control – such as staggered board elections and other anti-takeover mechanisms – will again significantly increase these agency costs and significantly reduce such efficiency and sustainability of the corporation.

In summary, the interests of (inside) management vis-à-vis (outside) shareholders and the discouragement of management misconduct are two underpinning themes of the nexus of contracts. As explained further below, these themes are reflected in the design of the Three Relational Axes of Good Governance, the Governance Factors and, consequently, the Interrelationship Schemes.\textsuperscript{43} Thus, the relational approach is aligned with the nexus of contracts theory in terms of seeking to avoid or diminish value-reducing behaviour which, in the long-term, is both inefficient and harmful to the survival or sustainability of the firm.

4.2.3 The Components of the Relational Approach and Agency Costs

In order to assist regulators, policy-makers, law reformers and corporate actors, the relational approach’s Governance Variables are aligned with, and complementary to, agency theory. Jensen and Meckling suggest that the bestowal of discretion in insiders may prompt

\textsuperscript{33} Reputational Constraints – ‘Disclosure Standards’ – see discussion in section 10.4.1 of chapter 10.
\textsuperscript{34} Reputational Constraints – ‘Transparency Reporting’ – see discussion in section 10.4.1 of chapter 10.
\textsuperscript{35} Transparency and Timing of Reporting – Monitoring Effect – see discussion in section 9.1.2.1 of chapter 9.
\textsuperscript{36} Audit Committee – Independence in Combination with Frequency of Meeting – Reduction in Earnings Manipulation Effect – see discussion in section 9.2.1 of chapter 9.
\textsuperscript{37} Audit Committee - Independence - Monitoring Effect – see discussion in section 8.4.3 of chapter 8.
\textsuperscript{38} Board – Attendance Level (High) – see discussion in section 7.3.2.1.2 of chapter 7.
\textsuperscript{39} Board Independent Director: Executive Director Proportion – Monitoring Effect – see discussion in sections 7.3.2.1.1-2 of chapter 7.
\textsuperscript{40} External/Independent Audit Function – see discussion in section 9.2.3.3 of chapter 9.
\textsuperscript{41} Staggered Board Elections – see discussion in section 8.3.1.1 of chapter 8.
\textsuperscript{42} Other Anti-Takeover Mechanisms (excludes staggered board elections) – see discussions in section 8.3.1.1 of chapter 8.
\textsuperscript{43} See Figures 2.7.2A and 2.7.2B of chapter 2.
managerial misconduct (again, such as shirking, empire-building, overcompensation and perquisites) giving rise to agency costs44 (which include monitoring costs45 and) that reduce the economic welfare of the outsiders and are reflected in the market price of shares.46

In the relational approach, the various structures, mechanisms, processes and protocols – i.e., the Governance Variables themselves - must be utilised to discipline managers or to align their interests with those of outsiders.47 Thus, Governance Variables such as [AudCom] (+)48 (Audit Committee - Presence, Operation and Frequency, +75.00 rprox), [BrdAttend] (+)49 (Board – Attendance Level (High), +87.50 rprox), [BrdIndMon] (+)50 (Board Independent Director: Executive Director Proportion – Monitoring Effect, +87.50 rprox), [CompCom] (+/-)51 (Compensation Committee - Presence, Operation and Frequency, +/- 87.50 rprox), [ExtAudEarn] (+)52 (External/Independent Audit Function, +87.50 rprox) and [TransTimeMon] (+)53 (Transparency and Timing of Reporting – Monitoring Effect, +100.00 rprox) in theory go toward reducing such monitoring costs. Significantly for the design of the relational approach, the agency cost relationship between ‘insider-managers’ and ‘outsider-shareholders’ underpins the nexus model. To align the relational approach in this respect, components of the approach – in particular, the Governance Factors – are similarly underpinned by the agency costs concept. It is to these components that this chapter now turns.

4.2.3.1 Governance Factors and Interrelationship Schemes are Based on Agency Costs Theory

General Agency Costs Theory

The purpose of the relational approach is to make hypotheses in relation to the relative importance of Governance Variables in affecting (positively or negatively) agency costs. This chapter has also explained that the Three Relational Axes of Good Governance, the weighing of the Governance Factors and the Interrelationship Schemes are a theoretical representation of the intersection of the voluntary obligations comprising the nexus of contracts. Thus, putting these two notions together here, the chapter demonstrates that the Governance Factors are based on – and further explain - the agency costs theory and its associated classification of those costs. Thus, too, the Interrelationship Schemes which depict the interrelationships between the Governance Factors54 are based on agency costs theory.

44 Jensen and Meckling, above n 9, 5-6.
45 Ibid.
47 Jensen and Meckling, above n 9, 5.
48 See discussion in section 8.4.2 of chapter 8.
49 See discussion in section 7.3.2.1.2 of chapter 7.
50 See discussion in sections 7.3.2.1.1-2 of chapter 7.
51 See discussion in section 10.2.4.1 of chapter 10.
52 See discussion in section 9.2.3.3 of chapter 9.
53 See discussion in section 9.1.2.1 of chapter 9.
54 As demonstrated in chapter 2, the Interrelationship Schemes in Figures 2.7.2A and 2.7.2B are a composite of the individual relationships between Governance Factors analysed in sections 2.6.1 – 2.6.8.
According to Jensen and Meckling, the agency costs of the nexus or set of contracts or relationships comprising the corporation include monitoring costs on behalf of the shareholder:\(^{55}\):

> [If both parties to the relationship are utility maximizers, there is good reason to believe that the agent will not always act in the best interests of the principal. The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent.\(^{56}\)]

Indeed, for Hermalin and Weisbach, governance mechanisms – in the terminology of the relational approach, the Governance Variables - "are simply restrictions on these contracts imposed by an outside authority.\(^{57}\)

---

55 Jensen and Meckling, above n 9, 5-6.
56 Ibid, 5 (emphasis in original).


> The finance literature has started to recognize the importance of the investment horizon of a firm’s investors. Only those with a long-term horizon show evidence of successful monitoring. Most of the evidence has been developed in the context of specific, observable decisions such as acquisitions. We add to the literature by examining the accumulation and management of internal slack, which is fundamental to the agency conflict between managers and shareholders. Monitoring—including information gathering and exerting influence on management—is costly, so it must produce a benefit. In the presence of external financing costs, financial slack can be valuable, but it also introduces the possibility of overinvestment. We show that long-horizon investors provide sufficient monitoring to capture the value of internal slack while mitigating the potential cost. Specifically, better-monitored managers are allowed to hold more internal slack, but they appear to spend it in ways that are in keeping with shareholders’ interests. When they have excess cash, they are more likely to distribute it than to invest it.


> [w]e model a firm over two periods and focus on the board of directors’ decision to retain or replace the incumbent manager after the first period. The accounting system provides information that is useful for this purpose, but also useful for the board’s monitoring decision. We establish a generally positive association between board efficiency and accounting conservatism; that is, if the board is more effective in monitoring, then the optimal accounting system is more likely to be conservative. If the board is not very effective or if the monitoring cost is high, the optimal accounting system is aggressive. It is the dual use of accounting information, affecting monitoring and manager replacement decisions, which generates the demand for conservative accounting. Thus, board effectiveness determines the properties of the accounting system, which again influences board efficiency. These results are consistent with empirical work that generally finds that stronger corporate governance, including more effective boards, is associated with more conservative accounting.

Monitoring Costs Require Countervailing Governance Variables

For example, the need (or cause) for such monitoring costs and, therefore, countervailing Governance Variables such as [AudCom] (+)\(^{58}\), [BrdAttend] (+)\(^{59}\), [BrdIndMon] (+)\(^{60}\), [CompCom] (+/-)\(^{61}\), [ExtAudEarn] (+)\(^{62}\) and [TransTimeMon] (+)\(^{63}\) is explained in more detail by Evans and Evans who point to the dispersed nature of shareholdings and informational imbalance between principal and agent:

…agency theory maintains that management (agents) will act opportunistically to increase their personal wealth at the expense of the owners (principal) of an organisation. To achieve this, managers rely upon the dispersed nature of ownership and their access to superior information ("information asymmetry").\(^{64}\)

Immediately, then, the effect of this monitoring costs concept in terms of the relational approach can be seen as giving rise to more than half the Governance Factors – the Reporting Factor No. 1, the Compliance Factor No. 2, the Alignment Factor No. 3, the Monitoring & Audit Factor No. 5 and the Responsibility Factor No. 8.\(^{65}\) Important, too, in the above description of managerial misbehaviour is the pursuit by management of ‘perks’ and over-compensation. This is specifically addressed in the relational approach by the Compensation Factor No. 4 and the Alignment Factor No. 3.\(^{66}\)

\(^{58}\) Audit Committee - Presence, Operation and Frequency, +75.00 rprox – see section 8.4.2 of chapter 8.

\(^{59}\) Board – Attendance Level (High), +87.50 rprox - see section 7.3.2.1.2 of chapter 7.

\(^{60}\) Board Independent: Executive Director Proportion – Monitoring Effect, +87.50 rprox – see sections 7.3.2.1.1-2 of chapter 7.

\(^{61}\) Compensation Committee - Presence, Operation and Frequency, +/- 87.50 rprox – see section 10.2.4.1 of chapter 10.

\(^{62}\) External/Independent Audit Function, +87.50 rprox – see section 9.2.3.3 of chapter 9.

\(^{63}\) Transparency and Timing of Reporting – Monitoring Effect, +100.00 rprox – see section 9.1.2.1 of chapter 9.


"we find that firms facing greater asymmetric information tend to impose less intensive board monitoring, install fewer anti-takeover provisions (i.e., have more exposure to external monitoring) and use higher powered CEO compensation. This is consistent with the monitoring cost hypothesis, which states that asymmetric information increases direct monitoring costs, therefore resulting in firms’ greater reliance on incentive compensation and external monitoring."

\(^{65}\) The Governance Factors are listed in section 1.7.1 of chapter 1.

\(^{66}\) Ibid.
**Other Agency Costs include ‘Bonding’ Costs and ‘Residual’ Losses**

Other agency costs include costs incurred by the agent for bonding with the principal (bonding costs\(^\text{67}\)) and any loss (residual loss) arising where the (agent) manager fails to act in the shareholder’s wealth-maximising interests\(^\text{68}\) (for example, a takeover bid at an overvaluation or the sale of a business asset of the corporation at an undervaluation).

For Jensen and Meckling, monitoring, bonding and residual costs together help to explain the market price of shares.\(^\text{69}\) As the shareholdings of the company become more diffused (i.e., the shareholdings of the original or founding manager-shareholders dilute with the result that ‘residual claims’ of these manager-shareholders decrease), the gap between the interests of outside shareholders and inside managers increases as the manager-shareholders seek additional perquisites in turn causing monitoring (and consequential agency) costs to increase.\(^\text{70}\)

**4.2.3.2 ‘Decision Management’ and ‘Decision Control’ Dichotomy Reflected in Governance Factors**

Thus, for Fama and Jensen, the separation (and dispersed nature) of the residual claimants from the decision-making management gives rise to a decision-making structure which, to be effective and reduce agency costs, typically divides decision “initiation” and “implementation” (“decision management”) from “ratification” and “monitoring” (“decision control”),\(^\text{71}\) the latter function being undertaken on behalf of shareholders by a board of directors.\(^\text{72}\) This critical ‘decision control’ function of the board – and its significance for the Governance Factors – is taken up below in discussing the director primacy model.\(^\text{73}\)

For present purposes, this chapter notes here that the constituent components of Fama and Jensen’s dichotomy between ‘decision management’ and ‘decision control’ are reflected in a number of the Governance Factors. Primarily, the Responsibility Factor No. 8\(^\text{74}\) is a reflection

\(^{67}\) Jensen and Meckling, above n 9, 5.


\(^{69}\) Jensen and Meckling, above n 9, 11. For further discussion of agency costs, see Roe, above n 46, 3-4.

\(^{70}\) Jensen and Meckling, above n 9, 11-12.

\(^{71}\) Fama and Jensen, above n 28, 4-5 and 9.

\(^{72}\) Ibid, 14 and 16.


\(^{74}\) The Governance Factors are listed in section 1.7.1 of chapter 1.
of this recommended division. Other Governance Factors illustrating the division of functions include the Decision-making Factor No. 7 and the Monitoring & Audit Factor No. 5.75

4.2.4 **Director Primacy Model Reflected in the Governance Factors**

The director primacy model places the board at the *precise* nexus of the various voluntary obligations or relationships representing the corporation.76 Bainbridge states that (unavoidable) agency costs are “the *inevitable* consequence of vesting discretion in someone other than the residual claimant”.77 In this way, Bainbridge explains that the benefits of discretion must be balanced with accountability in the exercise of that discretion.78 In terms of the relational approach’s own Three Relational Axes of Good Governance – the Behaviours Axis No. 2(a) and 2(b)79 - ‘entrepreneurism’ and ‘innovation’ (risk-taking) is balanced against risk management, ‘control’ and ‘accountability’ (responsibility).

How then is this balance achieved? For Bainbridge, it is through the *board itself*. The author sees the board as an “institutional restraint on agency costs” which it achieves by establishing a monitoring structure throughout each level of the company with itself at the top and with a ‘multi-membership’ of directors which is “inherently harder for misbehaving subordinates to suborn than would be a single autocrat”.80

75 Ibid.


79 See discussion in sections 2.3.1 – 2.3.3 of chapter 2.

For a theory that accepted governance theories – including the nexus of contracts – wrongly assume that the board of directors has practical authority over managers and that, instead, managers control the decision-making processes of the company, see Nicola F Sharpe, “Questioning Authority: Why Boards Do Not Control Managers
4.2.4.1 Board-Dependent Variables have a High Governance Factor Coverage and Relational Proximity

Adopting Bainbridge’s model, the relational approach displays a significant Board-Governance Factor relationship structure that also flows through to the relevant Governance Variables. Thus, board-dependent or board-influenced Governance Variables will have a relatively high Governance Factor Coverage and relational proximity Rating in the Relational Proximity Table in comparison to other Governance Variables. Thus, board-dependent Governance Variables with a positive effect on reducing agency costs will have a (relatively) high relational proximity.

For example, the [AudCom] (+)83, [AudAccEarn] (+)84 and the [AudExpAcc] (+)85 variables all have a relational proximity of +75.00 rprox. These comprise three out of the four variables with this Rating. Further, director-related variables such as [AudIndFreq] (+)86, [AudIndMon] (+)87, [BrdAttend] (+)88, [BrdIndMon] (+)89, [BrdReview] (+)90, [BrdSkills] (+)91, [NomInd] (+)92 and [EqOptIncent] (+)93 have a relational proximity of +87.50 rprox. These comprise eight out of the ten variables with this rating.

Not surprisingly on the negative side, the board-dependent Governance Variable of [StagBrdElect] (-)94 is one of the two Governance Variables with the highest negative Coverage/Rating of -8/-100.00 rprox while [AudShortOpts] (-)95, [EqOptEntrch] (-)96 and...
[ShortTOpts] (−)\(^97\) comprise three out of the six Governance Variables with the next-highest negative Coverage/Rating of -7/-87.50 prox.

4.3 Application of the Shareholder Primacy and Stakeholder Models to the Relational Approach

4.3.1 The Relational Approach and the Shareholder Primacy Model

Agency costs theory and the shareholder model are not co-extensive. While often combined in the same breath, the former is much broader and, as Jensen and Meckling describe, arises in any situation where discretion is vested in an agent to maximise the welfare of a principal.\(^98\) Similarly, the shareholder model, while incorporating an agency theory component, looks beyond agency costs. In this section, we are not concerned with the entirety of the shareholder model. Instead, this chapter is concerned to identify the distinguishing feature of the shareholder model which gives rise to governance (and equally, in this case, agency theory) considerations — that the outside shareholders are the only residual claimants and that inside managers must act to maximise the welfare of those outside shareholders.\(^99\)

4.3.2 Shareholder Primacy - The Precedence of the Shareholders' Residual Claims are Reflected in the Governance Factors

Jensen and Meckling consider that the corporation is, in addition to a nexus of contracts, also comprised of the shareholders’ “divisible residual claims on the assets and cash flows of the organization”.\(^100\) In the shareholder primacy model of corporate governance, the shareholders are the only residual claimants.\(^101\) Then, at this point, the shareholder-wealth maximisation principle aligns the interests of shareholders and managers as follows in the next section.

---

\(^97\) Short-Term Option Holdings/Plans of Directors and Executives – see discussion in section 10.2.5.1 of chapter 10.

\(^98\) Jensen and Meckling, above n 9, 6-7.


\(^100\) Jensen and Meckling, above n 9, 8-9. See discussion in section 1.2.2 of chapter 1.


See discussion in section 1.2.2 of chapter 1. For a discussion of the nature of agency costs and residual claims in different forms of organisation, see Fama and Jensen, above n 28.

\(^102\) See discussion in section 1.2.3 of chapter 1.
4.3.2.1 The ‘Default Standard’ of the Shareholder-Wealth Maximisation Principle

In this respect, Rhee explains the (well-known) purpose of the shareholder-wealth maximisation principle in terms of agency theory and the nexus of contracts. The principle acts as a ‘default standard’ that supplies the necessary rule governing the agent’s behaviour in the ‘contract’ between shareholders and managers:

[the profit maximisation norm is really a theory of approximation, an assessment that shareholders are rational wealth maximisers...The shareholder primacy norm can be seen, much like corporate law itself, as a default standard that encompasses the correct contract term in most cases if the relevant parties could have bargained for the choice under condition of zero transaction cost.]

The relational approach – through its alignment with the nexus of contracts and agency theories – is able to similarly adopt the operation of this default rule concept of shareholder primacy when (of course) in the relevant shareholder primacy mode.

4.4 The Influence of Stakeholder Theory in the Relational Approach

The stakeholder model posits that the shareholders are not the only residual claimants of the corporation. Thus, the stakeholder model argues, the management of a corporation should, in performing its duties, take into account the interests of others affected by the corporation’s actions. In this way, this chapter 4 will now examine the stakeholder model as an additional and significant influence on the Three Relational Axes of Good Governance and, in particular, limb 3(b) of the Positional Conflict Axis No. 3. Of course, the stakeholder model’s influence is also reflected in the Stakeholders Factor No. 6 - Identification, Participation and Protection of Stakeholder Interests.

The next subsection begins by identifying perceived problems with the shareholder primacy model to highlight arguments by commentators that satisfying a wide range of stakeholder needs is – consistent with the relational approach’s over-arching purpose - necessary to enhance the long-term survival or sustainability of the for-profit corporation.


104 See discussion in section 4.4.1.2 of this chapter 4.

105 See Figure 2.3.2B in section 2.3.2 of chapter 2.
4.4.1 Shortcomings of the Shareholder Primacy Model

Perceived shortcomings in the shareholder primacy model form the basis of its main rival, the stakeholder model. While a detailed criticism of the shareholder primacy model is beyond the scope of this thesis, Licht explains that the shareholder model's assumption of a single residual claimant (i.e., the shareholder) is flawed and 'unrealistic':

...this [the shareholder model's] analysis hides an implicit assumption, namely, that apart from the residual claim all other claims on the corporation—or, more accurately, the interests of other stakeholders—are fixed and well defined. Hence, these other claims are assumed away from the analysis such that only the residual claim remains to be maximized.

Accordingly, Jensen explains that the stakeholder model requires “that managers should make decisions that take account of the interests of all the stakeholders in a firm”. In terms of the composition of limb 3(b) of the Positional Conflict Axis No. 3, Maher and Andersson note that:

[other stakeholders may include contractual partners such as employees, suppliers, customers, creditors, and social constituents such as members of the community in which the firm is located, environmental interests, local and national governments, and society at large.]

Thus, a wide net of stakeholder interests are envisaged by the stakeholder model. But how does the stakeholder model enhance the long-term efficiency and survival of the firm?

---


109 See Figure 2.3.2B in section 2.3.2 of chapter 2.


4.4.1.1 Arguments that Maximising Stakeholder Interests is Critical for the Sustainability of the Corporation

In this section, this chapter considers arguments that the maximisation of stakeholder interests within the rubric of the stakeholder model is necessary to achieve the long-term sustainability of the for-profit firm. As this outcome is parallel or co-extensive with the over-arching purpose of the relational approach, then one implication of these arguments is that the stakeholder model’s additional underpinning influence on the Positional Conflict Axis No. 3 and the Stakeholders Factor No. 6 should be significant. And this should be irrespective of the current status of the shareholder primacy principle.

In the stakeholder model, the necessity for the recognition and the taking into account by management of stakeholder interests (for example, by consultation and participation) is not merely an ethical or moral call. Instead, according to Licht, and important for the foundations of the Positional Conflict Axis No. 3 and the Stakeholders Factor No. 6, the continual balancing or ‘maximisation’ of these various interests is critical to the future sustainability of the firm. Bainbridge, too, while a strong advocate of the shareholder model, impliedly acknowledges this argument.

While a detailed examination of the principles of corporate social responsibility or CSR is beyond the scope of this thesis, the CAMAC Social Responsibility Report describes the ‘compliance’, ‘philanthropic’ and ‘business’ approaches “each being directly or indirectly linked to corporate benefit (which includes avoidance of detriment)”. In addition, the CAMAC Social Responsibility Report describes two further approaches – ‘social primacy’ and ‘social obligation’ – that “are not necessarily linked to corporate benefit”.

In the case of the ‘business’ approach, CAMAC explains that compliance with ‘environmental and other societal laws’ is justified on the grounds of the long-term value of the corporation:

...it is likely to be in a company’s own commercial interests, in terms of long-term value creation and risk reduction, to take into account the environmental and social context in which it operates.

Immediately, it is observed that enhancing firm value and risk management are aspects of the Objectives Axis limb 1(a) and the Behaviours Axis limb 2(b) respectively of the Three Relational Axes of Good Governance.

CAMAC describes this ‘business’ approach as compatible with enhancing ‘shareholder interests’. CAMAC provides various examples of how the observance of CSR principles enhances firm value, operating profits, risk management and, ultimately, firm sustainability.

This thesis submits that this process is very closely akin to that of the firm-specific aims and effects of good governance described in subsection 2.2 of chapter 2 as depicted in the following diagram:

---

113 Bainbridge, "In Defense of the Shareholder Wealth Maximization Norm", above n 13, 1443 (footnote omitted). See also Bainbridge, "Director Primacy: The Means and Ends of Corporate Governance", above n 73, 52.
114 CAMAC Social Responsibility Report, above n 110, p. 34.
115 Ibid.
Relationships with Stakeholders are Vital to Sustainability

Capasso highlights the importance of relationships with stakeholders as ‘intangible assets’ of the firm which are beyond the firm’s ‘direct control’ and these are particularly important for firms:

whose critical factors for success are represented by the professional capabilities of the staff, but also in those firms owing their competitive advantage to their belonging either to an industrial district or to a network of interdependent firms.

Capasso therefore stresses that the preservation of these intangible assets is – in an echo of the Stakeholders Factor No. 6 - dependent on addressing and satisfying such stakeholder interests.

---


119 Ibid, 8-9.


4.4.1.2 **Comparison of the Influence of Shareholder Primacy and the Stakeholder Model on the Governance Factors**

How would the competing guiding principles – shareholder primacy and the stakeholder model – effect the operation of the Governance Factors? The influence of the shareholder primacy principle – including the Corporations Act’s subsection 181(1)(a)\(^{121}\) in the relational approach is readily apparent. The Alignment Factor No. 3\(^{122}\) is drawn squarely from this principle’s pre-eminent position (on account of the High Court’s decision in *Walker v Wimborne\(^ {123}\)*) in Key Field No. 1 (*the Application of the Principal Theories of the Firm to the Relational Approach*).

The tensions between the shareholder primacy principle and its main rival – the stakeholder model – are also reflected in the Stakeholders Factor No. 6. Indeed, the Alignment Factor No. 3 is an ‘umbrella’ or ‘guiding’ principle over all other Governance Factors except the Compliance Factor No. 2.\(^ {124}\) In such a case, the relational approach is in shareholder primacy mode. This was represented in Figure 2.6.3A reproduced here:

---

\(^{121}\) See discussion in section 1.2.3 of chapter 1.

\(^{122}\) The eight Governance Factors are listed in section 1.7.1 of chapter 1.

\(^{123}\) See discussion in section 1.2.3 of chapter 1.

\(^{124}\) See also Charreaux, above n 101, 6 (emphasis added), who explains that governance structures and mechanisms have a ‘disciplinary perspective’ – again, in terms of the shareholder model - which:

…*constitute a means of forcing the managers to “maximize” the shareholder value.* This perspective has particularly dominated the studies relating to the board of directors, the annual shareholder’s meeting, the remuneration systems for managers, the legal and accounting regulations and takeovers as well.
Where, by contrast, the relational approach is in stakeholder mode, then the reverse will be the case. The Stakeholders Factor No. 6 and the Alignment Factor No. 3 will then together constitute the ‘umbrella’ or ‘guiding’ principles on the grounds that the interests of ‘other’ stakeholders do not necessarily rank over those of the shareholder-stakeholders. Again, only the Compliance Factor No. 2 ranks above them on account of its overriding nature. This is represented in the following Figure 4.4.1.2:

125 See discussion in section 2.6.2 of chapter 2.
Figure 4.4.1.2: Relational Approach Stakeholder Mode

Compliance Factor No. 1: Corporate Governance and Legal Compliance

Alignment Factor No. 3: Alignment of Management and Shareholder Interests

Stakeholders Factor No. 6: Identification, Participation and Protection of Stakeholder Interests

Reporting Factor No. 1: Transparency, Timing and Integrity of Financial and Other Reports

Compensation Factor No. 4: Board, CEO and Management Compensation and Incentives

Monitoring & Audit Factor No. 5: Internal and External Audit Monitoring Quality

Decision-making Factor No. 7: Quality of Board, CEO and Management Decision-making

Responsibility Factor No. 8: Delineation and Disclosure of Powers, Duties and Lines of Responsibility
4.4.1.3 ASX 2007-10 Revised Principles Acknowledge Stakeholder Interests

In relation to the Stakeholders Factor No. 6 of the relational approach, Principle 3 of the ASX 2003 Best Practice Recommendations was amended in the ASX 2007-10 Revised Principles to provide for acknowledgement of stakeholder interests. Revised Principle 3 of the ASX 2007-10 Revised Principles is expressed in part in the following terms:

**Principle 3: Promote ethical and responsible decision-making**

Companies should actively promote ethical and responsible decision-making

To make ethical and responsible decisions, companies should not only comply with their legal obligations, *but should also consider the reasonable expectations of their stakeholders including: shareholders, employees, customers, suppliers, creditors, consumers and the broader community in which they operate*. It is a matter for the board to consider and assess what is appropriate in each company’s circumstances. It is important for companies to demonstrate their commitment to appropriate corporate practices and decision making.

Companies should:

* comply with their legal obligations and have regard to the reasonable expectations of their stakeholders...*126

Revised Principle 3.1 of the ASX 2007-10 Revised Principles requires companies to establish and disclose a code of conduct for various matters including “the practices necessary to take into account their legal obligations and the *reasonable expectations of their stakeholders*.127

It is submitted that, consequent on the introduction of these changes and ignoring the effect of *Corporations Act* subsection 181(1)(a) discussed above128, the ASX 2007-10 Revised Principles would now constitute a *composite* shareholder-stakeholder governance model.129

---


127 ASX 2007-10 Revised Principles, ibid, Revised Recommendation 3.1, p. 22. In its suggestions for the contents of such a code, Box 3.1 of the ASX 2007-10 Revised Principles seeks to include themes relating to both the shareholder (primary) model and the stakeholder model (at p. 23):

---

128 See discussion in section 1.2.3 of chapter 1 and section 4.4.1.2 of this chapter 4.
ASX 2007-10 Revised Principles Do Not Prioritise Stakeholder-Shareholder Interests

Again, as generally structured or operated, the relational approach is in shareholder primacy mode as described in section 4.4.1.2 – but may be ‘switched’ to stakeholder mode. However, the ASX 2007-10 Revised Principles give no further guidance on how, or in what priority, the various stakeholder interests should be balanced amongst themselves or against the shareholder-value maximisation principle.

This, of course, is a very relevant consideration if, when the relational approach is switched to stakeholder mode, it is necessary to utilise the Stakeholders Factor No. 6\(^1\) in conjunction with the Alignment Factor No. 3\(^1\) as the ‘umbrella’ or ‘guiding’ Factors. It is to this problem that the thesis now turns.

4.4.2 Perceived Problems and Suggested Solutions in Balancing Competing Stakeholder Interests

This chapter has already explained the pre-eminent influence of the shareholder primacy principle in the operation of the Alignment Factor No. 3, the Stakeholders Factor No. 6 and the Three Relational Axes of Good Governance. However, putting aside this pre-eminence, the chapter considers in this subsection the most controversial, if not difficult, problem faced by the stakeholder model – the balancing of shareholder and other stakeholder interests (i.e., on the assumption that no pre-eminence is given to the former\(^1\)).

Here, this chapter highlights Jensen’s ‘many masters’ problem that may reduce the ability to satisfy in total all such interests simultaneously. Further, and accepting this problem, the chapter examines proposals for how a stakeholder model may work in practice and highlights possible difficulties including Bainbridge’s problem of ‘managerial sin’.

4.4.2.1 Balancing and Priority of Stakeholder Interests

In terms of the weighing of competing interests, of ongoing difficulty for Licht and, separately, Bainbridge, in connection with the stakeholder model is how the balancing of interests should be performed in practice and the order of precedence.\(^1\) In the relational approach, this


\(^{130}\) The Governance Factors are listed in section 1.7.1 of chapter 1.

\(^{131}\) Ibid.

\(^{132}\) This assumption is, on purpose, expressed differently to any assumption that the relevant interests rank equally. Such an equal ranking pre-supposes that some form of weighing has already taken place which, in the absence of any model, is unsupportable. It is the determination of this ranking between the relevant shareholder and stakeholder interests that this section seeks to examine.

\(^{133}\) Licht, “The Maximands of Corporate Governance: A Theory of Values and Cognitive Style”, above n 101, 63-64, 67 and 79. Bainbridge, “In Defense of the Shareholder Wealth Maximization Norm”, above n 13, 1435-6, calls this the “two masters” problem: [what happens when there is a conflict between shareholders and nonshareholders and also between various nonshareholder constituencies? Suppose, for example, that management is considering closing]
The ‘Many Masters’ Problem of Stakeholder Interests

Similarly, Jensen highlights the ‘many masters’ problem that could mean no stakeholder’s interest is fully satisfied and which could lead to ‘managerial confusion’ and (importantly for the purposes of the relational approach) undermine future efficiency and sustainability. In this respect, Jensen also describes the impossibility of simultaneously maximising more than one interest with resultant (again) managerial confusion and lack of objective, again undermining sustainability.136

Indeed, similar to Jensen, Maher and Andersson note that one problem with the stakeholder model is that “it is difficult, if not impossible, to ensure that corporations fulfil these wider objectives”138 and suggest that insiders “may use ‘stakeholder’ reasons to justify poor company performance”.139 In the end, the authors appear to suggest a combination of aspects of the two principal models as a solution to perceived weaknesses.140 Bainbridge also highlights the problem of “managerial sin”:

management could freely pursue its own self-interest by playing shareholders off against nonshareholders. When management’s interests coincide with those of shareholders, management could justify its decision by saying that shareholder interests prevailed in this instance, and vice-versa.141

How, then, should the difficulties described by these authors be addressed? This chapter concludes the examination of the stakeholder model with a discussion of this question.

down an obsolete plant. The closing will harm the plant’s workers and the local community, but will benefit shareholders, creditors, employees at a more modern plant to which the work previously performed at the old plant is transferred, and communities around the modern plant. Assume that the latter groups cannot gain except at the former groups’ expense. By what standard should management make the decision?


135 See discussion in section 4.4.1.3 of this chapter 4.


137 Ibid, 10-11.

138 Maher and Andersson, above n 77, p 5.

139 Ibid, 6.

140 Ibid, 6-7.

141 Bainbridge, “In Defense of the Shareholder Wealth Maximization Norm”, above n 13, 1438. Continuing the example in footnote 133, Bainbridge here states:

[If management’s compensation is tied to firm size, we can expect it to resist down-sizing the firm. The plant likely will stay open, with the decision being justified by reference to the impact of a closing on the plant’s workers and the local community. In contrast, if management’s compensation is linked to firm profitability, the plant will likely close, with the decision being justified by management’s concern for the firm’s shareholders, creditors, and other benefited constituencies.

See also Capasso, above n 118, 14.
4.4.2.2 In-Practice Approaches to Implementation of the Stakeholder Model

Maximising Stakeholder (Including Shareholder) Interests Essential to Sustainability

In this subsection, the relational approach will assume that maximising in an ongoing sense the various stakeholder interests (including but not limited to shareholder-stakeholders) of the corporation is essential to the long-term existence/sustainability of the firm. This assumption, in effect, equates the maximisation (in the long term) of all stakeholder needs with the purpose of ‘good’ corporate governance. Therefore, and here accepting the problems of how the competing stakeholder interests are to be weighed, how could such a model work in practice?

One way is through the use of ‘non-shareholder constituency statutes’. These are provisions which expressly limit, in favour of particular stakeholders, the shareholder-wealth maximisation principle (or relevant provisions of the relevant companies statute) and these are also considered by CAMAC.

Another method to address the problem of the weighing of competing corporate stakeholder interests requires, on some views, little or no amendment to existing corporations’ legislation. Bainbridge, for one, does not overstate this balancing problem, suggesting that non-shareholder interests can often be catered for even in difficult cases - with the ‘business judgement rule’ in the US providing a viable defence for directors in most cases where shareholder ‘wealth’ is diminished.

While a detailed examination of Australia’s comparative Corporations Act subsection 180(2) is beyond the scope of this explanatory stage of the relational approach, CAMAC considers

---

142 In fact, the argument that maximising such stakeholder interests is for the long-term benefit of shareholders could be argued solely under the shareholder primacy principle.


144 Bainbridge, “In Defense of the Shareholder Wealth Maximization Norm”, above n 13, 1438-9 and 1440-1. See also Bainbridge, "Director Primacy: The Means and Ends of Corporate Governance", above n 73, 44.

145 Corporations Act 2001 (Cth), subsection 180(2) states:

Business judgment rule

(2) A director or other officer of a corporation who makes a business judgment is taken to meet the requirements of subsection (1), and their equivalent duties at common law and in equity, in respect of the judgment if they:

(a) make the judgment in good faith for a proper purpose; and
(b) do not have a material personal interest in the subject matter of the judgment; and
(c) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and
(d) rationally believe that the judgment is in the best interests of the corporation.

The director's or officer's belief that the judgment is in the best interests of the corporation is a rational one unless the belief is one that no reasonable person in their position would hold.
various proposals for legislative change in this respect\textsuperscript{146} and these include “an amended business judgment defence”\textsuperscript{147}. Ultimately, CAMAC views amendment to current law and statutory provisions as unnecessary as these “are sufficiently broad to enable corporate decision-makers to take into account the environmental and other social impacts of their decisions…”\textsuperscript{148}. CAMAC further observes that such amendments to require or permit directors to consider specific stakeholder interests could introduce uncertainty\textsuperscript{149}.

Again, the CAMAC Social Responsibility Report reviews various approaches to the incorporation of social responsibility interests in practice by corporations\textsuperscript{150}. CAMAC’s ‘business’ approach – which argues that satisfying ‘environmental’ and ‘social’ interests is in the interests of the company’s long-term value – bears some similarity to Jensen’s solution which is to propose a new ‘enlightened stakeholder theory’ which provides the traditional stakeholder model with:

\begin{quote}
 the simple specification that the objective function—the overriding goal—of the firm is to maximize total long-term firm market value\textsuperscript{151}
\end{quote}

This specification provides a means for managers to assess and compromise competing stakeholder interests\textsuperscript{152}.

This may well be, this chapter submits, the effect of the current combination of provisions in Australia. In other words, the effects of Revised Principles 3, 3.1 and Box 3.1 of the ASX 2007-10 Revised Principles\textsuperscript{153} and \textit{Corporations Act} subsection 181(1)(a) which provides that a director’s powers and duties must be exercised “in good faith in the best interests of the corporation”\textsuperscript{154} (i.e., under \textit{Walker v Wimborne}, for the benefit of its shareholders\textsuperscript{155}) might approximate the ‘enlightened stakeholder theory’ position.

Another way discussed by Turnbull is for stakeholder interests to receive formal recognition through ‘stakeholder panels’\textsuperscript{156}:

\begin{quote}
\end{quote}

\textsuperscript{146} CAMAC Social Responsibility, above n 110, Para [3.11.4], pp 109-110.
\textsuperscript{147} Ibid, Para [3.11.4], p. 109 (emphasis in original). See discussion in section 4.4.1.1 of this chapter 4.
\textsuperscript{148} Ibid, Para [3.12], p. 111.
\textsuperscript{149} Ibid, Para [3.12], pp. 111-112.
\textsuperscript{150} Ibid, Para [2.3], pp. 34-54.
\textsuperscript{151} Jensen, ”Value Maximization, Stakeholder Theory, and the Corporate Objective Function”, above n 108, 16-17.
\textsuperscript{153} See discussion in section 4.4.1.3 of this chapter 4.
\textsuperscript{154} \textit{Corporations Act} 2001 (Cth), subsection 181(1)(a).
\textsuperscript{155} \textit{Walker v Wimborne} [1976] HCA 7; (1976) 137 CLR 1 (3 March 1976). See discussion in section 4.4.1.2 of this chapter 4.
Large organisations would thus enable each class of strategic stakeholder to nominate and elect their own panel. In turn, these panels could play a role not just of scrutiny but of active involvement in the business of the organisation.\textsuperscript{157}

In addition, Turnbull describes that a ‘stakeholder council’ would then be elected from the panels to perform a monitoring role in the organisation\textsuperscript{158} and other structures are also contemplated.\textsuperscript{159} Capasso also notes (with controversy) the possibility of giving principal stakeholders a seat on the board.\textsuperscript{160}

How, then, is the problem of the constituency and priority of shareholder and rival stakeholder interests reflected in the relational approach? This is described in the next subsection.

\subsection*{4.4.2.3 The Constituency and Priority of Shareholder vis-à-vis Stakeholder Interests and the Purpose of the Relational Approach}

The relational approach – through the Three Relational Axes of Good Governance, Governance Factors and Interrelationship Schemes - is designed to determine the appropriate constituency or priority of stakeholder interests under the stakeholder model which may enhance the long-term efficiency and survival/sustainability of the corporation.

\textit{The Relational Approach Minimises Agency Costs to Prioritise Stakeholder-Shareholder Interests}

Accepting that it is necessary (as described in subsection 4.4.1.1) to maximise ‘other’ stakeholder interests in a shareholder-primacy environment, this chapter shows that the relational approach can determine or assess the priority of such interests (including, of course, the pre-eminence of the shareholder interests and/or interests prescribed in ‘non-shareholder constituency’ statutes and the like).

The relational approach solves the question of the identity and priority of competing stakeholder-shareholder interests with its own overriding goal for the firm – that the function of the firm is to minimise long-term agency costs.

\textsuperscript{157} Ibid, 35.
\textsuperscript{158} Ibid, 36.
\textsuperscript{160} Capasso, above n 118, 15.

For example, the relational approach will assist directors of the corporation to identify and prioritise interests by the weighing of the eight Governance Factors as applied to each proposed alternative course of action. Again, this exemplifies the critical nature of the Governance Factors to the operation of the relational approach.

Continuing this example, in the relational approach’s Shareholder-Primacy Interrelationship Scheme in Figure 2.7.2A, the Alignment Factor reflects the shareholder model and the Corporations Act subsection 181(1)(a). It acts as an ‘umbrella’ or ‘guiding’ principle over other Governance Factors (except the Compliance Factor No. 2). The Stakeholders Factor No. 6 reflects the influence of the stakeholder model. It remains a relevant and operative Governance Factor but does not predominate.

Also in the relational approach’s shareholder-primacy mode, the Positional Conflict Axis No. 3 will direct the application of the Objectives Axis No. 1 and the Behaviours Axis No. 2. It will treat widely-dispersed shareholder-stakeholders as predominant vis-à-vis other stakeholders (but, of course, still outside vis-à-vis directors and management). All this is subject to the overriding requirement above – that the overriding goal for the firm is to minimise long-term agency costs.

Support for the relational approach’s overriding goal of minimising agency costs can be drawn from Jensen’s ‘enlightened stakeholder theory’.161 Jensen’s own overriding goal in assessing and prioritising competing stakeholder-shareholder interests is to maximise long-term firm market value.162 The relational approach is constructed on the basis that reducing long-term agency costs in turn enhances the long-term efficiency and sustainability of the firm. As described in section 1.5, the relational approach assumes in chapters 2 – 6 that applying the weighing mechanism in a manner to reduce agency costs enhances shareholder-wealth welfare proxies or measures such as the firm’s cost of capital, firm value (as Jensen would have) and firm operating performance and reduces earnings management.163 In chapters 7 – 10, the relational approach examines empirical studies to determine the real-world effects of Governance Variables in enhancing these proxies or measures and reducing earnings management.

In future stages, the relational approach’s agency cost: sustainability relationship can be empirically tested.

4.5 Concluding Remarks for Chapter 4

This chapter 4 has explained the theoretical foundations of the relational approach by reference to Key Field No. 1 – the Application of the Principal Theories of the Firm to the Relational Approach. In particular, the chapter has examined the theoretical basis of the relational approach’s Weighing Mechanism – the Three Relational Axes of Good Governance, the eight Governance Factors and the two Interrelationship Schemes.

This chapter has emphasised the separation of ownership from management which gives rise to agency costs between insiders and outsiders. Thus, the corporation must apply

161 See discussion in section 4.4.2.2 of this chapter 4.
163 See discussion in subsection 1.5 of chapter 1.
countervailing Governance Variables to monitor, limit or punish management misconduct or to align the interests of insiders and outsiders.

The chapter has examined the currently pre-eminent theories of the firm to demonstrate how the relational approach adds explanatory power to the nexus of contracts, agency costs theory, the shareholder primacy model, the stakeholder model and the director primacy model. In particular, the examination of these models has highlighted that the foundations of the Weighing Mechanism rests upon the nexus of contracts and agency costs. Indeed, the Weighing Mechanism of the relational approach is a theoretical representation of the nexus of contracts itself. The relational approach’s operational Tables – the Coverage Table 3.3.1 and Relational Proximity Table 3.3.2.1 – are the operational representation of the nexus.

The relational approach utilises two Interrelationship Schemes in Figures 2.7.2A and 2.7.2B. The Interrelationship Schemes represent either shareholder-primacy or stakeholder model ‘modes’. Each Scheme is a diagrammatic representation of the hypothesised interrelationships between the Governance Factors under the relevant mode or model. In the shareholder-primacy mode, the Alignment Factor No. 3 is an ‘umbrella’ or ‘guiding’ principle over all other Governance Factors except the Compliance Factor No. 2.

In stakeholder model mode, the Stakeholders Factor No. 6 together with the Alignment Factor No. 3 constitute the ‘umbrella’ or ‘guiding’ principles over the other Governance Factors again with the exception of the Compliance Factor No. 2.

Important in this chapter 4 has been to highlight arguments that maximising stakeholder interests is critical for the sustainability of the corporation. In this respect, this chapter has shown that one purpose of the Governance Variables in the relational approach is to balance or weigh the various stakeholder interests inter se and against the shareholder-value maximisation principle in order to achieve long term efficiency and sustainability of the corporation. The relational approach solves the question of the identity and priority of competing stakeholder-shareholder interests with its own overriding goal for the firm – to minimise long-term agency costs.

The next chapter five distils the underlying themes and tensions from Key Field No. 2 – Autopsies of the Enron and Hastie Corporate Collapses - to determine the extent of the real world failures in Governance Variables which spring from the theory in this chapter. This is undertaken for the purposes of the identification, construction and articulation of the eight Governance Factors, to identify the intervening factors or variables which reduced the effectiveness of the Governance Variables examined in the thesis and to show how the Governance Variables in Table 2.4 behaved in the multitude of failures of those collapses. Many of these Governance Variables came to form the international and national Governance Codes examined in Key Field No. 2 (Comparative Corporate Governance Codes) in chapter 6 and whose effectiveness is assessed in the empirical studies of the effectiveness of Governance Variables in Key Field No. 4 in chapters 7 – 10.

---

164 See also the discussion in section 2.7.1 – 2.7.2 of chapter 2.
165 See discussion in sections 2.6.1 – 2.6.8 of chapter 2.
The firm collapsed for the most mundane of reasons--its managers suffered the behavioral biases of successful entrepreneurs. They overemphasized the upside and lacked patience. They pursued heroic short term growth numbers that their business plan could not deliver. That pursuit of immediate shareholder value caused them to become risk prone, engaging in levered speculation, earnings manipulation, and concealment of critical information.

They were rogues to be sure, but the self regulatory system nevertheless is deeply implicated in their company’s failure. Enron’s collapse reminds us that our corporate governance system takes some significant risks in the name of encouraging innovation and entrepreneurship and economizing on enforcement costs.

William W Bratton on Enron's demise

In this chapter 5, the thesis examines Key Field No. 2 - the well-known corporate collapse of Enron in the United States and the collapse of the Hastie Group in Australia. Enron’s dramatic rise from the largest pipeline owner to the seventh largest US company is documented extensively:

Enron began in the mid-1980s as a gas pipeline company owning the largest gas pipeline in the United States. It was formed by the merger of two natural gas pipeline companies, Houston Natural Gas and InterNorth. This merger left Enron with $4.2 billion in debt. Using additional debt financing, Enron soon acquired other energy-related assets, including power plants. In 1989, after deregulation of the gas industry, it opened GasBank—an energy trading operation that allowed consumers of natural gas to secure reliable sources of supply at a predictable price. Five years later, it created a market for


2 See the literature on the Enron and other corporate collapses in Appendix B2, Accounts of the Enron and Other Corporate Collapses.
electricity. These two markets operated at the wholesale level. By the late 1990s, most of Enron’s earnings came from businesses in which it had not engaged in ten years earlier.3

Thus, this Key Field has been chosen as literature on Enron is one of the four most significant and influential areas of corporate governance measured by the number of articles and/or working papers on the Social Science Research Network (SSRN).4 In other words, works on the Enron collapse were selected as one of the most expansive areas in corporate governance discourse measured by number of works. But while there is a huge volume of information and analysis in relation to Enron, there is little on Hastie. Hastie was selected for a different reason. As a relatively recent example of Governance Variable failures in a post-GFC climate, Hastie is illuminating on account of the detail provided by the Administrators’ Report in relation to the collapse.5 Thus, the analysis will be drawn in this US: Australian comparison to highlight recurring themes and tensions in the two collapses and to demonstrate the purchase of the relational approach in both the US and Australian contexts and in the present post-GFC time.

Overview of Hastie Group Collapse

The Hastie Group collapse is still unfolding. Hastie Group Limited (‘HST’), a listed company on the ASX, and a long string of subsidiaries were placed into Administration on 28 May 2012 with the Report by Administrators pursuant to section 439A of the Corporations Act 2001 published on 21 January 2013.6 After listing in March 2005, the Group embarked on a major acquisition programme with 8 businesses acquired in the period from the 2008 financial year to the 2010 financial year totalling $278m.7 The Administrators’ Report notes that businesses were acquired in Australia, New Zealand, Ireland and other countries.8 Much would appear in the Administrators’ Report relating to acquisitions in the Middle East including UAE, Saudi Arabia and Qatar.9 A large organisation emerged:

By [the 2011 financial year] Hastie Group had 7,000 employees, turnover in excess of $1.8b[illion], construction work-in-progress (WIP) of $2.9b[illion] and assets employed of nearly $1b[illion].10

The Administrators’ Report describes steady growth in revenue over the five years after listing but a sharp fall in profitability:

- …gross profit margins, EBIT [Earnings Before Interest and Tax] and overall profitability declined dramatically:
  - A loss of [approximately $258million] was reportedly incurred in the 22 months to 30 April 2012

4 See discussion in section 1.4 of chapter 1.
6 Administrators’ Report, ibid, section 2.1, p. 10 of 99.
7 Ibid, section 2.5.1, p. 12 of 99.
8 Ibid.
9 Ibid
10 Ibid.
Gross profit margin fell from 17% in [the 2005 financial year] to 10% in [the 2012 financial year] and
Earnings fell from $90.1m in [the 2009 financial year] to a loss of ($169.8m) for the 10 months to 30 April 2012.11

A “Timeline of Key Events” in the Administrators’ Report identifies five separate profit downgrades in the period from November 2010 to May 2012.12 The company entered into a ‘standstill’ agreement with its major banking syndicate and its banking covenants over this period were on occasions revised, breached (minor) and removed.13 The company undertook an equity raising of $158 million to repay a large proportion of syndicate debt.14

The Group’s most significant assets – goodwill, trade and other receivables and Work-In-Progress (WIP) – suffered large write-downs in each of the financial years 2010, 2011 and 2012 totalling $254 million.15 Still, at the date of the Administrators’ Report, the Administrators considered that these write-downs may not have been taken against profit early enough.16 Additionally, deferred tax assets were likely to be overstated.17 At different times, the CEO, CFO and Chairperson resigned. Charges against Earnings Before Interest and Tax (EBIT) for Middle East operations were announced of $55 million then increased to $88 million.18

Tellingly, trading in Hastie Group shares was suspended on two occasions - in February to April 2011 and then in April 2012, the latter lasting through to the time the company entered Administration.19 During the second suspension, the Board was informed of accounting irregularities of $20 million.20 The Administrators have recommended to creditors that all Hastie Group companies be wound up as insolvent.21

The Three Aims of Chapter 5

With these two collapses under the microscope, the approach of this chapter is threefold. First, the chapter extracts the themes and tensions underlying the Enron corporate collapse to support the identification, structure and articulation of the eight Governance Factors examined in chapters one and two.22 For a comparison of the pre- and post-GFC economic and governance climate, the examination of the Enron collapse is juxtaposed with that of the Hastie Group. The second aim is to identify the intervening variables of these organisations and their governance structures which reduced the effectiveness of the Governance Variables examined in this thesis. Third, as Bratton’s comments suggest in the case of Enron, these collapses involved a multitude of governance failures. These variables continue to be central to the

13 Ibid.
15 Ibid.
18 Ibid, Timeline of Key Events, p. 17 of 99 and section 5.2, p. 29 of 99.
19 Ibid.
20 Ibid.
21 Ibid, section 2.3, p. 11 of 99.
22 See discussion in section 1.7.1 of chapter 1 and sections 2.6.1 – 2.6.8 of chapter 2.
examination of the GFC. In other words, how did the 39 Governance Variables behave during the Enron and Hastie Group collapses?

The examination of failures in Governance Variables highlighted in this chapter will serve as a precursor to the examination of Key Field No. 3 - Comparative Corporate Governance Codes. This chapter identifies problems in the operation of many of the Governance Variables which are shown to be central or core features in the development of these codes and which continue in operation today.

5.2 Failures in ‘Central’ or ‘Proximate’ Governance Variables

In a nutshell, Gordon observes that:

"[The Enron case has seemed particularly disturbing because the case represents a failed stress test for many institutions of US shareholder capitalism, circa 1990s. As with most catastrophes, many separate systems simultaneously failed: auditing and accounting, executive compensation, internal monitoring by the board, and external monitoring by securities analysts."

This chapter focuses on these perceived problems including those relating to board and director-related variables, factors affecting earnings manipulation (including CEO, executive and director compensation structures), the external audit function and other financial intermediaries.

5.2.1 Agency Theory and the Shareholder Model

5.2.1.1 Market for Corporate Control and Efficient Market Hypothesis Undermined in the Enron Collapse

Gordon highlights, as a particular aspect of the Enron collapse, failings in the operation of the efficient market hypothesis. For Gordon, the variance between Enron’s share price, at one time US$90, and its ‘intrinsic value’ was striking despite the scrutiny of investors and securities analysts for this widely held stock. The answer, for Gordon, had two strands. First, the complexity of the company’s structure and off-balance-sheet transactions should have led (but did not) to a markdown in share price on account of the information asymmetry problems. Second, the lack of integrity of the auditor’s certification (supported by supposed reputational constraints on the auditor) of the financial accounts as “fairly” presenting Enron’s...
financial position was a ‘foreseeable failure’ – and, again, should have been reflected in a markdown of share price. This was on account of its lack of independence due to non-audit (particularly tax) services and failures of its own internal controls, both of which were known to ‘sophisticated’ investors.31 In short, Gordon appears to treat the Enron collapse as an example (at least in part) of two of the problems identified in chapter 4 – information asymmetry and time lag – and without satisfactory explanation for the failure of the market price mechanism to correct for these.33

**Hastie Group Danger Signs Were Prominent**

By contrast, the Hastie Group collapse had some prominent danger signs truer to the efficient market model. As noted in the introduction to this chapter, these included a ‘standstill’ agreement with its major banking syndicate, the breach, revision and removal of its banking covenants, an equity raising of $158 million to improve its balance sheet position and five Earnings Before Interest and Tax (EBIT) downgrades.34 The Group suffered large write-downs in each of the financial years 2010, 2011 and 2012 to goodwill, trade and other receivables and Work-In-Progress (WIP). Resignations of several key management positions took place. Charges against EBIT for Middle East operations were announced of $55 million then increased to $88 million.35 And trading in Hastie Group shares were suspended on two occasions. The half-year 2012 financial accounts noted material uncertainty in relation to the ‘going concern’ of the Group.36

However, there were time lag issues with significant effects. In relation to the asset write-downs, the Administrators have reported that:

- …had the write-downs been recognised earlier, the potential effects may have included:
  - Hastie Group breaching its banking covenants earlier/more frequently
  - the quantum of the capital raising in June 2011 being increased
  - the capital raising being carried out earlier
  - administrators being appointed earlier [and]
  - changes to investors’ and financiers’ decisions regarding investing in or supporting the Hastie Group.37

As a result of the overstatement of goodwill, the Administrators considered that the relevant “financial statements may be materially misstated and misleading to users of that information, particularly the investors who relied on the financial statements and forecasts included in the Prospectus.”38 Similar comments were made in relation to the late timing of write-offs for trade and other receivables39 and the construction Work-In-Progress element of inventories.40

---

31 Ibid, 6-9.
32 See discussion in section 4.2.2 of chapter 4.
34 Administrators’ Report, above n 5, section 2.5.2, p. 13 of 99 and Timeline of Key Events, p. 17 of 99.
36 Ibid.
37 Ibid, section 2.5.2, p. 13 of 99 (bullet-points in original).
Baird and Rasmussen point to a failure to understand (at least part of) the Enron business model as the first of their lessons from the Enron collapse. Translating this in terms of the efficient market hypothesis is that the market cannot correct for what it fails to understand. Indeed, the authors indicate that Enron’s complicated trading structure - where each trader was a “stand-alone profit center” - enhanced the appearance (but obscured the nature) of trading profits. In addition, Baird and Rasmussen tell us that the sheer complexity of the structure of interrelated entities – for example, the Special Purpose Entities described below - made both valuation of Enron as a whole and assessment of the solvency of those entities extremely difficult.

5.2.2 Board and Director Variables

5.2.2.1 Enron Director Independence Undermined by Equity Holdings and Share Options

As discussed later in the thesis, director independence is a core Governance Variable and is considered as critical to the board’s function of the monitoring of management. This thesis’ examination of the relationship between firm operating performance and/or value and the level of equity holdings of the CEO, management and both inside and outside directors had inconclusive results. Instead, a balancing exercise is required to ‘optimise’ the ‘incentive alignment’ and ‘entrenchment’ effects of these holdings as identified by Fuerst and Kang. In the Enron collapse, two principal reasons are highlighted. While authors such as Branson point to ‘outrageously high’ directors’ fees and consulting contracts for directors, a more prominent reason given for this lack of independence is the equity holdings and share options of supposedly outside directors. The Hastie Administrator’s Report also noted a number of director personal share holdings in the listed HST company but with no questions or conclusions drawn in the Report of the effects, if any, of these holdings.

5.2.2.1.1 Enron Share and Option Holdings May Affect Monitoring

Gillan and Martin’s views point squarely to problems in the quality of monitoring as a result of Enron director share and option holdings and conflicts of interest on the audit, finance and

---

40 Ibid, section 6.2.3, p. 43 of 99.
41 Baird and Rasmussen, above n 3, 117.
42 Ibid, 118.
43 See discussion in section 5.2.3.1 of this chapter 5.
44 Baird and Rasmussen, above n 3, 120-122.
45 See discussion in section 6.8.1 of chapter 6 and section 7.3.2.1 of chapter 7.
46 See discussion in section 7.3.2.1.4 of chapter 7
47 O Fuerst and S Kang, “Corporate Governance, Expected Operating Performance, and Pricing”, available at SSRN: http://ssrn.com/abstract=141357. See sections 7.3.2 and 7.3.2.1.5 of chapter 7 and section 10.2.1 of chapter 10.
50 See section 2.6.4 of chapter 2 for a discussion of the Compensation Factor No. 4 – Board, CEO and Management Compensation and Incentives.
nominating and corporate governance committees.\textsuperscript{51} The authors are also critical of Enron’s director compensation policy for undermining independence.\textsuperscript{52} For the authors, these arrangements and the share and option holdings of directors affected the management function as they “may have attenuated any inclination to aggressively monitor management’s practices”.\textsuperscript{53}

For Gordon\textsuperscript{54}, the director independence variable as a mechanism to enhance the monitoring of management was undermined by similar factors – substantial share ownership, the receipt of share options and excessive director compensation - “since a director’s sharp questioning of senior management may led (sic) to subtle pressures against his/her renomination”.\textsuperscript{55} In the case of share options, Gordon explains that, while such options may enhance the ‘alignment’ of managerial and outside shareholder interests, they may also inhibit directors in their monitoring function of making necessary enquiries of management due to “ambivalence about uncovering embarrassing facts that will reduce the share price”.\textsuperscript{56} The author observes that the problem in relation to stock options is “that they provide perverse managerial incentives” so “that managers will be strongly tempted to produce the financial results the market “expects” through manipulation of financial results.”\textsuperscript{57} Gordon observes that the Enron options had a significant accelerated vesting feature:

\begin{quote}
[\textit{moreover, the Enron compensation package provided for performance-based accelerated vesting that may have turbocharged these features. As the potential gains associated with options exercise grow in absolute amount – an increasing function in both the number of options granted and the rate of appreciation in the firm’s stock – these granting and exercise practices may tempt managers to “take the money and run.”}]\textsuperscript{58}
\end{quote}

Thus the structure of the options themselves exacerbated governance problems related to earnings manipulation which will be further discussed below.\textsuperscript{59}

\section{Enron Option Holdings and Risk Management}

Risk management issues at Enron are discussed below. But for Blanchard and Dionne, risk management also poses conflict of interest issues between inside directors and outside directors.\textsuperscript{60}

\textsuperscript{52} Ibid, 24.
\textsuperscript{54} See discussion in subsection 2.6.4 of chapter 2.
\textsuperscript{55} Gordon, above n 27, 12.
\textsuperscript{56} Ibid.
\textsuperscript{58} Gordon, above n 26, 5 (footnote omitted).
\textsuperscript{59} See discussion in section 5.2.3 of this chapter 5.
shareholders when stock options are paid to those directors.\textsuperscript{60} The authors suggest that directors on the company’s risk management committee therefore hold no stock options.\textsuperscript{61}

5.2.2.2 **Enron Board Member ‘Familiarity’, ‘Deference’ and the Independence of Committees**

The operation of a number of committees is contemplated by the Governance Variables listed in Table 2.4. - the audit committee (which, in the case of the Hastie Group, included risk management), nominating committee and the compensation committee. In Enron, problems were raised by independent directors (who were themselves CEOs or former CEOs of other companies) ‘deferring’ to ‘inside’ directors, a matter exacerbated by the length of the CEO’s tenure.\textsuperscript{62} In Enron, Gordon observed “bonds of long service and familiarity” in the boardroom.\textsuperscript{63}

‘**Dysfunctional Deference’ of the Enron Board**

For Sharfman and Toll, the failures in monitoring, questioning and supervision on the Enron board were due to what they call ‘dysfunctional deference’\textsuperscript{64} so “that there was little or no deliberation preceding some of the board’s most important decisions.”\textsuperscript{65} For the authors, the reasons lay in part in ‘informational signals’ – that directors believed public perceptions of the company and so, with little contact with management, relied on inside directors and executives.\textsuperscript{66} This was compounded by the fact that many independent directors had been former CEOs of the company and/or had been long-serving during a long period of perceived success.\textsuperscript{67} In addition, they suggest that directors may have been influenced by ‘informational cascades’ created by ‘management-generated’ briefing papers and recommendations or followed the ‘domino effect’ of the decisions and signals of others such as Kenneth Lay, Enron’s founding CEO.\textsuperscript{68}

\textsuperscript{61} Ibid.
\textsuperscript{62} See discussion in sections 7.3.2.1.1 and 7.3.2.1.3 of chapter 7. Bratton examines the monitoring failings of the Enron outside directors in Bratton, above n 1, 55.
\textsuperscript{63} Gordon, above n 27, 11.


\textsuperscript{65} Ibid, 155.
\textsuperscript{66} Ibid, 157-8.
\textsuperscript{67} Ibid, 158.
\textsuperscript{68} Ibid, 156 and 159 and Bratton, above n 1, 3. See also, Erica Beecher-Monas, “Marrying Diversity and Independence in the Boardroom: Just How Far Have You Come, Baby?”, Wayne State University Law School
The familiarity and deference factors may have affected some critical areas of director interaction in the Enron collapse. Gillan and Martin suggest that the board’s monitoring function may have been undermined by the regular attendance of the Chairman and (separate) CEO at various committees – particularly, ‘executive’, ‘finance’ and ‘audit’.69 To enhance independence consequent on Enron, Branson urges that independent directors and board committees – including audit, finance and nomination - exclude senior management from meetings.70 In addition, independent audit firm partners should meet with the audit committee again in absence of senior management.71

The Hastie collapse appears also to involve a form of dysfunctional deference, although not named as such by the Administrators:

- the Board did not appear to adequately challenge divisional/subsidiary results or forecasts...
- there appears to have been a general culture of ignoring bad news... [and]
- the Board, prior to the appointment of the interim CEO... appeared not to have ‘an enquiring mind’ as to reliability of financial statements and overall reporting72

Thus, the Hastie Board’s dysfunction may be seen as a product of the culture73 at the company - a culture of failure to enquire into or challenge financial information and of ignoring bad news. But the result is the same as in Enron – little or no deliberation involved in the Board’s decision-making processes in relation to financial reporting.


70 Branson, above n 48, 1016-7.
71 Ibid.
72 Administrators’ Report, above n 5, section 2.5.3, p. 14 of 99.
73 See discussion in section 5.2.2.3.2 of this chapter 5.
5.2.2.3  Risk Management – ‘Innovation’ vs ‘Control’

5.2.2.3.1  Enron Risk Management Complexity and the Adequacy of Reports, Monitoring and Control

Rosen discusses in detail risk management failures within Enron, particularly in the case of various ‘off-balance sheet’ transactions discussed below. In particular, the author highlights the complexity of the transactions questioning the capacity of finance committee and board members to fully understand risk management reports in relation to the transactions. In addition, Rosen questions the quality of the risk management reports themselves. Finally, Rosen identifies the limited role played by Enron’s risk management group in the approval of transactions:

[To exemplify risk management’s limited role at Enron, consider its failures to establish adequate procedures for approving projects and ensuring that all projects enter the approval process.]

The author concludes that the content-standard of risk management reports did not explain risks adequately for monitoring purposes leading to poor decision-making.


75 Ibid, 1175-6.

76 Ibid, 1176.

‘SPEs’ or ‘Special Purpose Entities’ are described in section 5.2.3.1 below. Internal control failures in relation to the SPEs are also examined in Stuart L Gillan and John D Martin, “Corporate Governance Post-Enron: Effective Reforms, or Closing the Stable Door?”, (March 21, 2007), available at SSRN: http://ssrn.com/abstract=977585, 12-15.

77 Rosen, above n 74, 1178-9.

78 Ibid,1179.


[This paper also investigates the risk and performance relationship when directors occupy positions on both committees (hereafter, “dual membership”). The study finds a positive association between risk and performance when committee members simultaneously serve on the RC and CC. This result demonstrates lower information asymmetry when directors have responsibilities in both committees as they are able to oversee the association between the firm’s risk exposure and the proportion of risk-taking incentives in compensation packages. Subsequently, more informed decisions result in a positive association between risk and performance. Although the result disappears when controlling for endogeneity, dual committee membership remains positively significantly associated with firm performance.

Inadequacies in Hastie Audit and Risk Committee, Monitoring and Control

The Administrators of the Hastie Group listed as one reason for the group’s failure that “the Audit and Risk Committee (ARC) was largely inactive”. They considered the failure was also caused by:

- inadequate operational management processes…;
- inadequate management reporting systems, including from subsidiary management to the Board…;
- inadequate Board reporting systems and interrogation of management and financial reports by the Board…; [and]
- inadequate control exercised by the Board over management.

Further “serious deficiencies with the overall control of the Hastie Group” included:

- internal systems for project management were inadequate and not to industry standard…[and]
- there was possibly a lack of due diligence around acquisitions.


80 Ibid. See also, section 7.9, p. 61 of 99 and section 7.9.5, p. 65 of 99 (bullet-points in original).
81 Ibid.
Hastie is thus an overwhelming example of inadequacy in the Board’s primary monitoring and control subcommittee – the Audit and Risk Committee – as well as the monitoring and control functions in general.

**Poor Management and Monitoring of Hastie Acquisitions**

The introduction to this chapter noted a significant acquisition program on the part of Hastie with eight businesses acquired in the financial years 2008 to 2010 totalling $278 million. However, poor management and monitoring by the Board appears to have contributed to falls in the profitability of various of these businesses:

- The decline in the Hastie Group’s performance subsequent to the various business acquisitions and poor retention of key management/ex owners after they had completed their earn-out periods indicates potential mismanagement, poor strategy implementation and monitoring by the Board...

Indeed, the Administrators conclude there was a “poorly implemented acquisition strategy” with “profitable companies subsidising the loss-making Middle East businesses”. The acquisition strategy resulted in:

- high levels of debt funding and associated costs
- subsidisation of losses in the Middle East by other profitable businesses
- poor post-acquisition performance of acquired businesses
- duplication of overhead costs [and]
- inaccurate and inadequate financial reporting and consequently poor decision making by the Board.

**Inadequate Risk Assessment and Control of Hastie Middle East Projects**

The “failure to assess adequately the risks of expansion into foreign jurisdictions significantly affected cash flow”. Relevant risks in the Middle East not assessed properly included “project management, the recovery of receivables and options for dispute resolution”. Post-acquisition failures included “a lack of integration, performance management and appropriate oversight from the Board”. The size of the Middle-East losses were contributed to by:

- Middle East management’s poor project management and communication with customers
- a lack of support for Middle East management from the Board [and]
- poor control and oversight from the Board.

**Significant Failures in Relation to Construction Work-in-Progress**

Perhaps most scathing is the Administrators’ comments in relation to construction Work-in-Progress. There a relevant report to the Board had noted:

---

82 Ibid, section 2.5.1, p. 12 of 99.
83 Ibid, section 2.5.2, p. 14 of 99 (bullet-point in original).
84 Ibid, section 7.9, p. 61 of 99.
87 Ibid.
89 Ibid, section 7.9.3, p. 63 of 99 (bullet points in original).
• the Hastie Group had a history of poor project management
• there was an absence of project governance frameworks
• contract variations (even on the largest contracts) were not communicated to clients
• valid claims were not fully pursued
• a lack of honesty in the financial reporting
• a culture that may have led to hiding margin write-backs and losses [and]
• contract finalisation in the Middle East may have been deliberately avoided so that losses did not have to be taken to account.90

Thus, in the end, the Hastie Group collapse is a significant departure from best practice in project management, risk management, monitoring and control. Significant, too, was the lack of honesty in financial reporting with a culture of hiding write-backs and losses. It is to these culture issues that the thesis now turns

5.2.2.3.2 Risk Management and Company Culture

The very culture at Enron has been argued to have contributed to the subversion of management control practices.91 Free and Macintosh describe an ultra-competitive culture where dissent was stifled, misconduct was overlooked and tolerated in the pursuit of risk and gain and where incentives distorted moral and ethical norms to achieve short-term figures.92

90 Ibid, section 6.2.3, pp. 43-44 of 99 (bullet-points in original).


[s]tronger shareholder governance significantly increases results-orientation but decreases customer-orientation, integrity, and collaboration. Consistent with the positive link between gov- ernance and value, stronger governance increases tangible results such as sales and profitability in the short term. But by focusing on tangible benchmarks, managers hurt the intangibles, which is not in the firm’s best long-term interests. Governance reduces intangibles such as goodwill and customer satisfaction, which ends up reducing firm value by 1.4%.

The findings suggest that shareholders face a tradeoff between the unobservable quality of corporate culture and observable, tangible results. On net, the effect of governance changes is positive for the average firm. But quantile instrumental variable regressions show the effect is negative for many firms because of this corporate culture channel.

Culture issues at Hastie were presented in the preceding section in relation to the monitoring and valuation of construction Work-in-Progress. Further cultural problems reported at Hastie were presented in relation to 'dysfunctional deference' issues:

- the Board did not appear to adequately challenge divisional/subsidiary results or forecasts...
- there appears to have been a general culture of ignoring bad news...[and]
- the Board, prior to the appointment of the interim CEO...appeared not to have ‘an enquiring mind’ as to reliability of financial statements and overall reporting.

The Administrators also noted a report to the Board with adverse “internal cultural issues concerning inflated reported results and optimistic forecasting”. In the latter respect, they observed that “the 2011 prospectus was not adequately reviewed and challenged with regard to the financial forecasts”. Indeed, the preparation of financial forecasts was highly criticised, the administrators having found “no evidence that the Board reviewed the annual forecasts and compared them with actual results on a regular ongoing basis”. Instead, the Board should have:

- required more detailed actual to forecast information
- made regular monthly reviews of the actual to forecast performance [and]
- recast budgets and forecasts where actual performance indicated revision was necessary.

If this is a snapshot of the Enron risk-management culture, what was the effect of the consequent US’ Sarbanes-Oxley Act (‘SOX’) reforms? Vakkur et al’s 2009 study of 149 CEOs and 57 directors suggests that the SOX reforms did not cause “defensive management” and, thus, there was no reduction in the rate of firm innovation. However, the authors found that SOX had caused a “centralisation of core processes” and a managerial bias toward more conservative project selection.

### 5.2.3 Earnings Manipulation

Coffee contrasts corporate scandals in the US and Europe to explain that the nature of the scandal is driven by the differences in the structure of share ownership. Thus, for the

---

93 See discussion in section 5.2.2.2 of this chapter 5.
94 Administrators’ Report, above n 5, section 2.5.3, p. 14 of 99 (bullet-points in original).
97 Ibid, section 7.13.4, p. 77 of 99.
98 Ibid (bullet-points in original).

For a further explanation and comparison of how differences in share ownership affect corporate collapses and
article, dispersed ownership is the driver of earnings manipulation. If dispersed ownership is a factor in earnings manipulation – which is not contested – what structural factors in dispersed-ownership companies were exacerbated in the Enron and Hastie Group cases to contribute to the critical paths to collapse?

In the case of Enron, Catanach and Rhoades describe three factors identified by the US Treadway Commission in 1987 relating to the risk of fraudulent financial reporting - performance pressures, oversight issues, and changing structural conditions. In addressing the criteria, the authors highlight a fatal confluence of “significant contractual incentives” including the substantial debt and stock options of executives, the complex ownership and financial structures which reduced the efficacy of analyst, auditor and regulator monitoring and oversight and changes in the company’s innovativeness and business environment all contributing to the risk of earnings manipulation Yet the authors do not blame the often-


[the power of short-term shareholders, it is argued, leads to “short- termism”: managers feel pressured to boost the short-term stock price at the expense of maximizing the size of the economic pie created by the firm over time. To counter short-termism, commentators have proposed various reforms aimed at increasing both the number and power of long- term shareholders relative to short-term shareholders. These proposals appear to reflect the strongly-held intuition that managers serving long- term shareholders are likely to generate more value over time than managers serving short-term shareholders.]

In this paper, I have shown that this intuition is generally flawed. Although it is correct when a corporation does not transact heavily in its own shares in the short term, most corporations do just that. Indeed, the typical U.S. corporation buys and sells over 40% of its market capitalization over a five-year period. In such a transacting firm, long-term shareholders, like short-term shareholders, can benefit from firms destroying value. In many cases, long-term shareholders may even benefit more from value destruction than short-term shareholders. Thus, favoring long-term shareholders in the typical firm could actually reduce the pie.


105 Ibid.
argued inadequacy of the then current accounting standards and rules, instead identifying non-compliance as the issue at the heart of the accounting fraud and earnings manipulation.106

The opportunity for manipulation of financial reports was also a factor in the Hastie collapse through lack of uniformity. There, the Administrators concluded that “financial reporting from subsidiary level up to HST [Hastie Group Limited] was not uniform and open to manipulation”.107

Additionally, some structural blame for the Enron collapse was attributed to a significant fall in profit margins caused by competitive pressures from new entrants into the energy trading market:

Enron’s results for 1998, 1999, and 2000 suggest some interesting comparisons. The firm’s revenues increased by $10 billion from 1998 to 1999, and by $60 billion (to $100 billion) from 1999 to 2000. During the period, revenues contributed by Enron’s old economy asset businesses — its pipelines and water companies — stayed stable. The revenue growth came from Enron’s new economy trading business. Meanwhile, net after tax income rose much more slowly...Pre-tax profits...increased by $1 billion in 1998, and then by only $500 million in each of 1999 and 2000. These simple horizontal analyses suggest declining returns in the trading business. More particularly, even as Enron had opened more and more new trading territory, entrance barriers were low. As time went on, Enron had to deal with dozens of competitors who hired away its employees to compete in what had become its bread and butter business, undercutting its profit margins. According to one analyst, Enron’s trading margins collapsed from 5.3 percent in early 1998 to 1.7 percent in the third quarter of 2001.108

In the Hastie case, too, operating performance and margin difficulties arose. This time, some blame was laid at the feet of the GFC:

[while the GFC had its origins in August 2007, its full effect on entities such as the Hastie Group was delayed because of the time lag associated with large projects. The GFC’s detrimental effects started to emerge in the 2009 financial year...These effects included the deferral or cancelation of projects and lengthening of payment terms.109

Somewhat akin to Enron, Hastie also experienced an “increase in competition caused by the lower volume of new tenders” which impacted margins.110

5.2.3.1 Enron Earnings Management and ‘Off-Balance Sheet’ Transactions

In discussing the Enron collapse many commentators including Bratton, and, separately, Gillan and Martin, describe in detail various transactions involving Enron which allegedly involved ‘aggressive’ accounting treatments, disguised liabilities and concealment – and therefore, inflated revenue figures over several years.111 The Administrators considered that Hastie, too,
may have involved a failure to comply with accounting standards, this time relating to provisioning for asset impairment.\footnote{112}

In the case of accounting treatments, Gillan and Martin explain how Enron used ‘mark-to-market’ (or ‘fair value’) valuations for certain investments – such as power plants and pipelines – which ‘lacked observable market values’\footnote{113} and consequently brought into question some of the large ‘gains’ recorded in the company’s profit figures over several periods.\footnote{114} In the Hastie case, the failure to recognise asset write-downs in earlier periods resulted in material overstatement.\footnote{115} Thus, the Administrators observed that “compliance with accounting standards appears to be lacking, particularly with reference to provisioning for asset impairment”.\footnote{116}

Commentators also describe how Enron established ‘Special Purpose Entities’ or ‘SPEs’ - ordinarily permissible – which had the effect of disguising contingent liabilities and other debt which was properly required to be disclosed in the consolidated balance sheet.\footnote{117} In one case, available at SSRN: \url{http://ssrn.com/abstract=2246168} and Yongtae Kim, Siqi Li, Carrie H Pan and Luo Zuo, “The Role of Accounting Conservatism in the Equity Market: Evidence from Seasoned Equity Offerings” \textit{The Accounting Review}, Forthcoming, (April 2013), available at SSRN: \url{http://ssrn.com/abstract=2170179}.

\footnote{112} Administrators’ Report, above n 5, section 2.5.3, p. 14 of 99.
\footnote{113} Gillan and Martin, above n 51, 10.
\footnote{114} Ibid, 10-11.


\footnote{116} Ibid, section 7.3, p. 58 of 99.
\footnote{117} Bratton, above n 1, 30-31. See also Gillan and Martin, above n 51, 12-14.


For the suggestion that Enron’s collapse was not due to fraud relating to SPEs but to derivatives trading, see Frank Partnoy, “A Revisionist View of Enron and the Sudden Death of ‘May’” \cite{48(4) Villanova Law Review 1245} available at SSRN: \url{http://ssrn.com/abstract=417281}. See also Frank Partnoy, “Enron and Derivatives”, \cite{28 February 2002} available at SSRN: \url{http://ssrn.com/abstract=302332}.\footnote{118}
an SPE was managed by an Enron employee who reported to Enron’s CFO in breach of Enron’s own code of conduct for conflicts. The SPE funded a buyout of a joint venture partner by a loan guaranteed by Enron and an ‘outside’ equity requirement in the capital of the SPE was allegedly funded by a ‘disguised’ loan taken out by Enron. The result enabled Enron to recognise over US$400 million of income for the years 1997-2001 - which was subsequently restated downwards with over US$600 million of debt additionally recognised. For Fleischer, some of these transactions sought to manipulate earnings but minimise tax.

In another case, the outside equity requirements of two other SPEs established by Enron were allegedly supplied by limited partnerships of which an officer of Enron – the CFO - was allegedly in control and received substantial payment totalling some US$30 million. Yet more SPE-related transactions involved these two SPEs. Through a complicated series of transactions, hedging arrangements were entered into between Enron and the SPEs. Gillan and Martin explain that the arrangements relied, in effect, on the market value of Enron stock held by the SPEs to meet the SPE’s commitments and became unravelled once Enron’s share price began falling - the resultant ‘correction’ removed over US$1 billion from the ‘net shareholders equity’ of Enron. Discussing some of the hedge arrangements entered into by Enron and the relevant SPEs, Gillan and Martin concluded that “Enron effectively entered into hedges with itself”. Gordon, too, is critical of the conflicts of interest involved in these entities.

Why were these and other transactions entered into by Enron? The answer for some commentators lies - in part - in the form of executive compensation to which this chapter now turns.

5.2.3.2 Enron Earnings Manipulation and CEO, Executive and Director Compensation

A detailed investigation into the role of executive remuneration in corporate scandals, strategies to address this issue and the on-going evolution of regulation in the area has been undertaken by Professor Hill and will not be repeated in this work. In chapter 10, the thesis


examines issues relating to ‘good’ corporate governance and director, CEO and management compensation. Here, the chapter highlights aspects that recur in commentator examinations of the Enron collapse, in particular, the short-term structure of compensation schemes.

### 5.2.3.2.1 Enron Short-Term Share Options and Earnings Manipulation

Bratton suggests that the form of executive compensation – the granting of share options – contributed to the behaviour which resulted in earnings manipulation:

> [o]ption holding dulls the actor's sensitivity to degrees of distress on the downside, and at the same time gives the actor an incentive to generate chances for upside gains of high magnitude. Thus directed, a group of managers certainly would be more disposed to high risk strategies.\(^{129}\)

The Enron story involved a truly huge volume of options which were converted into stock and then sold by Enron executives and management:

> top executives holding Enron stock purchased through the stock option plan...continued the heavy selling in which they had been engaged for some months. Market sales of personal Enron stock yielded Kenneth Lay proceeds of $23 million in 2001; redemptions of Lay's stock by Enron itself during the year netted him an additional [sic] $70.1 million. Skilling [the CEO after Lay] sold $15.6 million worth before he resigned and $15 million thereafter. Amalgamated Bank, the plaintiff in a lawsuit against Enron's officers and directors, alleged gross sales of $1 billion of Enron stock by its officer and director defendants over a three year period.\(^{130}\)

Certainly Armour and McCahery also identify ‘aggressive accounting manipulations’ to boost stock option values.\(^{131}\) Gordon, too, identifies the issue of substantial amounts of share options as a feature of the Enron collapse.\(^{132}\) In particular, for Gordon – and a tension in executive compensation examined in Chapter 10\(^{133}\) - the granting of options exercisable in the

---

\(^{129}\) Bratton, above n 1, 49.

\(^{130}\) Bratton, above n 1, 17 (footnotes omitted).


\(^{132}\) Gordon, above n 27, 14-16.

\(^{133}\) See discussion in section 10.2.5 of chapter 10.
short-term may have increased fraudulent practices and risk-taking by executives to increase the share price.\footnote{134} In addition, for Bratton, Enron’s bonus payment scheme – linked to share price performance – exacerbated the problem\footnote{135} and Gillan and Martin similarly highlight the short-term focus of this issue.\footnote{136}

Gordon sums up this area as a four-part failure relating to stock-based compensation combined with the corresponding risk of financial manipulation by management both exacerbated by a lack of financial transparency and failure of sufficient board monitoring which should instead have been heightened by these factors.\footnote{137}

\section*{5.2.3.2.2 Competing Hypotheses for Option Structuring Since Enron}

What has changed since Enron in the structure of options? In the period to 2008, Banerjee \textit{et al} find a decline in share-option issues subsequent to Enron and other scandals\footnote{138} distinguishing between the \textit{number} of firms and the \textit{magnitude} of option compensation:

\begin{quote}
\textit{[t]he decline in firms awarding CEO option grants is not predicted by changes in firm, CEO, board of directors, and market characteristics whereas approximately one half of the decline in the magnitude of CEO option-based compensation is predicted by changes in these characteristics.\footnote{139}}
\end{quote}

Banerjee \textit{et al} seek to explain the decline in terms of theories for the motivation for issuing share options. The first – the ‘alignment’ or ‘incentive’ approach in agency cost theory to be examined in chapter 10\footnote{140} and which the authors call ‘optimal contracting’ – is given reduced importance.\footnote{141} Two other hypotheses are explained:

\begin{quote}
[0]n[e] of these hypotheses argues that, when determining option-based compensation, boards of directors and managers are guided by the perceived costs of options, which are usually lower than the actual costs to shareholders. A second hypothesis predicts that CEOs with power use options to extract rents on their human capital in excess of what they will get in an "arm’s-length" bargaining.\footnote{142}
\end{quote}

The authors conclude:

\begin{quote}
[w]e also find some evidence that after the scandals increased perceived costs of options have also lead to the reduction in CEO options. We do not find evidence of the scandals changing the importance of CEO power in shaping option-based compensation.\footnote{143}
\end{quote}

But not all authors play down the effects of improvements in ‘optimal’ or ‘efficient’ contracting in the use of options. In a more recent 2009 study, Brown and Lee investigate the relationship

\footnotesize{\begin{itemize}
\item \footnote{134} Gordon, above n 27, 15-16.
\item \footnote{135} Bratton, above n 1, 49.
\item \footnote{136} Gillan and Martin, above n 51, 29-31. See also Gillan and Martin, above n 76, 9-11.
\item \footnote{137} Gordon, above n 26, 3-4
\item \footnote{139} Ibid.
\item \footnote{140} See discussion in section 10.1.2 of chapter 10.
\item \footnote{141} Banerjee, Noe and Gatchev, above n 138, 31.
\item \footnote{142} Ibid.
\item \footnote{143} Ibid.
\end{itemize}}
between corporate governance and CEO equity grants finding that “weaker governance as proxied by lower takeover vulnerability and weaker board and shareholder monitoring is associated with larger abnormal equity grants for CEOs after controlling for economic determinants of equity grants.” However, post-Enron, the authors found a “more efficient” use of options with a consequent reduction in the negative effects on governance quality. The authors suggest this is consequent on “more efficient contracting after the governance reforms initiated by Sarbanes-Oxley Act of 2002 (SOX) and major stock exchanges took effect in the post-Enron period.”

The choice of compensation structure also appears to affect the quality or transparency of restatements. In a 2011 study, Hogan and Jonas found that equity pay for executives encourages ‘low-transparency’ (i.e., less prominent) disclosures of restatements (as did long-term CEO pay).

5.2.4 External or Independent Audit

5.2.4.1 External/Independent Audit is a Core Governance Variable

This thesis will identify external or independent audit – supported by reputational constraints on the auditor - as one of the central planks of corporate Governance Variable schemes, codes and directives comprising Key Field No. 3 – Comparative Corporate Governance Codes. Indeed, this variable will be identified in terms of both continuity and centrality as one of the core variables in global and national corporate Governance Codes. How, then, did this variable operate in the case of the Enron and Hastie Group corporate collapses?

Following this, then, the rate of restatements of financial results is treated as an important indicator of the performance and governance of accounting firms in the conduct of audits. In

145 Ibid, 29.
146 Ibid, 28-29.
147 Ibid, 6 (footnote omitted).
this respect, Professors Eisenberg and Macey tell us that, in the case of the rate of restatements of financial results, Enron’s auditor Arthur Andersen did not perform objectively differently to the other major firms for the period 1997-2001. Kroger is of a different view and tells us that Andersen’s failure to protect investors is not isolated to the Enron case. Thus, important for this chapter’s analysis of the Enron collapse - and its lessons for the balancing of the eight Governance Factors identified herein – is to analyse the features of the Arthur Andersen audit function that contributed to gatekeeper failure. In the Enron context, both the independence of the external auditor and the role of non-audit services – tensions identified in upcoming chapter 9 - were critically questioned as significant causes of this failure.

In the case of the Hastie collapse, the Administrators have queried the auditor’s compliance with a number of Australian Auditing Standards including not having:

- notified the Board of the underlying control and management issues within the Hastie Group [and]
- made appropriate recommendations regarding the write down of certain asset values.

The Administrators have suggested that, had the true financial position been known, funders and investors may not have supported the 2011 capital raising and remedial action may have been taken sooner. In relation to the December 2010 financial statements, the Administrators noted that the recognition of certain “significant write-downs” indicated “internal accounting control deficiencies” yet the auditor’s report to the Audit and Risk Management Committee did “not identify any significant issues with…accounting records or internal controls”.

For the June 2011 financial statements, the auditor “challenged the goodwill assumptions”. Yet, certain of the auditor’s calculations and growth rates “still indicated that no goodwill impairment was required”. Additionally, there were no signs that “the auditor challenged the valuation of receivables or WIP [Work-in-Progress]” which were significantly overstated. Finally, for the December 2011 financial statements, a report to the Audit and Risk Management Committee maintained that the auditor “did not note any significant issues


---

152 Eisenberg and Macey, ibid.
153 Kroger, ibid.
154 Administrators’ Report, above n 5, section 7.11, p. 67 of 99 (bullet-points in original).
155 Ibid.
158 Ibid.
with...corporate accounting records that warranted reporting” and “had not identified any significant deficiencies in internal controls...”. In the report, the auditor had drawn “attention to the material uncertainty...to continue as a going concern” but had stated that it was not aware of any matter not in accordance with the Corporations Act including the true and fair view requirement. The Administrators concluded that:

the auditor should have identified the underlying management and control issues giving rise to these significant write-downs and communicated them to the Board in a timely manner.

In summary, the Hastie Audit issues are significant and centre on a number of alleged failures - to comply with Australian Auditing Standards, to identify significant issues with accounting records and internal controls and to challenge the value in assets such as goodwill, receivables and Work-in-Progress. It remains to be seen what a liquidator will make of all this.

5.2.4.2 Independent Auditors and Reputational Constraints

If reputational constraints are an important ingredient of the independence of the auditor - and therefore the attraction of the auditor to the client - audit failures should have significant negative effects on the business and prospects of the auditor itself. This appears to be the case. The reputational fallout on Andersen is attested to by Barton who finds support for the strength of this constraint:

Andersen’s collapse in just a few months allows me to assume that client defections most likely reflected the auditor’s loss of reputation rather than changes in clients’ operating, financing, and investing activities.

The author concludes that ‘highly visible clients are more sensitive to auditor reputation’:

it is managers of firms that are more visible in the capital markets. That is, managers appear to engage highly reputable auditors as part of a strategy to build a reputation for financial reporting credibility, presumably to secure external financing at lower cost.

Along this line, Chang, Chi and Liu investigated whether Andersen clients – to reduce damage to the perceived integrity of their own reputations and financial information - were likely to switch auditor in the post-Enron fallout. The results supported this view but with the authors

160 Ibid, section 7.11.4, p. 68 of 99.
161 Ibid.
162 Ibid.
163 Jan Barton, “Who Cares about Auditor Reputation?”, available at SSRN: http://ssrn.com/abstract=436967, 22. As to the effect on other auditors of the Andersen failure, see Doogar, Xie and Sougiannis, above n 156.


164 Barton, ibid.
finding that the fraction of clients switching to a (then) ‘Big 5’ accounting firm declined over time.\footnote{Ibid, 23.}

This, then, is the theory. Callen and Morel used the Andersen reputational damage from Enron to test whether auditor reputation enhances equity prices.\footnote{Jeffery L Callen and Mindy Morel, “The Enron-Andersen Debacle: Do Equity Markets React to Auditor Reputation?”, EFMA 2003 Helsinki Meetings, (December 2002), available at SSRN: http://ssrn.com/abstract=341440.} The authors found some loss in firm value on the Andersen fallout but less than expected.\footnote{Ibid, 11. See also Yanmin Gao, Karim Jamal, Qiliang Liu and Le Luo, “Does Reputation Discipline Big 4 Audit Firms?”, CAAA Annual Conference 2011, (June 28, 2010), available at SSRN: http://ssrn.com/abstract=1633724.}

Gillan and Martin point out that the Arthur Andersen firm undertook both the internal and external audit function for some two years and so “[e]ssentially...was reviewing its own work”.\footnote{Gillan and Martin, above n 51, 27.} For Barrett, conflicts of interest are only the surrounding circumstances of the Enron audit failure. For the author, the Arthur Andersen failure is predominantly due to ‘unconscious bias’ although culture problems are not ignored.\footnote{Matthew J Barrett, “Enron and Andersen - What Went Wrong and Why Similar Audit Failures Could Happen Again”, available at SSRN: http://ssrn.com/abstract=794831, 158.}

Yet, if the SOX reforms were intended to increase auditor independence, then – on Vakkur et al’s 2009 empirical study of 149 CEOs and 57 directors – there may be unintended consequences and costs as auditors are perceived to have gained more influence on management.\footnote{Vakkur, McAfee and Kipperman, above n 100, 15.}

Bratton\footnote{Bratton, above n 1.} suggests, as a ‘broadbrush explanation’ for Andersen’s actions in Enron, a three-pronged failure as undermining auditor independence - the significant size of consulting services revenue, that Enron was Andersen’s second-largest client and Enron’s practice of hiring former Andersen employees as senior accounting officers.\footnote{Ibid, above n 68.}

Yet Ball does not immediately leap to the non-audit services scapegoat, pointing to the ‘unusual’ relationship between auditor and client:

[a]uditors supply a certification that is used by investors and the public at large, and it is to them that they owe a standard of care. However, they are engaged and compensated by client firm managers, who are interested parties (i.e., prefer a clean audit certificate). The argument here is not that non-audit revenues create a potential conflict of interest, but that audit fees themselves do.\footnote{Ball, above n 131, 9.}

Barrett gets to the heart of the matter which he calls 'attachment':


For Barrett, this 'attachment' was then strengthened – thus undermining the independence of Andersen – by the “integrated audit” where Andersen undertook both the internal and external audit function. The integrated audit model, the ‘revolving door’ practice – that Enron hired


[a]udit fees have been shown to be related to corporate performance... Auditors have a potentially privileged position to forecast the client’s economic condition. The risk-based approach of audit planning and subsequent pricing means that clients perceived by the auditor as risky are typically assigned more labor... which in turn results in higher audit fees. So, audit fees are expected to be a sign of current and future performance...

The authors conclude (at 21):

[t]here are multiple studies investigating firm performance, in particular studies on which firm characteristics drive performance. On the other hand, research on the pricing of audit fees has empirically proved that the financial condition of a client is a critical factor, in the sense that riskier clients demand more thorough audit procedures. Auditors have a potentially privileged position in assessing client firms' economic condition, and so, required audit fees may be a reasonable pointer of the direction a specific firm’s performance is taking. This study’s purpose is to see whether this statement holds, from the firm performance perspective...

Estimations' results provide empirical evidence on the relationship between firm performance and audit fees. Specifically, increases (decreases) in operating performance are connected with decreases (increases) in audit fees. This relationship also applies to financial performance.

175 Barrett, above n 170, 159.


[o]ur empirical findings indicate that the employment of a joint audit is associated with a higher degree of earnings conservatism for both public and private firms. Joint liability essentially means that both auditors bear the (potentially) incremental audit risk arising from the likelihood that the other auditor fails to perform its share of the audit work. Hence, the increased conservatism may at least partially be
many former Andersen employees – together with some personal relationships between Andersen and Enron personnel leads Barrett to conclude that ‘familiarity’ between auditor and client was a serious flaw leading to a far too uncritical acceptance of management assertions.177

In chapter 9178, this thesis will examine suggestions that the provision of non-audit services179 by auditors increases the likelihood of earnings manipulation. Yet, chapter 9 will present conflicting studies in relation to whether such a relation exists.

Gillian and Martin highlight consulting fees as an independence question in Enron.180 In this respect, Rosen explains the problem for the auditor when reviewing work of its own (tax) partners in terms both of reduced independence and the transformation of ‘compliance’ functions into a ‘risk management’ function where “noncompliance becomes an option”.181

As noted above, Coffee suggests the Enron collapse is a case of ‘gatekeeper failure’.182 One theme investigated by Coffee is that ‘reputational constraints’ on auditors are eroded or overborne by the company’s (non-overt) threat of removal or reduction in non-audit services. For Coffee, difficulties for the client to fire the auditor over non-acquiescence with ‘aggressive’ accounting treatments – which may cause the client public embarrassment and invite investigation by authorities – are replaced by a ‘low visibility’ sanction of terminating or reducing consulting services.183 Coffee also points to a movement during the 1990s to ‘equity based’ executive compensation – particularly short-term share options - as increasing pressure on auditors to ‘acquiesce in earnings management’.184 Related to the consulting services issue, Coffee also suggests that an audit firm’s own internal control/monitoring function may fail in the face of sizeable consulting fees.185

---

177 Barrett, above n 170, 161-162.
178 See discussion in sections 9.2.3 – 9.2.3.3 of chapter 9.
180 Gillan and Martin, above n 51, 28.
181 Rosen, above n 74, 1180.
183 Ibid, 15-16.
184 Ibid, 18-19.
185 Ibid, 21-22.
5.2.4.3 *Other Gatekeepers*

While auditors are perceived as the primary gatekeepers in Anglo-American corporate governance, they are not the only ones. The Enron scandal enveloped the role of other gatekeepers, in particular securities analysts, investment banks, brokers and lawyers. But their roles should be seen in light of the market and (decentralised) regulatory climate of the time to which the thesis now turns.

5.2.4.3.1 ‘Boom’ and ‘Bust’ Expectations and Pressures

Ball gives us a confluence of events both market and regulatory-based – from which can be extracted an explanation for multiple and simultaneous gatekeeper failure:

> The longest boom in U.S. history ended in March 2001. Bearing this in mind, the following sequence of cycle-related events seems plausible. First, in an extended boom high growth becomes built into performance expectations: into earnings and revenue forecasts, budgets, share prices, option values, investment decisions, and debt commitments. Managers therefore come under peer and financial pressures to deliver strong earnings growth and share market performance. Second, lax practices likely develop in a long boom: corporate monitors (boards, internal and external auditors, analysts, rating agencies, the press, and regulators) come to accept high growth as normal, and there is a risk of “falling asleep at the switch.” Third, the boom “busts,” growth suddenly falters, and around the same time many managers are unable to meet expectations. Fourth, some managers resort to either faking transactions or adopting unaccepted accounting methods to disguise their faltering performance. 186

---


A detailed review of external gatekeeper failures including regulators, credit agencies and analysts is undertaken in Gillan and Martin, above n 76, 15-21.


5.2.4.3.2 ‘Decentralisation’ of US Corporate Regulation

On a more structural level, for Roe, the ‘porous’ and decentralised structure of American corporate regulation is a principal cause of ‘instability’ in corporate governance and therefore major firm collapse:

\[\text{we have multiple regulators, each with strengths and weaknesses. Moreover, the regulated often affect how they’re regulated. Some of the breakdowns in the gatekeepers, and in the efforts to shore them up, emanated from the actions of the core group to be controlled—often American managers themselves, sometimes accountants, sometimes promoters of Silicon Valley start-ups. The regulated often sought to weaken the regulation that would have reduced their—the managers’—discretion.}^{187}\]

Thus, for Roe, the decentralised regulatory climate of the time reduced the external checks and balances on firm managers. It is in this reduced monitoring environment – for Roe ‘porous’ - that the thesis now examines the role of a number of gatekeepers important to the Enron story.

5.2.4.3.3 Securities Analysts, Investment Banks, Brokers and Credit Rating Agencies

Armour and McCahery, too, note that external auditors were not the only potential gatekeepers nullified by conflicts, securities analysts also having played a role in the failure:

\[\text{Moreover, analysts at several investment banks, supposedly offering independent advice, were tainted by conflicts of interest arising out of their firms’ involvement in Enron’s financing. As a result, Enron’s share price was artificially inflated for a considerable period of time.}^{188}\]


\[\text{Armour and McCahery, above n 131, 2.}\]
Indeed, Felton and Kim criticise these investment banks as acting as both ‘brokers and bankers’ as “analysts had mostly “buy” and “strong buy” recommendations for Enron at the same time that their firms sought banking relationships with Enron.”

For Julia Black, failure of the financial markets in the Enron case rested with the credit rating agencies which had been ‘enrolled’ as a strategy of regulation:

As the corporate accounting scandals of Enron, World-com, Parmalat and their ilk demonstrated, those relied upon to act as gatekeepers can be less than reliable, and need not necessarily perform the role that regulators assume they will play. In the corporate sector, the failings arose from lawyers and accountants. In financial markets, the most significant failure was that of the credit rating agencies (CRAs). The experience of enrolling CRAs illustrated that although gatekeeper regulation is a potentially useful regulatory strategy, whether the strategy is successful depends on the motivation, regulatory capacity, and most importantly, the broader market context, culture and incentives of those being relied upon to act as gatekeepers.

Thus, for Black, alignment of other gatekeepers with the regulatory regime is vital.

---


191 Ibid.

5.2.4.3.4 The Role of Lawyers

For Bainbridge, the ethical standards of lawyers acting for Enron (and WorldCom) contributed to those debacles – both in terms of negligence as well as “facilitators and enablers of management impropriety” – particularly in the area of company disclosures.\(^{192}\) Certainly Cunningham identifies business lawyers at the heart of – and allowing - many accounting frauds such as that at Enron.\(^{193}\) The author squarely lays the blame for formation, structuring and reporting of Enron’s off-balance sheet entities at the feet of lawyers and argues that these gatekeepers should enhance their accounting skills and knowledge.\(^{194}\)


\(^{194}\)Cunningham, ibid, 18-19.


\([\text{I}]\)he costs of being a lawyer-director can still be significant, but the balance has now shifted in its favor—reflecting a lawyer-director's ability to assist the board in managing the significant rise in litigation and regulation affecting businesses and changes in CEO compensation that occur when a lawyer is on the board. In fact, based on an average of 10,000 or more observations from 2000 to 2009, we find a statistically and economically significant increase in firm value (as measured by Tobin’s Q) of the companies that have a lawyer on the board. A lawyer-director increases firm value by 9.5 percent, and when the lawyer is also a company executive, the increase in firm value rises to 10.2 percent. The result has been an almost doubling in the percentage of public companies with lawyer-directors from 2000 to 2009.
5.2.5 Inadequate Disclosure Affects the Transparency and Timing of Financial Reporting and Monitoring

5.2.5.1 Non-Disclosure and Reduced Board Monitoring

In the Enron case, Gordon identifies enhanced financial disclosure as promoting heightened board monitoring through market monitoring of the board.\textsuperscript{195} Indeed, in the relational approach, the Shareholder Primacy Interrelationship Scheme depicts a reflexive relationship between the Reporting Factor No. 1 and the Monitoring & Audit Factor No. 5.\textsuperscript{196} Gordon criticises the extensive use of the SPEs to conduct transactions which contributed significantly to Enron’s earnings as severely hampering the market’s ability to monitor the Enron managers\textsuperscript{197} concluding that:

\[\text{[s]o the Board blinded the external monitors in circumstances where managers would face strong temptations to cheat and where the blinding would make cheating easier.}\textsuperscript{198}\]

Thus, not only was the US regulation system ‘porous’ for authors such as Roe\textsuperscript{199}, simultaneous monitoring by the market and board was dulled by non-transparent transaction methods such as off-balance sheet SPEs.

In the Administrators’ Report, the Board of the Hastie Group received a very critical assessment of its governance and financial reporting. The Administrators concluded that the Board had failed to:

\begin{itemize}
  \item regularly request and obtain a comprehensive set of performance reports
  \item properly interrogate the reports presented to it
  \item exercise an adequate level of control over the Hastie Group operations [and]
  \item take action over declining performance in a timely manner…\textsuperscript{200}
\end{itemize}

The lack of adequate information was extensive, covering areas such as:

\begin{itemize}
  \item KPIs and margin reporting
  \item profit and loss detail
  \item full year cash flow projections
  \item working capital detail
  \item balance sheet detail [and]
  \item regular impairment reviews.\textsuperscript{201}
\end{itemize}

The Administrators thus suggest that the Prospectus for the capital raising and the 2011 financial year financial statements “were possibly materially misstated” leading the banking syndicate and investors to possibly be misled.\textsuperscript{202}

The Administrators were highly critical of Hastie’s books and records considering that they were:

\begin{itemize}
  \item \footnote{195}{Gordon, above n 26, 7.}
  \item \footnote{196}{See Shareholder Primacy Interrelationship Scheme in Figure 2.7.2A of chapter 2.}
  \item \footnote{197}{Gordon, above n 26, 7.}
  \item \footnote{198}{Ibid, 8.}
  \item \footnote{199}{See discussion in section 5.2.4.3.2 of this chapter 5.}
  \item \footnote{200}{Administrators’ Report, above n 5, section 7.9.5, p. 65 of 99 (bullet-points in original).}
  \item \footnote{201}{Ibid (bullet-points in original).}
  \item \footnote{202}{Ibid.}
\end{itemize}
likely to be deficient in that they do not accurately explain the Hastie Group's financial position and performance. This deficiency may give rise to a presumption of insolvency that a liquidator may rely on.203

The Administrators found “indications of liquidity and cashflow issues” and suspected that the “financial reports may have been materially misstated”.204 Additionally, if there was material overstatement of particular key asset values, the Hastie Group “may have been balance sheet insolvent in the period prior to our [the Administrators’] appointment”.205

5.2.5.2 Enron’s (Non) Disclosure – Ignored or Too Complex?

But Armour and McCahery have a different slant on the non-disclosure issue. After citing studies supporting the workings of the efficient market hypothesis206, the authors consider that many ‘irregularities’ and relevant disclosures were not concealed but merely ‘ignored’:

[the notes to the company’s accounts dropped very large hints about the over-engineering of its finances. The surprising thing, if the finance orthodoxy is correct, is not that the company ultimately failed, but that this publicly-available information seems to have been ignored.207

But the picture seems less clear at least in relation to Enron’s more complex transactions. Indeed, Schwarcz points to the limitations on the effectiveness of disclosure in complex transactions such as the securitisation transactions of the Enron SPEs.208 The author argues that only one additional measure is required in such cases, that management “be free of material conflicts of interest stemming from disclosure-impaired transactions.”209

5.3 Summary - Some Recurring Themes in the Enron and Hastie Group Corporate Collapses

In this chapter’s presentation of Key Field No. 2, the thesis has reviewed the complex – and often competing – evaluations of the Enron corporate collapse and the detailed Administrators’ Report into the Hastie Group collapse to identify common themes. A multitude of theories and suggestions – again competing – permeate this Key Field. Of course, much more than the other Key Fields, this Field - comprised largely of commentator evaluation – represents a much greater degree of individual opinion, conjecture and hypothesis than do the others. With that caveat, the following presents a summary of the principal perceived failures in corporate Governance Variables in the Enron and Hastie corporate collapses. The aim of this concluding section of the chapter will be to emphasise why the relevant failures are important in the relational approach and how the failures compare to the relative importance Ratings210 of the Governance Variables examined in the thesis.

203 Ibid, section 7.10, p. 66 of 99. See also section 7.13, p. 70 of 99.
206 Armour and McCahery, above n 131, 4-5.
208 Schwarcz, “Rethinking the Disclosure Paradigm in a World of Complexity”, above n 117, 34.
209 Ibid, 35 (footnote omitted).
210 For a full list of relational proximity Ratings for the Governance Variables, see the Relational Proximity Table 3.3.2.1 in chapter 3
5.3.1 The Nexus of Contracts and Agency Theory in the Enron and Hastie Failure Scenarios

The market for corporate control – incorporating the efficient market hypothesis – acts in conjunction with nexus theory to punish managerial structures or behaviours which reduce firm value and the relational approach is aligned with this mechanism.\textsuperscript{211} In addition, the Governance Factors and the Interrelationship Schemes of the relational approach are based on agency cost theory.\textsuperscript{212} In short, the relational approach seeks to explain the behaviour and relative importance of Governance Variables in reducing agency costs – including monitoring costs, bonding costs and residual losses – between inside management and outside dispersed shareholders.\textsuperscript{213} In the relational approach, managerial structures or behaviours which increase agency costs will reduce the long-term efficiency and sustainability of the firm.\textsuperscript{214} This includes structures or behaviours which increase the information asymmetry between insiders and outsiders.\textsuperscript{215}

The Enron failure was characterised by significant asymmetric information problems. In particular, the complexity of its company structure and business plan – such as the use of off-balance sheet transactions and SPEs – increased the information asymmetry of investors and the time for market corrections. This undermined the operation of the efficient market hypothesis that the share price will reflect all publically-available information relating to the company.\textsuperscript{216} It is also consistent with the ‘bounded rationality’ of investors – that there was only so much the market could understand - and time-lag problems both identified by Dent.\textsuperscript{217} For Gordon, the problems extended to more sophisticated securities analysts - Enron’s high share price failed to reflect its ‘intrinsic value’ even with the attention of a barrage of such analysts.\textsuperscript{218} But complexity in the Enron entities and business plan had further effects which led to problems for the market in determining the ownership of assets and the solvency of group entities.\textsuperscript{219}

Lack of disclosure in the Enron case was also significant in harming the quality of monitoring – of both the market and the board. For Gordon, increases in the level and quality of company disclosures increase the level of monitoring by the market which, in turn, increases monitoring by the board.\textsuperscript{220} Indeed, this is represented in the relational approach by the \textbf{[TransTimeMon]} \textsuperscript{(+)} variable\textsuperscript{221} (Transparency and Timing of Reporting – Monitoring Effect) which has the highest Coverage/Rating of +8/100.00 rprox. Further, the reputational constraints on outside directors - emphasised by Fama and Jensen\textsuperscript{222} – are represented by the individual

---

\textsuperscript{211} See discussion in section 4.2.2
\textsuperscript{212} See discussion in section 4.2.3.1 of chapter 4.
\textsuperscript{213} Ibid.
\textsuperscript{214} See discussion in section 1.5 of chapter 1.
\textsuperscript{215} See discussion in sections 4.2.2 and 4.2.3.1 of chapter 4.
\textsuperscript{217} Ibid.
\textsuperscript{218} Gordon, above n 27, 3 and 5-10. See discussion in section 5.2.1.1 of this chapter 5.
\textsuperscript{219} See discussion in section 5.2.1.1 of this chapter 5.
\textsuperscript{220} Gordon, above n 26, 7. See discussion in section 5.2.5.1 of this chapter 5.
\textsuperscript{221} Transparency and Timing of Reporting – Monitoring Effect – see discussion in section 9.1.2.1 of chapter 9.
Governance Variables of\([\text{ReputDiscl}]\) (Reputational Constraints – ‘Disclosure Standards’, +8/100.00 \text{rprox}) and \([\text{ReputRep}]\) (Reputational Constraints – ‘Transparent Reporting’, +8/100.00 \text{rprox}). Yet the use of off-balance sheet entities by Enron - in conjunction with significant managerial incentives - increased the sensitivity of management to the share price which consequently reduced the likelihood of adverse disclosures by management. As a consequence, this reduced the quality of monitoring by the market which in turn reduced the quality of board monitoring.\(^{225}\)

Poor financial reporting also plagued the Hastie Group.\(^{226}\) The Administrators were highly critical considering that Hastie’s books were deficient in representing the Group’s financial position\(^{227}\) and suspected that the “financial reports may have been materially misstated”.\(^{228}\) Significantly in the case of the Hastie Group – but hidden from view - profitable businesses within the Group were used to subsidise losses in the Middle East operations\(^{229}\) thus masking liquidity problems. Yet, unlike Enron, the many danger signs announced to the market should have raised problems much earlier. Why didn’t they? The problem for market monitoring was the significant time-lag issues in relation to asset write-downs such as goodwill, trade and other receivables and construction Work-in-Progress.\(^{230}\) For the Administrators, earlier disclosure of these deficiencies may have led to “administrators being appointed earlier [and] changes to investors’ and financiers’ decisions regarding investing in or supporting the Hastie Group.”\(^{232}\)

What do these failures tell us about pre- and post-GFC collapses? The answer is that the ‘disclosure – market monitoring - board monitoring’ cycle is a significant relationship in both eras. Indeed, the efficient market hypothesis is dependent on the quality/transparency and timing of management disclosure – the \([\text{TransTimeMon}]\) variable. Management structures or behaviours which increase information asymmetry – and therefore agency costs - between inside management and outside shareholders will increase the likelihood of a ‘lagged’ corporate failure. This is a failure whose occurrence is delayed on account of non-disclosing behaviour by management and thus is eventually much greater than otherwise would be the case in effects on wealth-measures of outside shareholders such as operating profit and share price.

5.3.2 Director Independence, Monitoring and Risk Management

In theory, a significant proportion of the integrity of the Anglo-American shareholder protection regime rests on the independence of outside directors. It is considered one of the most important variables for enhancing the monitoring of management in the dispersed-shareholding public company. Such independence is argued to improve the quality of acquisitions and the

\(^{223}\) See discussion in section 10.4.1 of chapter 10.
\(^{224}\) Ibid.
\(^{225}\) See the views of Gordon in sections 5.2.2.1.1 and 5.2.5.1 of this chapter 5.
\(^{226}\) See discussion in section 5.2.5.1 of chapter 5.
\(^{227}\) Administrators’ Report, above n 5, section 7.10, p. 66 of 99. See also section 7.13, p. 70 of 99.
\(^{228}\) Ibid, section 7.13.2, p. 71 of 99.
\(^{229}\) See discussion in section 5.2.2.3.1 of this chapter 5.
\(^{230}\) See discussion in section 5.2.1.1.
\(^{231}\) Ibid.
\(^{232}\) Ibid. See Administrators’ Report, above n 5, section 2.5.2, p.13 of 99 (bullet-points in original).
\(^{233}\) Transparency and Timing of Reporting – Monitoring Effect – See discussion in section 9.1.2.1 of chapter 9.
likelihood of replacement of a CEO in times of falling profitability.\textsuperscript{234} The principal variable in this respect is board and director independence and the proportion of non-executive/independent directors – [BrdIndMon] (+).\textsuperscript{235} It has a high Coverage/Rating of +7.50 reflecting this theoretical importance.\textsuperscript{236} Other Governance Variables with a positive direction related to independence are [AudIndMon] (+), [AudIndFreq] (+)\textsuperscript{237} and [NomInd] (+), each with the same Coverage/Rating as [BrdIndMon] (+). The importance of the independence variable is also reflected in the Key Field No. 3 – \textit{Comparative Corporate Governance Codes}. There, the key features of global and national listed Governance Codes include\textsuperscript{240}:

- “board functions and independence – compliance with statutory and legal duties on organisation/directors”;
- “independence from management – non-executive/independent directors”; and
- “independence from management – responsibilities of board sub-committees delineated and disclosed”.

The Enron collapse suggests that ‘abnormally’ high directors’ consulting fees and related-party transactions for outside directors may reduce outside director independence and the quality of monitoring.\textsuperscript{241} But commentators place greater reliance for the independence failure on equity and option holdings undermining independence and the quality of monitoring.\textsuperscript{242} In an important study in Key Field No. 4,\textsuperscript{243} Fuerst and Kang identify two opposing effects of inside equity ownership – the ‘incentive alignment’ effect and the ‘entrenchment’ effect. This suggests that equity ownership helps to align the interests of insiders and outsiders, but that excessive equity ownership promotes insider self-interest (thus increasing agency costs) to the detriment of outside shareholders.\textsuperscript{244} Given the sheer volume of equity and option holdings in Enron\textsuperscript{245}, it is not surprising that the entrenchment effect dominated.

The competing ‘incentive alignment’ and ‘entrenchment’ effects of executive compensation observed by Fuerst and Kang and reflected in the Enron case are consistent with the Governance Variables of the relational approach. These Governance Variables predict that increases in equity holdings and options for outside directors will:

\textsuperscript{234} See discussion in sections 7.3.2.1.1 – 3 of chapter 7.
\textsuperscript{235} Board Independent Director: Executive Director Proportion – Monitoring Effect – See discussion in sections 7.3.2.1.1-2 of chapter 7.
\textsuperscript{236} See the Relational Proximity Table 3.3.2.1 of chapter 3.
\textsuperscript{237} Audit Committee – Independence – Monitoring Effect – see discussion in section 8.4.3 of chapter 8.
\textsuperscript{238} Audit Committee – Independence in Combination with Frequency of Meeting – Reduction in Earnings Manipulation Effect – see discussion in section 9.2.1 of chapter 9.
\textsuperscript{239} Nominating Committee – Independence Proportion – see discussion in section 7.3.1.2.2 of chapter 7.
\textsuperscript{240} See discussion in section 6.8.1 of chapter 6.
\textsuperscript{241} See the views of Branson in section 5.2.2.1 of this chapter 5.
\textsuperscript{242} See discussion in section 5.2.2.1.1 of this chapter 5.
\textsuperscript{243} \textit{Empirical Studies of the Effectiveness of Governance Variables} - See discussion in section 10.2.1 of chapter 10.
\textsuperscript{245} See discussion in section 5.2.3.2.1 of this chapter 5.
• improve the ‘alignment’ of the interests of inside management and outside shareholders consistent with the [EqOptIncent] (+)\textsuperscript{246} variable; and

• reduce outside director independence and quality of monitoring consistent with the [EqOptEntrch] (-)\textsuperscript{247} variable.

The significance of these effects – testified to by the Enron collapse – is consistent with the Coverage/Ratings of these Governance Variables of 7/87.50 rprox but in opposite directions.\textsuperscript{248} Similar effects on the quality of monitoring are predicted by the relational approach for the granting of short-term options to outside audit committee members ([AudShortOpts] (-)\textsuperscript{249}) and to directors generally ([ShortTOpts] (-)\textsuperscript{250}). Both these Governance Variables have the second-highest negative Coverage/Rating of -7/87.50 rprox.

Enron also suggests that equity holdings and options for outside directors increase agency costs for outside shareholders by:

• increasing the potential for earnings manipulation or management\textsuperscript{251} to meet market expectations; and

• increasing conflict of interest issues for outside directors on the audit or risk management committees.\textsuperscript{252}

Again, this is consistent with the ‘incentive alignment’ and ‘entrenchment’ effects identified by Fuerst and Kang and the Coverages/Ratings of the above Governance Variables of the relational approach.

The monitoring effects of director independence can also be undermined by familiarity and deference among board members. Both Enron and Hastie tell us that such behaviour can be a product of corporate culture issues. A study in Key Field No. 4\textsuperscript{253} suggests that CEO turnover after poor performance is more likely with increases in the independence of the board but that “board independence declines over the course of a CEO’s tenure” on account of the CEO’s control over the director nomination and appointment process.\textsuperscript{254} For Dent, the appointment of former CEOs as outside directors reduces monitoring, questioning and deliberation of outside directors due to the reciprocal practice of CEOs deferring to one another and loyalty by outside directors to the person who nominated them.\textsuperscript{255}

\textsuperscript{246} Equity/Option Plans and Holdings of Directors/Executives – Incentive/Alignment’ Effect (excludes short-term options). See also section 10.2.4 of chapter 10.

\textsuperscript{247} Equity/Option Plans and Holdings of Directors/Executives – ‘Entrenchment’ Effect (excludes short-term options). See also section 10.2.4 of chapter 10.

\textsuperscript{248} See Relational Proximity Table 3.3.2.1 in chapter 3.

\textsuperscript{249} Audit Committee – Short Term Options Granted to Outside Directors – Reduction in Monitoring Effect – see discussion in section 10.2.5.1 of chapter 10.

\textsuperscript{250} Short-Term Option Holdings/Plans of Directors and Executives – See discussion in section 10.2.5.1 of chapter 10.

\textsuperscript{251} See discussion in sections 5.2.2.1.1 and 5.2.3.2.1 of this chapter 5.

\textsuperscript{252} See discussion in section 5.2.2.1.2 of this chapter 5.

\textsuperscript{253} Empirical Studies of the Effectiveness of Governance Variables


\textsuperscript{255} Dent, above n 216, 14 of 72. See discussion in section 7.3.2.1.3 of chapter 7. See also discussion in section 5.2.2.2 of this chapter 5.
In Key Field No. 4, the thesis hypothesises that the $[\text{NomCom}]^{(\pm)}_{256}$ variable has a dual direction marker as it can affect the board’s skill mix in a positive or negative direction. Its relational effect path thus follows that of the $[\text{BrdSkills}]^{(+)}_{22}$ variable but in both directions with a Coverage/Rating of $\pm/787.50$ rprox.$^{257}$ By analogy to board skills, the quality of board monitoring and decision-making is also dependent in part on the independence and qualities of those selected to be directors by the nominating committee. In other words, the thesis hypothesises that increases in the independence proportion of the nominating committee ($[\text{NomInd}]^{(+)}_{258}$) will similarly have a positive effect on the monitoring and decision-making – and therefore board skills – attributes of directors nominated by that committee.$^{259}$ Again, its relational effect path follows that of the $[\text{BrdSkills}]^{(+)}$ variable this time in the positive direction with a Coverage/Rating of $+787.50$ rprox.$^{260}$

Enron displayed a significant level of familiarity in the boardroom.$^{261}$ But the level of ‘dysfunctional deference’ – particularly to the CEO Ken Lay – was alarming and even extended to important decisions.$^{262}$ Should this be surprising? Certainly not for Dent whose warning from Key Field No. 1$^{263}$ could be applied to the Enron case:

most boards are passive, dominated by CEOs who exert their power in their own interests.$^{264}$

This is consistent, too, with other studies in Key Field No. 4. For example, Cremers, Bebchuk and Peyer measure the ‘relative importance’ of the CEO in the firm and find that CEO ‘centrality’ is negatively associated with firm value$^{265}$ and results in “lower CEO turnover”$^{266}$ which “might reflect governance problems”$^{267}$:

[the probability of CEO turnover is lower if CEO centrality is higher controlling for the CEO’s length of service and performance.$^{268}$]

The Enron experience tells us that the complexity of transactions – again including any off-balance sheet aspects – reduce outside director understanding of risk management reports. In turn, this reduces the quality of monitoring and risk management functions of the board.$^{269}$ Again, this undermines the operation of the efficient market hypothesis consistent with the ‘bounded rationality’ of investors and time-lag problems identified by Dent.$^{270}$

---

$^{256}$ Nominating Committee – Presence, Operation and Frequency – see discussion in section 7.3.1.2.2 of chapter 7.
$^{257}$ Ibid.
$^{258}$ Nominating Committee – Independence Proportion – see discussion in section 7.3.1.2.2 of chapter 7.
$^{259}$ Ibid.
$^{260}$ Ibid.
$^{261}$ See the views of Gordon in section 5.2.2.2 of this chapter 5.
$^{262}$ See the views of Sharfman and Toll in section 5.2.2.2 of this chapter 5.
$^{263}$ Key Field No. 1: Application of the Principal Theories of the Firm to the Relational Approach. See discussion in chapter 4.
$^{264}$ Dent, above n 216, 14 of 72.
$^{265}$ Martijn Cremers, Lucian Bebchuk and Urs Peyer, "CEO Centrality", Harvard Law and Economics Discussion Paper No. 601, (December 2007, Revised May 2008), available at SSRN: http://ssrn.com/abstract=1030107, 1. The authors define this as the relative importance of the CEO in the corporation’s upper management as measured by the ‘CEO’s pay slice’ or ‘CPS’ being the percentage of the total compensation of the top 5 executives captured by the CEO. See discussion in section 7.3.2.1.1 of chapter 7.
$^{266}$ Ibid.
$^{267}$ Ibid, 3
$^{268}$ Ibid, 3.
$^{269}$ See discussion in section 5.2.2.3.1 of this chapter 5.
$^{270}$ See the views of Dent in section 4.2.2 of chapter 4.
The Enron discussion also suggests that inadequacies in risk management reports - including failure to establish adequate procedures for approving projects and ensuring that all projects enter the approval process - result in:

- failure to describe risks adequately for board members;
- reduction in the quality of the monitoring and risk management functions of the board; and
- a reduction in the quality of board decision-making. 271

The risk management function in both the pre- and post-GFC case studies in this chapter was vulnerable to corporate culture issues. The Enron collapse shows that adverse corporate culture behaviours such as:

- the stifling of dissent;
- acquiescence in management misconduct;
- the centralisation of power;
- a reduction in the flow of negative information; and
- incentives with a focus on short-term results

will result in a failure to describe risks adequately for board members, a reduction in the quality of the monitoring and risk management functions of the board and, consequently, a reduction in the quality of board decision-making. 272 In the case of the Hastie collapse, the Audit and Risk Management Committee was largely inactive. 273 The Hastie Group, too, suffered from serious culture issues in relation to forecasting, control and monitoring including that:

- the Board did not appear to adequately challenge divisional/subsidiary results or forecasts...
- there appears to have been a general culture of ignoring bad news... [and]
- the Board, prior to the appointment of the interim CEO... appeared not to have ‘an enquiring mind’ as to reliability of financial statements and overall reporting 274

The Administrators also noted a report to the Board which considered that there were “internal cultural issues concerning inflated reported results and optimistic forecasting...” 275

5.3.3 **Earnings Manipulation**

Earnings manipulation or management - through ‘aggressive’ accounting treatments, misstatement, non-compliance 276 with accounting standards, disguise or concealment 277 - is

---

271 See discussion in section 5.2.2.3.1 of this chapter 5.
272 Free and Macintosh, above n 91, 28. See discussion in section 5.2.2.3.2 of this chapter 5.
273 Administrators’ Report, above n 5, section 2.5.3, p. 14 of 99. See discussion in section 5.2.2.3.2 of this chapter 5.
274 Ibid.
276 See discussion in section 5.2.3 of this chapter 5.
clearly an anathema to the efficient market hypothesis on account of an increase in asymmetric information between insiders and outsiders. Thus, the practice increases agency costs between those insiders and outsiders which in turn reduces firm value and the long-term efficiency and sustainability of the firm.278

Again, this is represented in the relational approach by Governance Variables which all have the maximum Coverage/Rating - the [TransTimeMon] (+) variable279 (Transparency and Timing of Reporting – Monitoring Effect, +8/100.00 rprox) and the individual Governance Variables of [ReputDiscil] (+)280 (Reputational Constraints – ‘Disclosure Standards’, +8/100.00 rprox) and [ReputRep] (+)281 (Reputational Constraints – ‘Transparent Reporting’, +8/100.00 rprox). Thus, management structures or behaviours which reduce the effectiveness of these Governance Variables have a significant effect on agency costs and, in turn, the long-term efficiency and sustainability of the firm.

Structural factors such as performance pressures, oversight issues and changing structural conditions appear to increase the risk of fraudulent financial reporting.282

More particularly from the case studies, Enron-specific structural factors such as:

- performance incentives including equity options;
- complexity in the structure and financing of inter-related entities which reduced the efficacy of analyst, auditor and regulator monitoring and oversight;
- innovation in technology and financing methods; and
- decline in sector in which Enron operated,283

resulted in increases in the risk of earnings manipulation. These factors also resulted in increases in the complexity of the structure and financing of inter-related entities which reduced the capability and effectiveness of internal and external monitoring. In turn, this increased the risk of earnings manipulation. For example, in the case of accounting treatments, Enron used ‘mark-to-market’ or ‘fair value’ in the valuation of certain investments which produced questionable gains in the profit and loss statements for several periods.284

Lack of uniformity in financial reporting method also causes a problem. In Hastie, “financial reporting from subsidiary level up to HST [Hastie Group Limited] was not uniform and open to manipulation”.285 But the Hastie problems were far more than this in relation to reporting. Described in relation to Hastie’s risk management and culture issues, the treatment of construction Work-in-Progress displayed significant manipulation practices including:

- …a lack of honesty in the financial reporting

277 See the views of Bratton and, separately, Gillan and Martin in section 5.2.3.1 of this chapter 5.
278 See discussion in section 1.5 of chapter 1.
280 See discussion in section 10.4.1 of chapter 10.
281 Ibid.
282 Catanach and Rhoades, above n 104, 5. See discussion in section 5.2.3 of this chapter 5.
283 Ibid.
284 See the views of Gillan and Martin in section 5.2.3.1 of this chapter 5.
• a culture that may have led to hiding margin write-backs and losses [and]
• contract finalisation in the Middle East may have been deliberately avoided so that losses did not have to be taken to account.\textsuperscript{286}

It was thus not surprising to see the Administrators found that the financial statements may have been materially misstated and misleading.\textsuperscript{287}

The use of off-balance sheet transactions and entities by Enron was shown to have significant negative effects including \textit{increased risk of}:

• non-disclosure or disguise of contingent liabilities and other debt\textsuperscript{288};
• earnings manipulation;
• tax-minimisation\textsuperscript{289}
• non-disclosure or disguise of executive payments (of some $30 million to the Enron CFO)\textsuperscript{290}; and
• conflicts of interest of executives\textsuperscript{291}.

Off-balance sheet transactions and entities also increased the risk of disguised ‘self-hedging’ transactions which in turn increased the risk of earnings manipulation.\textsuperscript{292} The result in Enron was a correction which removed over US$ 1 billion from net shareholders equity of the company.\textsuperscript{293}

In the Enron case-study, CEO, executive and director compensation factors such as share options, the short-term structure of those options and bonus payments linked to share-price performance appear to have:

• Increased the likelihood of the adoption of high-risk taking/strategies by management\textsuperscript{294};
• Increased the risk of ‘aggressive accounting manipulations’ to boost stock option values);\textsuperscript{295} and
• Increased the likelihood of fraud and risk-taking.\textsuperscript{296}

Again these results are consistent with the following predicted outcomes for relational approach Governance Variables:

\textsuperscript{286} Ibid, section 6.2.3, pp. 43-44 of 99 (bullet-points in original).
\textsuperscript{287} See discussion in section 5.2.1.1 of this chapter 5.
\textsuperscript{288} See discussion in section 5.2.3.1 of this chapter 5.
\textsuperscript{289} Ibid.
\textsuperscript{290} Ibid.
\textsuperscript{291} Ibid.
\textsuperscript{292} Ibid.
\textsuperscript{293} Bratton, above n 1, 37-38. See also Gillan and Martin, above n 51, 17. See discussion in section 5.2.3.1 of this chapter 5.
\textsuperscript{294} See discussion in section 5.2.3.2.1 of this chapter 5.
\textsuperscript{295} Armour and McCahery, above n 131, 2. See discussion in section 5.2.3.2.1 of this chapter 5.
\textsuperscript{296} See discussion in section 5.2.3.2.1 of this chapter 5.
• Improvement in the ‘alignment’ of the interests of inside management and outside shareholders consistent with the [EqOptIncent] (+) variable;

• Reduction in outside director independence and quality of monitoring consistent with the [EqOptEntrch] (-) variable;

• the behaviour of the [DirCEO$] (+/−) variable, the [AudShortOpts] (-) variable and the [ShortTOpts] (-) variable; and

• the behaviour of the [NomCom] (+/−) and the [CompCom] (+/−) variables.

These are some of the most significant Governance Variables in the relational approach in their effect on long-term efficiency and sustainability. All these Governance Variables have the second-highest Coverage/Rating of 7/87.50 prox (in various directions).

5.3.4 External/Independent Audit

Chapter 6’s examination of Key Field No. 3 – Comparative Corporate Governance Codes – identifies external/independent audit as a ‘core’ feature of both global and national corporate Governance Codes. Indeed, so important is it that the role of independent audit reaches to the Governance Factors. Governance Factor No. 5 – the Monitoring & Audit Factor – extends to both internal and external/audit quality. As such, it is recognised in the relational approach as one of the eight most significant and recurring themes underpinning the four Key Fields.

Thus, management – and particularly auditor – structures or behaviours which reduce the effectiveness of the independent audit will significantly affect the long-term sustainability of the firm. For example, the [ExtAudEarn] (+) variable representing the external/independent audit function has a Coverage/Rating of +7/87.50 prox which predicts a reduction in earnings management as a result of the external audit function. On account of the ‘externality’ and consequent independence of the auditor, it is a ‘strong form’ independence variable. In other words, the relational approach predicts [ExtAudEarn] (+) to have a stronger monitoring ‘improvement’ or ‘enhancement’ effect on the Monitoring & Audit Factor No. 5 than any of the other variables.
[BrdIndMon] (+) 307, [AudIndMon] (+) 308 or [AudExpAcc] (+) 309 which are outside-director-based.

As part of this, structures or behaviours that affect the quality of the independent audit will have a flow-on effect to the Reporting Factor No. 1 – *Transparency, Timing and Integrity of Financial and Other Reports*. The Shareholder Primacy Interrelationship Scheme 310 depicts a reflexive relationship between the Monitoring & Audit Factor No. 5 and the Reporting Factor No. 1. From the Monitoring & Audit Factor No. 5, the reflexive relationship with the Decision-making Factor No. 7 is also harmed and, from this, there is a single-direction flow-on to the Reporting Factor No. 1 again. Thus, the Enron case study shows us that if the external audit fails significantly, the whole house of cards comes crashing down.

**Auditor Attachment**

The chapter examined issues related to the Enron external/independent audit and auditor ‘attachment’311 including:

- substantial consulting fees;
- increases in the proportion of the client’s fees to total fees of the firm;
- hiring of former audit firm employees by the client;
- audit fees; and
- the auditor’s desire to foster long-term business relationship.

These factors were found to:

- decrease auditor independence and in turn the quality of the external monitoring function312;
- create conflicts of interest for the auditor vis-à-vis the client who prefers a ‘clean’ audit report313; and
- increase the pressure to issue unqualified audit reports to avoid being replaced by the client.314

---

307 Board Independent Director: Executive Director Proportion – Monitoring Effect – see discussion in section 7.3.2.1.1-2 of chapter 7.
308 Audit Committee – Independence – Monitoring Effect – see discussion in sections 8.4.3 of chapter 8.
309 Audit Committee – Financial Expertise (Accounting) – see discussion in section 8.4.4 of chapter 8.
310 See Figure 2.7.2A of chapter 2.
311 This term is taken from Barrett, above n 170, 159.
312 See the views of Bratton in section 5.2.4.2 of this chapter 5.
313 See the views of Ball in section 5.2.4.2 of this chapter 5.
314 See the views of Barrett in section 5.2.4.2 of this chapter 5.
Non-Audit Services of the Auditing Firm

The audit firm ‘self-review’ of tax or consulting services advice provided by partners of same firm increases conflicts of interest for the audit firm and in turn reduces the independence of the auditor.\(^{315}\) It is also argued that it results in the transformation of ‘compliance’ functions into a ‘risk management’ function with, again, consequent reduction in independence of the auditor.\(^{316}\)

Factors around the performance of non-audit services such as:

- the client’s (non-overt) threat of removal or reduction in non-audit services;
- equity-based compensation including short-term options for management; and
- increases in the size of consulting and non-audit fees for the auditor,

together are predicted to result in:

- the erosion or overbearing of ‘reputational constraints’ on the auditor with consequent reduction in auditor independence\(^{317}\);
- increase the likelihood that management will use consulting contracts/fees to encourage the auditor to ‘acquiesce in earnings management’\(^{318}\); and
- increases the likelihood of a failure in an audit firm’s own internal controls/monitoring.\(^{319}\)

Thus, the \[^{\text{NonAuditS}}\] (-)\(^{320}\) variable – representing the non-audit services of the external auditor – is a significant Governance Variable in the relational approach with a Coverage/Rating of -7/87.50 rprox. This represents a negative effect on all the Governance Factors with the exception of the overriding nature of the Compliance Factor No. 2.\(^{321}\) Thus, increases in non-audit services by the external auditor are predicted to significantly reduce the firm’s long-term efficiency and sustainability.

5.3.5 Concluding Remarks

This chapter has extracted the themes and tensions underlying the Enron and Hastie corporate collapses to support the identification, structure and articulation of the eight Governance Factors.\(^{322}\) Importantly, the chapter has identified the factors which reduced the effectiveness of some of the Governance Variables in Table 2.4 in deterring or punishing management misconduct or which led to a misalignment between inside managers and outside dispersed shareholders.

\(^{315}\) See the views of Gillan and Martin in section 5.2.4.2 of this chapter 5.
\(^{316}\) Ibid.
\(^{317}\) Ibid. See the views of Coffee in section 5.2.4.2 of this chapter 5.
\(^{318}\) Ibid.
\(^{319}\) Ibid.
\(^{320}\) Non-Audit Services of External Auditor - see the discussion in section 9.2.3.2-3 of chapter 9.
\(^{321}\) See the discussion in section 9.2.3.3 of chapter 9.
\(^{322}\) These are examined in sections 2.6.1 – 2.6.8 of chapter 2
The thesis now turns in chapter 6 to examine the *Comparative Corporate Governance Codes* Key Field No. 3. This Key Field is comprised of international and national (US, UK and Australian) Governance Codes. Many of these codes emerged out of the collapse of Enron and other companies. Hence, the chapter 6 analysis takes place in the context of the Enron collapse that came before and the Hastie collapse which took place post-GFC. Chapter 6 will assess the position and relative importance of many of the Governance Variables in Table 2.4 and this chapter 5. Again, a critical goal will be to identify the underlying themes and tensions in these Governance Codes for the construction of the Governance Factors.
CHAPTER 6
KEY FIELD NO. 3:
COMPARATIVE CORPORATE GOVERNANCE CODES

Under the precepts of capitalism and globalisation, defrauding, deceiving or ignoring the wishes of minority investors counters the received wisdom that investor protection is vital to financial development and economic growth. Fraudulent behaviour, deceit or the exposure of minority investors to self-interested directors, large shareholders or the markets, discourages participation, limits the availability of equity to firms dependent upon external finance, and so constrains financial growth.¹

6.1 The Purpose, Scope and Function of Chapter 6

6.1.1 Exploring Relative Importance

In the previous chapter, the thesis examined the corporate collapses of Enron and the Hastie Group to support the identification, structure and articulation of the eight Governance Factors. The examination also revealed the intervening variables of these organisations which reduced the effectiveness of Governance Variables. The chapter identified problems in the operation of Governance Variables in the collapse context, a context which was a precursor to the development of the predecessors of the principal Governance Codes in operation today.

This chapter has three principal purposes. First is to identify underlying themes of the Comparative Codes Key Field No. 3 (Comparative Corporate Governance Codes) for the identification, construction and articulation of the Three Relational Axes of Good Governance² and the eight Governance Factors³ in chapter 2. As a continuing theme, the

² See discussion in sections 2.3.1 – 2.3.3 of chapter 2.
³ See section 1.7.1 of chapter 1 for the eight Governance Factors which are discussed in sections 2.6.1 – 2.6.8 of chapter 2.

For an earlier working paper version of this chapter by de Zwart, see Francesco de Zwart (90% author) and George Gilligan, “Comparative Corporate Governance Schemes and their Relevance for the Sporting Sector”, Monash University Department of Business Law and Taxation, Working Paper No. 16, (November 2008), available at http://ssrn.com.abstract=1295682. See also Francesco de Zwart (95% author) and George Gilligan, ‘Sustainable Governance in Sporting Organisations’ in Placido Rodríguez, Stefan Kesenne and Helmut Dietl (editors), Social Responsibility and Sustainability in Sports, Ediciones de la Universidad de Oviedo, 2009, p. 165-227.
Governance Factors are the eight most significant and recurrent themes underlying the four Key Fields as drawn from the SSRN platform. In other words, the chapter assesses the continuity and commonality of particular aspects of governance in global and national Governance Codes.

Continuity is measured by identifying Governance Variables which recur over time throughout the evolution (including reform) of Governance Codes in a sector. For example, which variables recur in the United Kingdom from the Cadbury Report⁴ to the UK Combined Code⁵ to the UK Corporate Governance Code 2010-12?⁶ In Australia, which Governance Variables recur throughout the codes of the Australian Securities Exchange⁷ and IFSA⁸? Relative importance is measured by ‘commonality’ of Governance Variables in the codes of a particular sector and across all sectors (i.e., the international/cross border sector and each of the national sectors of the US, UK and Australia). The process of determining which variables kept recurring in each sector and over time is a process this thesis calls ‘commonality’. The list of recurring variables is known as a Commonality Table. There is a Commonality Table for the international/cross border sector and for each of the national sectors of the US, UK and Australia.

Second, flowing from this, the chapter assesses the relative importance of Governance Variables in the context in which they primarily operate – the various global and national Governance Codes – in order to identify:

- a comparative scheme in table-form for comparing Governance Codes; and
- a ‘core’ set of Governance Variables for each sector.

What is the significance of these outputs for the relational approach? The analysis in chapter 1 identified Governance Codes as one of the four Key Fields that together represent a simulation of the ‘real world’ of corporate governance discourse.⁹ Critically, the ‘core’ set of Governance Variables identified at the end of this chapter have already been used to construct the Three Relational Axes of Good Governance and the Governance Factors in chapter 2. Here in chapter 6, the thesis justifies the selection of that core set.

Third, the introductory quote from Kirkbride et al highlights a financial objective of corporate governance through the elimination of – in terms of agency theory – harmful conduct. This objective is shared by Governance Codes. Given this shared objective, to what extent do the Governance Codes examined in this chapter display a converging aspect? For this purpose,

---

⁷ See Table 6.1.4 of this chapter 6.
⁸ Ibid.
⁹ See discussion in sections 1.3.2 and 1.3.2.3 of chapter 1.
the Governance Variables listed in table-form in this chapter are known as a Governance Code Table. There is a Governance Code Table for the international/cross border sector and for each of the national sectors of the US, UK and Australia. Those variables which continuously recur within each sector and across all sectors give rise to a smaller ‘core’ set of Governance Variables.

6.1.2 The Function of Commonality – How to Use Chapter 6

This chapter is not intended to present in detail the content of the various Governance Codes presented. The detailed content, nature and operation of the relevant Governance Variables will be examined in chapters 7 – 10. Instead, chapter 6 is intended to demonstrate the underlying foundation for the thesis. Indeed, the construction of a comparative scheme to compare Governance Codes (i.e., a Governance Code Table) and a ‘core’ set (i.e., a Commonality Table) were the first steps in the construction of the relational approach. The remaining chapters are intended to explain the interrelationships and relative importance of the Governance Variables drawn from these Governance Codes. In this way, the chapter sets out the foundations of the thesis by demonstrating the significant structural aspects of these Codes. Commonality is the methodology chosen for highlighting these structures. As noted above, the process of determining which variables kept recurring in each sector and over time is called ‘commonality’. Again, there is a Commonality Table for the international/cross border sector and for each of the national sectors of the US, UK and Australia.

However, in important respects, the US’ Sarbanes-Oxley Act of 2002 has spearheaded post-collapse reform of national Governance Codes, in particular for its significant effects on the US’ Securities Exchange Act of 1934 (‘SEA’) and listing requirements such as the New York Stock Exchange Listing Rules. Therefore, as an introduction to the detailed examination of Governance Variables in chapters 7 – 10, Appendices C2 and C4 will analyse in table-form the content of the SOX reforms and NYSE Final Rules for the purposes of the construction of the Three Relational Axes of Good Governance and the Core Field Factors.

6.1.3 Justification for Selection of Global and National Corporate Governance Codes

The examination in this chapter will involve a selection of the major well-established Codes in the world today - both global/cross-border and national Anglo-American (US, UK and Australian) – in relation to publicly-traded for-profit companies. While the four Key Fields are determined largely by the size of the literature base, it is not sufficient to include Governance Codes among those Fields merely by the number of articles. Instead, justification is required on a number of levels. First, what is the justification for focussing on Governance Codes? In
other words, what explains the prevalence of the so-called ‘soft law’? Then, why does the chapter first examine international Codes and then move onto the national Codes? Lastly, what is the reason for selecting particular international and national Codes?

6.1.3.1 The ‘Soft Law’ - The Prevalence of Governance Codes

Black’s Seminal ‘Decentred’ Regulation

In her seminal work, Julia Black examined the phenomenon of ‘decentred’ regulation – that regulation does not flow solely from governments (nor should it) but extends to other social actors. This is based on various aspects. First, ‘complexity’ in which:

- social problems are the result of various interacting factors, not all of which may be known, the nature and relevance of which changes over time, and the interaction between which will be only imperfectly understood.

Second, for Black, is the ‘fragmentation’ of knowledge or:

- information asymmetry between regulator and regulated: that government cannot know as much about industry as industry does about itself.

Third, for Black - again on avoiding a monopoly for governments - is the “fragmentation of the exercise of power and control…between social actors and between actors and the state.” This fragmentation leads to a fourth element to the nature of Black’s decentred regulation – “a recognition of the autonomy of social actors…[who] will continue to develop or act in their own way in the absence of intervention.” The final aspect of decentred regulation for Black is:

- the existence and complexity of interactions and interdependencies between social actors, and between social actors and government in the process of regulation.

This thesis seeks to contribute to the understanding of the interrelationships and interactions between the ‘factors’ of Black’s first aspect and between ‘social actors’ in her final aspect. Of course narrower than Black, for the thesis, the factors and actors are limited to economic ones in and about the corporation.

Similar to Black, for Colin Scott, the ‘post-regulatory state’ is typified by a shift away from sole governmental control to ‘other bases for control’ and this underpins much of (corporate) governance regulation:

[If a central characteristic of the regulatory state is an emphasis on hierarchy as an instrument of control, then a key feature of the post-regulatory state is a shift towards other bases for control. This is a key theme of the governance literature. This change may be one of thinking rather than underlying mechanisms, since it has long been clear that the period of organized capitalism is characterized by a

---

16 Ibid, 106-7.
18 Ibid, 108 (footnote omitted).
19 Ibid, 108
Given the ‘decentred’ theme of Black, the thesis will now examine the development of Governance Codes to understand their prevalence in modern corporate governance regulation. As part of this, the role of norms of behaviour described by Scott in the development of Governance Codes is also examined below.

**Categorisation of Forms of Decentred Regulation – What is ‘Soft Law’?**

In the case of various forms of ‘decentred’ regulation relating to corporate governance, du Plessis et al adopt the categorisation method of Professor Farrar which involves:

> categorising the various sources of corporate governance regulation in Australia – into ‘hard law’, ‘hybrids’ and ‘soft law’...[i]t could be said that ‘hard law’ means ‘traditional black-letter law’; ‘soft law’ includes voluntary sources of corporate governance standards that companies have the freedom to adopt or not; and ‘hybrids’ fall somewhere between the two: neither mandatory nor purely voluntary.  

As ‘hard law’, the authors describe Australia’s **Corporations Act 2001 (Cth)** as containing many “mandatory rules, with sanctions imposed for non-compliance”. But this does not mean rigidity. The authors explain that this Act allows a company a high degree of flexibility to govern its internal management through the company’s constitution. Other forms of ‘hard law’ include the interpretation, development and application of black-letter law by judges. For the authors, ‘soft law’:

> involves the purely voluntary (that is, no formal sanctions arise from non-compliance) codes and guidelines articulating benchmarks for what is considered best practice in corporate governance, as well as scholarly and trade writings (in the form of books, reports and articles) that have had some role in influencing companies to shape their internal arrangements and management to achieve best practice.  

Thus the authors categorise ‘soft law’ as including the IFSA Blue Book for fund managers and corporations presented in table-form below.

---


24 du Plessis et al, above n 22, p. 162.

25 Ibid.

26 Ibid, p. 165.


Not surprisingly given the various forms, the process of labelling shows much variation beyond the extremes of ‘hard’ and ‘soft law’. Du Plessis et al note that the ASX Listing Rules are said to be a ‘hybrid’ by Farrar - but possess for the authors some ‘hard law’ characteristics because “they are mandatory rules, given statutory force under section 793C of the Corporations Act…”29 Again, du Plessis et al note that the ASX 2007-10 Revised Principles30 are said to be ‘soft law’ by Farrar because of their ‘comply or explain’ enforcement method - but a ‘hybrid’ by the authors:

[...the ‘comply or explain’ regime stems from Listing Rule 4.10.3, which expressly states that listed entities must comply with the recommendations…or explain why not in their annual report…[They] are not prescriptive rules – as exist in the USA with the Sarbanes-Oxley Act of 2002 and the New York Stock Exchange corporate governance rules – neither are they purely voluntary…31

Putting aside questions of categorisation, the thesis will now examine the development of Governance Codes to understand their prevalence in modern corporate governance regulation.

6.1.3.2 The Influence of Structural Issues from Pre-Millennium Corporate Collapses

In general terms, impetus for the development of many Governance Codes came from the loss of investor and public confidence occasioned by pre-millennium corporate disasters which received global attention. Many commentators identify the Governance Codes as emerging from the significant corporate collapses of the 1990’s including America's Enron and WorldCom and, in Australia, HIH Insurance and One.Tel.32

In the UK, the collapse of BCCI bank and depletion of pension funds connected with Robert Maxwell companies were the ‘smoking guns’ for the establishment of the Cadbury Committee

30 The original ASX best practice recommendations were contained in the ASX Corporate Governance Council, Principles of Good Corporate Governance and Best Practice Recommendations, Australian Securities Exchange, March 2003 (‘ASX 2003 Best Practice Recommendations’). Proposed changes to the ASX 2003 Best Practice Recommendations were the subject of public comment. See ASX Corporate Governance Council, Principles of Good Corporate Governance and Best Practice Recommendations, Exposure Draft of Changes, Australian Securities Exchange, 2 November 2006 (‘ASX Draft Recommendations’).
and its now seminal Report. In this respect, the UK Financial Reporting Council (FRC) stated in 2006 that:

[the development of corporate governance in the UK has its roots in a series of corporate collapses and scandals in the late 1980s and early 1990s, including the collapse of the BCCI bank and the Robert Maxwell pension funds scandal, both in 1991.]

[the UK business community recognised the need to put its house in order. This led to the setting up in 1991 of the Committee on the Financial Aspects of Corporate Governance, chaired by Sir Adrian Cadbury, which issued a series of recommendations - known as the Cadbury Report – in 1992.]

Of course, much of the push in the US for the adoption of good governance practices came from the effects of scandals, albeit at a later time, including the highly-publicised demises of Enron and WorldCom. Indeed, echoing the analysis of the Enron corporate collapse, the US’ Conference Board has suggested that underlying many major corporate collapses such as these was that:

strong CEOs appear to have exerted a dominant influence over their boards, often stifling the efforts of directors to play the central oversight role needed to ensure a healthy system of corporate governance. In such circumstances, boards have often either lacked the structure and information to perform their roles properly, or they have simply abdicated their responsibilities to provide the oversight required of them. In such circumstances, the board cannot properly oversee the CEO’s performance.

Hill, too, saw the collapses of HIH Insurance and One.Tel in part in terms of their domineering CEOs:

[both companies had charismatic and dominating CEOs, and both engaged in high-risk practices in extremely competitive markets.]

The Conference Board pointed to collapses such as Enron and WorldCom as also undermining public confidence in audit processes and in the reliability of published financial data while Professor Hill would add to this “aggressive and questionable accounting practices.” The FRC similarly connects these collapses to an updating of the UK Combined Code in 2003 to incorporate other reviews including the Higgs Report (the later version of the UK Combined Code was published in 2006 and the UK Corporate Governance Code 2010-12 in June 2010 as amended in September 2012).

What does this mean for the foundations of the relational approach in this thesis? The answer is that an examination of these codes is in part justified on account of the detailed analysis of the Enron and Hastie collapses in chapter 5. Commentator evaluations of those collapses form

---

33 The UK Approach to Corporate Governance, November 2006, London (‘FRC UK Governance Approach 2006’), pp 3-4. This was revised in The UK Approach to Corporate Governance, October 2010, London (‘FRC UK Governance Approach 2010’).
35 Hill, above n 32, 371.
36 Conference Board Principles, above n 34, p 29.
37 Hill, above n 32, 371-2.
39 See UK Corporate Governance Code 2010-12, above n 6.
Key Field No. 2 of the four Key Fields of the relational approach. Having examined the collapses in detail, this chapter demonstrates that Key Field No. 3 of the relational approach is similarly founded on the structural changes which regulatory responses to those collapses sought to achieve and which continue to this day. For example, chapter 5 identified in the Enron and Hastie scenarios failures relating to the operation of agency theory\(^{40}\), director independence, monitoring and risk management\(^{41}\), equity and option holdings\(^{42}\), familiarity and deference\(^{43}\) and complexity and corporate culture issues\(^{44}\). Also dominating these failures were issues relating to earnings manipulation\(^{45}\), off-balance sheet transactions and entities\(^{46}\), CEO, executive and director compensation\(^{47}\) and external and independent audit\(^{48}\).

Flowing from this, the Governance Codes reflect particular emphasis on the following key features identified by Ross Grantham and which resound with many of the failures identified by chapter 5:

- that the board should have independent directors;…
- that the board should be composed of individuals having a mix of skills and knowledge;…
- that there should be subcommittees of the board to deal with matters such as audit and remuneration;…
- to put in place robust procedures for reporting financial and governance information…[and] to adopt procedures and policies to ensure the integrity and accuracy of that information;…
- that the remuneration of the board should be fair and reasonable and should be the result of transparent procedures…[and]…should be linked to the performance of the company;…[and]
- the board is enjoined to observe the highest standards of ethical behaviour and to adopt a code of ethics against which the behaviour of directors might be measured.\(^{49}\)

Indeed, Grantham identifies as common to the Australian and US Codes that they are based on "the agency cost problem as the central obstacle to good governance"\(^{50}\). Again, this is consistent with Key Field No. 1 of the relational approach which is based on the concept of agency costs.\(^{51}\)

### 6.1.3.3 The Development of Norms of Behaviour

For Le Mire, Governance Codes have significant advantages which help to explain their prevalence:

> [a]s ‘soft law’…[t]hey can avoid the formality inherent in legislation. They are also less constrained by the normative ideas about law, such as that it should comply with rule of law values. Furthermore, unlike law where change is often incremental and built on the legacy of past views…soft law can be a new broom. Furthermore soft law can be more flexible and less formal than legislation. This may mean

\(^{40}\) See discussion in section 5.3.1 of chapter 5.
\(^{41}\) See discussion in section 5.3.2 of chapter 5.
\(^{42}\) Ibid.
\(^{43}\) Ibid.
\(^{44}\) Ibid.
\(^{45}\) See discussion in section 5.3.3 of chapter 5.
\(^{46}\) Ibid.
\(^{47}\) Ibid
\(^{48}\) See discussion in section 5.3.4 of chapter 5.
\(^{50}\) Ibid, 221.
\(^{51}\) See discussion in sections 4.2.2 – 4.2.3 of chapter 4.
that it can provide more concrete and contemporary statements about corporate governance... It may also mean that interest groups seek to define soft law in ways that meet their needs or desires.\textsuperscript{52}

For the author, Governance Codes such as the ASX 2007-10 Revised Principles also perform an important function of ‘symbolic regulation’ where “public reassurance has been the primary motivator of reform.”\textsuperscript{53} She summarises such regulation as having elements which include:

- Enhancing the popularity of the officeholder with the public;
- Reassuring the public that steps are being taken to address the problem;
- Simplifying a complex problem;
- Providing a ‘normative improvement in corporate governance with applicability across the states that was difficult to contest’;
- Demonstrating acceptable and unacceptable behaviour; [and]
- Educating the public about the problem.\textsuperscript{54}

Hill, too, shows that changes to the role and structure of the board “have been driven, not by legislative intervention and direct regulation, but by the development of commercial practices and norms.”\textsuperscript{55} Hill identifies at least two influences deriving from these norms on the prevalence of Governance Codes. First is the wide sources from which so-called ‘voluntary’ Codes spring:

[n]orms have become increasingly important in corporate governance. They have generally emanated from voluntary adoption of guidelines from a range of sources. A comparative study of corporate governance codes in Europe identified such sources as including governmental or quasi-governmental entities; committees organized by governments or by stock exchanges; business, industry and academic associations; directors’ associations and investor-related groups.\textsuperscript{56}

Indeed, Hill identified in the mid-nineties a trend of greater involvement in corporate governance regulation by stock exchanges.\textsuperscript{57} Second, the Codes have also performed a ‘gap-filling’ function where ‘hard law’ was inadequate or to stave it off:

[t]here is, nonetheless, a relationship between governmental regulation and voluntary corporate governance codes of this kind. The development of self-regulatory codes of conduct has tended to be either a response to the lack of specific governmental regulation in particular areas or, in some cases, a justification for the absence of such regulation.\textsuperscript{58}

For the thesis, this raises a theoretical justification for these Codes. That Governance Codes should perform a gap-filling function resounds with the nexus of contracts theory. On this view, ‘voluntary’ Governance Codes are an additional set of ‘contractual relationships’ between the inputs to the firm (eg., shareholders and management) envisaged by Bainbridge.\textsuperscript{59}

\textsuperscript{53} Ibid, 286-287.
\textsuperscript{54} Ibid (footnote omitted).
\textsuperscript{55} Hill, above n 32, 376 (footnote omitted).
\textsuperscript{56} Ibid, 376 (footnote omitted).
\textsuperscript{57} Ibid, 377.
\textsuperscript{58} Ibid 376 (footnote omitted).
This does not mean, however, that ‘enrolling’ other social actors - such as stock exchanges - in the regulation function is without its own difficulties. Julia Black, in an article in the 2012 *Modern Law Review*, tells us that this regulation technique had its own difficulties in the GFC:

> The new governance strategies do have strengths in that they can potentially respond to the conditions of uncertainty, complexity, fragmentation and ungovernability that pervade any regulatory governance regime. But what can be underplayed are their own vulnerabilities, internal tensions and paradoxes. The central claims of proponents of the new governance techniques to functional superiority over CAC [command and control] regulation are that they are responsive, flexible, and in enrolling others in the regulatory project, they thereby expand its capacity and enhance its effectiveness and can even add to its legitimacy. However, their experience in the crisis revealed that in practice they can be either out of touch or indulgent, that they can be implemented in ways which focus heavily on auditable systems and processes, and that in enrolling others they can increase vulnerabilities and the potential for negative endogenous effects.60

Thus, for Black, additional social actors in the regulation function caused their own brand of problems related to the vulnerabilities of each actor.

### 6.1.3.4 Governance Codes as a Product of Enforceability

Indeed, the differing manner in which hard law and soft law may be enforced is also a factor affecting the operation of these Codes. The justifications for including Governance Codes as a Key Field flow from their manner of enforceability61 in two ways. First, for comparative purposes, to compare the approaches to enforceability (for example, voluntary codes, ‘comply or disclose’ regimes and mandatory rules) between ‘global’ and ‘national’ corporate governance schemes. Second, to recognise that the relevant method of enforceability is itself an element of the level of shareholder protection afforded by the relevant global or national regime with the consequences for firm performance and firm value described in chapter 7.62

Thus, the major global or cross-border Governance Codes presented below are not binding on countries by way of international treaty or the like but are intended to operate by way of example or a benchmark for conduct in order to promote international consistency in governance. In the case of the OECD Principles:

> [t]he Principles are non-binding and do not aim at detailed prescriptions for national legislation. Rather, they seek to identify objectives and suggest various means for achieving them. Their purpose is to serve as a reference point.63


For a discussion of whether the ‘comply or explain’ method of enforceability is adequate or should be replaced by regulatory body which can determine compliance, see Andrew R Keay, “Comply or Explain: In Need of Greater Regulatory Oversight?”, (September 10, 2012), available at SSRN: http://ssrn.com/abstract=2144132.

62 See discussion in sections 7.3.1.3 – 7.3.1.3.3 of chapter 7.

Inevitably, different national Governance Codes adopt various approaches to applicability/compliance. For example, in the case of Australia’s ASX 2007-10 Revised Principles, companies listed on the Australian Securities Exchange are, under ASX Listing Rules, required to disclose the extent of their compliance with the Revised Recommendations.64 This method of compliance has been referred to as ‘disclosure (comply or explain).65 The IFSA Blue Book similarly contains a corporate Governance Code for IFSA members (principally fund managers) for use “in determining their approach to Corporate Governance, voting and other issues proposed by public companies in which they invest.”66 As noted above, this is a voluntary code, not linked to the ASX Listing Rules. However, the IFSA Blue Book describes that various versions of the ASX Codes have adopted many of the IFSA Blue Book guidelines.67 There, IFSA also recommends that companies disclose in their annual reports the way in which they comply with the guidelines or disclose why the company has departed from those guidelines.68

In the case of the UK Corporate Governance Code 2010-12 a similar approach is adopted to the ASX Codes with linkage to the London Stock Exchange Listing Rules69 as was the case with the UK’s original Cadbury Report in 199270 and the Financial Reporting Council’s UK Combined Code of 2006.71 Indeed, Hill tells us that the original ASX Code was limited to a requirement on listed companies to disclose their corporate governance practices without prescription as to content but, after criticism from institutional investors, adopted the UK’s comply or explain enforceability measure.72 In the United States, the New York Stock Exchange (NYSE) has issued its Final NYSE Corporate Governance Rules.73 The Rules are prescriptive in relation to content and mandatory in relation to enforcement. They form Section 303A of the Exchange’s Listed Company Manual and apply to all ‘common equity securities’ subject to various exceptions.74

Other US bodies such as the Business Roundtable have issued corporate governance principles which – as a matter of enforceability - are ‘softer’ than the NYSE Final Rules. Comprised of CEOs from various large companies, the Business Roundtable has issued a number of influential guidelines and in 2005 produced its revised corporate governance principles - the Business Roundtable Principles of Corporate Governance 200575 which are

66 IFSA Blue Book, above n 28, section 7.5, p. 5.
67 Ibid, section 7.3, p. 5.
68 Ibid, section 5.2, p. 4.
71 UK Combined Code, above n 5.
72 Hill, above n 32, 377-378.
73 NYSE Final Rules, above n 12.
74 Ibid, s. 303A.00 Introduction. The exceptions include “controlled companies”, “Limited Partnerships and Companies in Bankruptcy”, “Closed-End and Open-End Funds” and “Foreign Private Issuers”.
voluntary in nature\textsuperscript{76} and which were updated in April 2010 and June 2012.\textsuperscript{77} The Conference Board Principles\textsuperscript{78}, issued by a twelve-member Commission of the Conference Board, itself an organisation of industry and other participants, are similarly voluntary suggestions for best practice. The US comparison also includes the CalPERS Global Principles of Accountable Corporate Governance which, like those of the Business Roundtable and Conference Board, are not linked to the NYSE Listed Company Manual. The CalPERS Global Governance Principles “create the framework by which CalPERS executes its proxy voting responsibilities.”\textsuperscript{79} The CalPERS’s ‘sanction’ is to:

withhold its vote from or vote “Against” an individual or slate of director nominees at companies that do not effectively oversee CalPERS interests as a shareowner consistent with the Principles.\textsuperscript{80}

Thus, this influence may be significant as CalPERS is the largest pension fund in the US.\textsuperscript{81}

6.1.3.5 The Harmonisation\textsuperscript{82} or Convergence of Global and National Corporate Governance Codes

The inclusion of Governance Codes within the Key Fields is also justified by an examination of the reasons promoting or inhibiting convergence in global and national corporate governance structures, mechanisms and processes. For example, convergence or divergence may take place between dispersed-shareholding and concentrated-shareholding countries and continues to be examined by many commentators.\textsuperscript{83} The relational approach in this chapter contributes to the debate in this area by using commonality as a measure of convergence.

Many commentators describe similar themes for the use of Governance Codes. For du Plessis \textit{et al}, the objectives of corporate governance are financial:

\begin{quote}
\[\text{[m]ost, if not all, contemporary corporate governance reports, guidelines, commentaries and legislative packages strongly emphasise the link between sound corporate governance practices and success within the corporation and throughout the economy.}\]
\end{quote}

\begin{thebibliography}{9}
\bibitem{2010} Business Roundtable Principles 2005, ibid, Foreward and Introduction, p. 3. See also WB-OECD Global Corporate Governance Forum, above n 65, Annexure 5, p. 91.
\bibitem{2012} Business Roundtable Principles 2012, above n 75.
\bibitem{2011} See above n 34.
\bibitem{2011} Ibid.
\bibitem{2011} Ibid, 5.
\bibitem{2011} See the references in Appendix C1, \textit{Harmonisation or Convergence of Global and National Corporate Governance}.
\bibitem{2011} du Plessis \textit{et al}, above n 22, p. 159
\end{thebibliography}
The authors suggest the OECD Principles as supporting this theme including promoting confidence in the proper functioning of a market economy, lowering the cost of capital for firms and enhancements in efficiency to promote growth.85

With similar themes or objectives, it is not surprising that convergence is a readily observable phenomenon between Governance Codes. Cunningham, for one, describes that many national jurisdictions have enhanced their governance regimes by the adoption of structures and mechanisms from other countries.86 For Cunningham, an important driver of this convergence in governance structures and mechanisms is the growing competition between capital markets:

financial markets across borders increasingly compete with one another as investors (suppliers of capital) look across borders for additional investment opportunities. Simultaneously, corporations (and other organizations) seek lowest cost capital from any market in the world where it can be obtained.87

Specifically in terms of UK and US convergence, the author identifies the Cadbury Report and its descendents as adopting US ‘technical innovations’:

such as increasing the number and roles of independent directors, creating board audit and nominating committees comprised mostly of independent directors and other governance devices heralded and adopted in the US.88

Flowing from this, for authors such as Parbonetti, Markarian and Previts, the drivers of convergence are international institutional investors and the holding of foreign equity:

we see that active institutional investors that operate on a global basis advocate strong governance practices characterised by independent boards, separation of the chairmanship/CEO roles (where the chairman is a non-executive director), and the presence of fully independent audit and remuneration committees. These demands, coupled with their increased holdings of foreign equities have influenced the governance changes in EU and Asian companies.89

Based on an underlying harmonisation theme, the function of the Governance Code Tables is to suggest a comparative scheme in table-form for comparing Governance Codes. Thus, the final Governance Code Table 6.6.190 is comprised of features that have been identified over time and across schemes as prominent in the construction of global and national US, UK and Australian codes. The question to be answered here is with which Code to commence the comparison? The answer the thesis explains below is the OECD Principles.91 But before that, the wide range of codes will be identified.

6.1.4 The Governance Codes Examined in Chapter 6

Accordingly, the review in this chapter will concentrate on the Governance Variable Codes listed in the following Table:

85 Ibid pp. 159-160. The authors cite OECD Principles, above n 63.
86 Cunningham, above n 82, 12.
87 Ibid.
88 Ibid, 15.
90 Australian Governance Code Table 6.6.1: Australian Corporate Governance Variable Codes.
91 See discussion in section 6.2.1 of this chapter 6.
### Table 6.1.4: Global and National Governance Codes

<table>
<thead>
<tr>
<th>International/Cross-Border</th>
<th>OECD Principles(^{92})</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>ICGN Statement(^{93})</td>
</tr>
<tr>
<td></td>
<td>CACG Guidelines(^{94})</td>
</tr>
<tr>
<td>United States</td>
<td>SOX(^{95})</td>
</tr>
<tr>
<td></td>
<td>Final NYSE Corporate Governance Rules(^{96})</td>
</tr>
<tr>
<td></td>
<td>Business Roundtable Principles of Corporate Governance 2012(^{97})</td>
</tr>
<tr>
<td></td>
<td>The Conference Board Commission on Public Trust and Private Enterprise(^{98})</td>
</tr>
<tr>
<td></td>
<td>California Public Employees’ Retirement System (CalPERS) Global Principles of Accountable Corporate Governance(^{99})</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>The Cadbury Report(^{100})</td>
</tr>
<tr>
<td></td>
<td>FRC Combined Code on Corporate Governance(^{101})</td>
</tr>
<tr>
<td></td>
<td>FRC UK Corporate Governance Code 2010-12(^{102})</td>
</tr>
</tbody>
</table>

\(^{92}\) See above n 63.


\(^{94}\) Commonwealth Association for Corporate Governance, *CACG Guidelines of Corporate Governance*, November 1999, (‘CACG Guidelines’).

\(^{95}\) See above n 10.

\(^{96}\) NYSE Final Rules, above n 12.

\(^{97}\) Business Roundtable Principles 2012, above 75.

\(^{98}\) Conference Board Principles, above n 34, pp. 2-28.

\(^{99}\) CalPERS Global Governance Principles, above n 79.

\(^{100}\) Cadbury Report, above n 4.

\(^{101}\) UK Combined Code, above n 5.

\(^{102}\) UK Corporate Governance Code 2010-12, above n 6. The UK Financial Reporting Council (FRC) has published a number of further Codes and guidance notes in relation to corporate governance including:

- FRC UK Governance Approach 2006, above n 33, revised in FRC UK Governance Approach 2010, above n 33;
- *Challenges for Audit Committees Arising from Current Economic Conditions*, November 2009, London;
- *Internal Control: Guidance to Directors*, (formerly known as the Turnbull Guidance), originally published in 1999 and last revised in 2005, London; and

Australia

ASX 2003 Best Practice Recommendations
ASX 2007-10 Revised Principles
IFSA Blue Book

6.2 Global/Cross-Border Corporate Governance Codes

6.2.1 Selection of the Global Sector and OECD Principles

Why have the global sector and, representing that sector, the OECD Principles been selected as the foundation of the convergence exercise in this chapter? For du Plessis et al, the OECD Principles provide a criteria to measure the effectiveness of a corporate Governance Code:

Thus, according to the OECD Principles, whether or not a corporate governance regulatory framework is effective depends on whether the following three criteria are satisfied:

- promotion of transparent and efficient markets;
- consistency with rule-of-law principles (namely accountability, accessibility and clarity; [and]
- clear articulation of the division of responsibilities among the different supervisory, regulatory and enforcement authorities.106

This has compelling explanatory power for this thesis. But the selection of the OECD Principles is justified for three additional reasons particular to the thesis. First, the OECD Principles have been used as a model in the development of many other ‘global’ codes (including the ICGN Statement107 and the CACG Guidelines108). Second, the OECD Principles were retained in the construction of the ‘national’ Governance Code Tables as the Principles themselves state – following a harmonisation theme - that they are intended to be a model for OECD and non-OECD countries alike in the development of corporate governance frameworks.109 In other words, the OECD Principles are not intended to regulate companies directly but to encourage countries to adopt principles which will enhance their national Codes. Finally, in this way, a consistent measure for comparison, commonality (continuity across codes and over time) and relative importance is retained throughout all the Tables. The result is that the nature and extent of the harmonisation of Governance Variables between global, US, UK and Australian corporate Governance Codes can be identified and discussed.110

In addition to the OECD Principles, this thesis also adopts the use of the ICGN Statement and the CACG Guidelines at the global level. This is done for three reasons. The first is to demonstrate the support for the OECD Principles at a global level. Second is to demonstrate that, even at a global level, stakeholders and interest groups may have requirements particular to them in addition to the OECD Principles. The final reason is to demonstrate the strong convergence force emanating from the global level.

103 ASX 2003 Best Practice Recommendations, above n 30.
104 ASX 2007-10 Revised Principles, above n 30.
105 IFSA Blue Book, above n 28.
106 du Plessis et al, above n 22, p. 175.
107 ICGN Statement, above n 93.
108 CACG Guidelines, above n 94, Preface, pp. [2-3].
109 OECD Principles, above n 63, Preamble, p. 11.
110 Of course, the thesis recognises that the third argument would be true of any Code the thesis selected as the basis of all the Governance Code Tables. However, the thesis considers the first two reasons compelling in the context of identifying the ‘contours’ of the general corporate governance ‘landscape’ and so consistency must flow from this.
These reasons are demonstrated by the ICGN Statement and CACG Guidelines themselves. For example, while the upcoming Global Governance Code Table 6.2.2 demonstrates that the ICGN Statement and CACG Guidelines contain some additional provisions to the OECD Principles, these are often by way of placing a greater or different emphasis on particular aspects of governance rather than representing omissions from the OECD Principles altogether. This is recognised by the ICGN Statement itself which states:

[this revision, in general, endorses the revised OECD Principles, a number of which are thus repeated here. The revision also identifies additional principles of corporate governance of particular concern to the ICGN and its members.]

The CACG Guidelines, too:

have been structured on a basis complementary to the OECD Principles of Corporate Governance, with particular focus on the emerging and transition economies in the global market which comprise a substantial number of Commonwealth countries.

Thus the ICGN Statement and CACG Guidelines are intended to operate in a similar fashion to the OECD Principles which adds to the convergence aspect. But the particular interest group concerns add additional features, the ICGN Statement representing investing members and the CACG Guidelines encompassing emerging and transition markets. In the case of the ICGN Statement, its intention is to “highlight elements that ICGN investing members take into account when making asset allocations and investment decisions”. Hence, this emphasis can help to explain some of the Governance Variables additional to the OECD Principles in Global Governance Code Table 6.2.2 presented below.

### 6.2.2 Principal Governance Variables in Global Corporate Governance

Global Governance Code Table 6.2.2 below demonstrates the ‘sphere of operation’ of the three global Governance Codes to be examined in this thesis. In other words, the chapter demonstrates in a comparative table form the place that the Governance Variables examined in chapters 7 – 10 have in an overall governance scheme for publically-traded for-profit organisations.

A comparison of the three global codes will then be undertaken in section 6.2.3. This will again be in table form - this time using a Commonality Table. This will identify the core features of those global Governance Codes to distil the main themes and variables derived from those Codes. The following Global Governance Code Table 6.2.2 represents the principal governance themes and Governance Variables that underpin the global Governance Codes listed in Table 6.1.4 of this chapter 6:

---

111 ICGN Statement, above n 93, p. 1 (emphasis added).
112 CACG Guidelines, above n 94, p. 6 (emphasis in original).
113 ICGN Statement, above 93, pp. 1-2.
114 CACG Guidelines, above n 94, p. 6.
115 ICGN Statement, above n 93, p. 1.
### Global Governance Code Table 6.2.2:
**Global/Cross-Border Governance Codes**

<table>
<thead>
<tr>
<th>No.</th>
<th>Governance Variable (Based on OECD Principles)</th>
<th>OECD Principles</th>
<th>ICGN Statement</th>
<th>CACG Guidelines</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td><strong>External Governmental Legal and Governance Structure/Compliance</strong>:&lt;sup&gt;116&lt;/sup&gt;</td>
<td>IA – D</td>
<td>7.2</td>
<td>5, 7</td>
</tr>
<tr>
<td></td>
<td>i. Appropriate legal structures/agencies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>ii. Governance structures and practices consistent with law and transparent/enforceable</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>iii. Demarcation and transparency for governmental and regulatory agencies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2.</td>
<td><strong>Owner Shareholding and Participation Rights</strong>:&lt;sup&gt;117&lt;/sup&gt;</td>
<td>IIA – G</td>
<td>4.1-4.16</td>
<td></td>
</tr>
<tr>
<td></td>
<td>i. Ownership and transfer structures</td>
<td>2.2</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>ii. Participation in profits</td>
<td>2.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>iii. Timely/regular disclosure of information</td>
<td>2.1-2.2</td>
<td>6, 7</td>
<td></td>
</tr>
<tr>
<td></td>
<td>iv. Questions and voting in meetings including re:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>a. Appointment/removal of directors</td>
<td>4.4, 4.6</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>b. Key/extraordinary changes</td>
<td>4.7, 4.8-10</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>c. Corporate governance</td>
<td>4.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>d. External audit</td>
<td>4.5, 4.9</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>e. Remuneration policy re board/execs</td>
<td>3.1-3.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>v. Disclosure of disproportionate control structures/arrangements</td>
<td>2.2, 4.3</td>
<td>9</td>
<td></td>
</tr>
<tr>
<td></td>
<td>vi. Protection for market for corporate control</td>
<td>4.5, 8.2</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>vii. Disclosure of institutional shareholder governance/voting policies and conflicts</td>
<td>2.2, 4.11-4.12</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.</td>
<td><strong>Fairness</strong>:&lt;sup&gt;118&lt;/sup&gt;</td>
<td>IIIA-C</td>
<td>4.16</td>
<td>7</td>
</tr>
<tr>
<td></td>
<td>i. Ability to bring action for breach of shareholder rights</td>
<td>4.2</td>
<td>7</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ii. Equality within share classes</td>
<td>4.2</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>iii. Safeguards for minority</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>iv. Prohibition re inside/self dealings</td>
<td>4.2</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>v. Interested or conflicted director disclosure</td>
<td>5.5, 5.14-5.15</td>
<td>6, 7</td>
<td>7, 9</td>
</tr>
<tr>
<td>4.</td>
<td><strong>Stakeholder Participation</strong>:&lt;sup&gt;119&lt;/sup&gt;</td>
<td>IVA-F</td>
<td>7</td>
<td>8</td>
</tr>
<tr>
<td></td>
<td>i. Identification, consultation and participation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>ii. Ability to bring action for breach of enforecible stakeholder rights</td>
<td>7.3</td>
<td>3, 6, 8</td>
<td></td>
</tr>
<tr>
<td></td>
<td>iii. Timely disclosure of information</td>
<td></td>
<td></td>
<td>6</td>
</tr>
<tr>
<td></td>
<td>iv. Employee/management/director incentive and participation schemes</td>
<td>5.1(4), 5.18, 7.4</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

---

<sup>116</sup> OECD Principles, above n 63, p. 17.
<sup>117</sup> Ibid, pp. 18-19.
<sup>118</sup> Ibid, p. 20.
<sup>119</sup> Ibid, p. 21.
### 5. Access/Transparency of Information\(^{120}\):

<table>
<thead>
<tr>
<th></th>
<th>VA-F</th>
</tr>
</thead>
<tbody>
<tr>
<td>i</td>
<td>2.1-2.2, 6.1, 5.18, 7.3, 8.1, 3.1-3.5, 5.1(7), 3.1, 3.5</td>
</tr>
<tr>
<td>ii</td>
<td>6, 7, 7</td>
</tr>
<tr>
<td>iii</td>
<td>10, 15</td>
</tr>
</tbody>
</table>

### 6. Board Functions and Independence\(^{121}\):

<table>
<thead>
<tr>
<th></th>
<th>VIA-F</th>
</tr>
</thead>
<tbody>
<tr>
<td>i</td>
<td>5.3, 7.2, 1.5, 7</td>
</tr>
<tr>
<td>ii</td>
<td>7.5-7.6, 5, 8</td>
</tr>
<tr>
<td>iii</td>
<td>8</td>
</tr>
<tr>
<td>iv</td>
<td>5.1(1)–(8), 1, 3, 2, 3, 4, 7, 14</td>
</tr>
<tr>
<td>v</td>
<td>3, 4, 3, 4, 7, 11, 12</td>
</tr>
<tr>
<td>vi</td>
<td>2</td>
</tr>
<tr>
<td>vii</td>
<td>5.12-5.13, 1, 2, 9</td>
</tr>
<tr>
<td>viii</td>
<td>3, 9</td>
</tr>
<tr>
<td>ix</td>
<td>5.4-8.5.11, 1, 2, 9</td>
</tr>
<tr>
<td>x</td>
<td>5.2, 5.9, 2, 9</td>
</tr>
<tr>
<td>xi</td>
<td>5.9</td>
</tr>
<tr>
<td>xii</td>
<td>5.16, 11</td>
</tr>
<tr>
<td>xiii</td>
<td>3.5, 4, 10</td>
</tr>
<tr>
<td>xiv</td>
<td>4.4, 13</td>
</tr>
<tr>
<td>xv</td>
<td>5.10, 15</td>
</tr>
</tbody>
</table>

### 7. Maximising Profits/Value

<table>
<thead>
<tr>
<th></th>
<th>1.1-1.2</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1, 14</td>
</tr>
</tbody>
</table>

\(^{120}\) Ibid, pp. 22-23.
\(^{121}\) Ibid, pp. 24-25.
\(^{122}\) ICGN Statement, above n 93, p. 9.
6.2.3 Global ‘Core’ Variables - Comparison and Commonality of Global/Cross-Border Corporate Governance Codes

6.2.3.1 Global ‘Core’ Variables as a Product of Commonality

The CAGG Guidelines reproduce more of the OECD Principles than the ICGN Statement, but a number of issues have been directly transplanted from the OECD Principles to both the ICGN Statement and CAGG Guidelines. The following Global Commonality Table 6.2.3.1 represents the core corporate Governance Variables common to all three global Governance Codes:

**Global Commonality Table 6.2.3.1: ‘Core’ Global Governance Variables**

<table>
<thead>
<tr>
<th>No</th>
<th>Table 6.2.2 Reference</th>
<th>‘Core’ Global Governance Variable</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1.i</td>
<td>Appropriate legal structures/agencies</td>
</tr>
<tr>
<td>2</td>
<td>2.iii, 5.i</td>
<td>Timely/regular disclosure of material information</td>
</tr>
<tr>
<td>3</td>
<td>2.iv</td>
<td>Shareholder questions and voting in meetings re:</td>
</tr>
<tr>
<td></td>
<td>a.</td>
<td>a. Appointment/removal of directors</td>
</tr>
<tr>
<td></td>
<td>b.</td>
<td>b. key/extraordinary changes</td>
</tr>
<tr>
<td>4</td>
<td>2.v</td>
<td>Disclosure of disproportionate control structures or arrangements</td>
</tr>
<tr>
<td>5</td>
<td>3.ii</td>
<td>Equality within share classes</td>
</tr>
<tr>
<td>6</td>
<td>3.v, 6.iv.e</td>
<td>Interested or conflicted director disclosure</td>
</tr>
<tr>
<td>7</td>
<td>4.i</td>
<td>Stakeholder identification, consultation and participation</td>
</tr>
<tr>
<td>8</td>
<td>4.iv</td>
<td>Employee/management/director incentive and participation schemes</td>
</tr>
<tr>
<td>9</td>
<td>5.i.b</td>
<td>Disclosure of remuneration policies</td>
</tr>
<tr>
<td>10</td>
<td>5.ii</td>
<td>Independent/external audit</td>
</tr>
<tr>
<td>11</td>
<td>5.iii</td>
<td>Quality and integrity of information</td>
</tr>
<tr>
<td>12</td>
<td>6.i</td>
<td>Compliance with statutory and legal duties on organisation/directors</td>
</tr>
<tr>
<td>13</td>
<td>6.ii</td>
<td>Fair and ethical decision-making</td>
</tr>
<tr>
<td>14</td>
<td>6.iv</td>
<td>Principal board responsibilities:</td>
</tr>
<tr>
<td></td>
<td>a.</td>
<td>a. Strategic/long-term planning; budget; performance review</td>
</tr>
<tr>
<td></td>
<td>b.</td>
<td>b. Corporate governance compliance</td>
</tr>
<tr>
<td></td>
<td>c.</td>
<td>c. Selection and monitoring of key management</td>
</tr>
<tr>
<td></td>
<td>d.</td>
<td>d. Fair and open election of directors</td>
</tr>
<tr>
<td></td>
<td>e.</td>
<td>e. Interested director or management conflicts or transactions</td>
</tr>
<tr>
<td></td>
<td>f.</td>
<td>f. Reporting, audit, financial/operational control, risk management</td>
</tr>
<tr>
<td></td>
<td>g.</td>
<td>g. Disclosure of information</td>
</tr>
<tr>
<td>15</td>
<td>6.v.a</td>
<td>Independent/non-executive directors</td>
</tr>
<tr>
<td>16</td>
<td>6.v.b</td>
<td>Responsibilities of board subcommittees delineated and disclosed</td>
</tr>
</tbody>
</table>
Which Governance Variables represent these themes and how are they analysed in this thesis? Taken from this Table, the following areas have ongoing prominence in corporate governance discourse and are included in the Governance Variables listed in Table 2.4:

- **Items 1 - 6**: Appropriate legal structures/agencies, shareholder voting and meetings, disclosure of disproportionate control structures or arrangements, equality within share classes and interested or conflicted director disclosure – these raise the strength of the national governance regime;

- **Items 6, 14 and 15**: Director independence;

- **Items 2 and 11**: Timely/regular disclosure of material information and the quality and integrity of information – these raise the transparency and timeliness of reporting;

- **Items 8 – 9**: Incentive-based performance and participation schemes for directors and executives and disclosure of remuneration policies; and

- **Item 10**: Independent/external audit.

### 6.2.3.1.1 The National Regime and ‘Overall’ Governance Level

Chapter 7 identifies the strength of the national governance/shareholder protection regime as a significant contributor to firm performance:

- **[NationGov] (+)**: National Governance/Shareholder Protection Regime, +100.00 rprox (section 7.3.1.3.3).

The selection of this variable is supported by the presence of the core variables displayed in the above Table, particularly Items 1 - 6. That this should be the case in the global Code sphere is not surprising as these Codes seek to be models for national adoption. But the national company governance regime is also comprised of additional aspects examined individually in the thesis. For example, the above Table displays a number of variables prominent (in combination or groupings) in the determination of ‘overall’ governance strength – independent/non-executive directors (including, here, interested or conflicted director disclosure), board subcommittees and independent/external audit.

### 6.2.3.1.2 Director Independence

The director independence theme is a feature of a significant number of Governance Variables found in chapters 7 - 10 of the thesis, both in relation to directors individually and in committee:

- **[AudIndFreq] (+)**: Audit Committee – Independence in Combination with Frequency of Meeting – Reduction in Earnings Manipulation Effect, +7/87.50 rprox (section 9.2.1);

- **[AudIndInfo] (-)**: Audit Committee - Independence - Information Flow and Decision Quality ‘Trade-off’, -4/50.00 rprox (section 8.4.3);

---

123 See discussion in section 6.1.3.2 of this chapter 6.

124 See discussion in section 7.3.1.1 – 7.3.1.3 of chapter 7.
• [AudIndMon] (+): Audit Committee – Independence – Monitoring Effect, +7/87.50 rprox (section 8.4.3);
• [BrdIndInfo] (-): Board Independent: Executive Director Proportion – Information Flow and Decision Quality ‘Trade-off’, -4/50.00 rprox (section 7.3.2.1.3);
• [BrdIndMon] (+): Board Independent: Executive Director Proportion – Monitoring Effect, +7/87.50 rprox (section 7.3.2.1.1-2);
• [CompCom] (+/-): Compensation Committee – Presence, Operation and Frequency, +/- 7/87.50 rprox (section 10.2.4.1);
• [NomInd] (+): Nominating Committee – Independence Proportion, +7/87.50 rprox (section 7.3.1.2.2); and
• [OutBrdPos] (-): Outside Board Positions of Independent Directors, -6/75.00 rprox (section 8.2.3.1)

Thus the aspect of director independence receives substantial focus in chapter 7 as it figures prominently in the above Table – items 6, 14e and 15.

6.2.3.1.3 Transparency and Timeliness of Information and Quality of Monitoring of Management

Also prominent are items relating to transparency and timeliness of information – items 2, 11, 14f and 14g. Examples of relevant Governance Variables from the thesis in this respect are:

• [TransTimeMon] (+): Transparency and Timing of Reporting – Monitoring Effect, +8/100.00 rprox (section 9.1.2.1); and

In chapter 9, the thesis will examine whether the transparency and timing of information is effective in the reduction of agency costs and, flowing from this, a consequent reduction in the cost of equity capital. In addition, improvement in the quality of monitoring of management is one of the prominent perceived benefits of many of the Governance Variables examined in chapters 7 - 10 and all three global Governance Codes recognise this as a principal responsibility of the board (Item 14c).

6.2.3.1.4 Compensation, Incentive Schemes and the Quality of Monitoring

Chapter 10 examines whether there is a causative relation between increases in the level of director or CEO compensation and improvements in the quality of monitoring of management. The relevant Governance Variable is:

• [DirCEO$] (+/-): Director/CEO Compensation Levels, +/-7/87.50 rprox (section 10.2.4)

The thesis examines whether improvements in monitoring require intervening factors. For example, that the directors are independent and the compensation incentive-based and/or that those directors have ‘substantial’ equity holdings. The following variables are examples of intervening factors examined for their affect on the quality of monitoring:

125 See discussion in section 9.1.1 – 9.1.2.1 of chapter 8.
126 See discussion in sections 10.2 – 10.2.6 of chapter 9.
• [AudIndMon] (+): Audit Committee - Independence – Monitoring Effect, +7/87.50 rprox (section 8.4.3);
• [AudShortOpts] (-): Audit Committee – Short Term Options Granted to Outside Directors – Reduction in Monitoring Effect, -7/87.50 rprox (section 10.2.5.1);
• [BrdIndMon] (+): Board Independent: Executive Director Proportion – Monitoring Effect, +7/87.50 rprox, (section 7.3.2.1.1-2);
• [EqOptIncmt] (+): Equity/Option Plans and Holdings of Directors/Executives – Incentive/Alignment Effect (excludes short-term options), +7/87.50 rprox (section 10.2.4);
• [EqOptEntrch] (-): Equity/Option Plans and Holdings of Directors/Executives – ‘Entrenchment’ Effect (excludes short-term options), -7/87.50 rprox (section 10.2.4); and
• [ShortTOpts] (-): Short-Term Option Holdings/Plans of Directors and Executives, -7/87.50 rprox (section 10.2.5.1).

Using these variables, chapter 10 also examines the relationship between director/CEO pay levels and firm performance and/or firm value.

As can be seen from the Global Commonality Table, the presence of employee/management/director incentive and participation schemes (item 8) and the disclosure of remuneration policies (item 9) are prescribed by all three global Governance Codes. ‘Disclosure standards’ and ‘transparent reporting’ are also highlighted in Singh’s study in chapter 10127 as being necessary for reputational constraints to operate (downwardly) on the level of executive remuneration and this end is also served by item 9. The relevant governance variables reflecting this are:

• [ReputDiscl] (+): Reputational Constraints – ‘Disclosure Standards’, +8/100.00 rprox (section 10.4.1); and
• [ReputRep] (+): Reputational Constraints – ‘Transparent Reporting’, +8/100.00 rprox (section 10.4.1).

6.2.3.1.5 Independent/External Audit

Independent/external audit has already been identified as significant in the corporate collapses of Enron and the Hastie Group.128 Not surprisingly then, it is identified in the Global Commonality Table as a core variable of international/cross-border Governance Codes. The following variables are relevant to this area. The latter is an intervening factor examined for its affect on the quality of the independent audit:

• [ExtAudEarn] (+): External/Independent Audit Function, +7/87.50 rprox (section 9.2.3.3); and
• [NonAuditS] (-): Non-Audit Services of External Auditor, -7/87.50 rprox (section 9.2.3.2-3).

127 See discussion in section 10.4.1 of chapter 10.
128 See discussion in section 5.2.4 of chapter 5.
6.3 **National Corporate Governance Codes**

6.3.1 **Focus on US, UK and Australian National Codes**

Of all the national corporate Governance Codes, this thesis focuses on the principal codes of the United States, United Kingdom and the thesis’ ‘home’ jurisdiction of Australia for five reasons.

First, these national governance regimes govern ‘dense’ markets comprised of companies with widely-dispersed shareholdings, being the type of shareholdings envisaged by the agency theory component of the shareholder primacy and stakeholder models examined in chapter 4. Second, again aligned with such agency theory, the relevant governance regimes contemplate a single-tier board model. Thirdly, these jurisdictions are all common-law based or, at the least, English in origin which the thesis identifies in chapter 7 as being considered (as a relative measure) ‘high’ or ‘strong’ shareholder protection countries. So far, apples are being compared with apples.

Fourth, as far as content is concerned, national corporate Governance Codes are intended to be more ‘focussed’ than their global counterparts because the former Codes are:

> aimed at improving and guiding the governance practices of corporations within a country’s specific legal environment and business context. These codes are typically based on principles and focus on country-specific issues.

Thus, a comparative examination of the nature, status and content of various national corporate Governance Codes, guidelines and schemes adopted by countries has been undertaken by the Global Corporate Governance Forum and will not be repeated here.

Finally, these three jurisdictions have experienced continual, and at times substantial, change and development to their corporate Governance Codes in the past 20 years, reflecting, and as the chapter will demonstrate, often spearheading good corporate governance practice. In this way, core variables or other harmonisation/underlying themes and tensions for each of these national sectors have temporal (as a measure of continuity over time) and, related to this, developmental comparative integrity. For example, the Australian company governance regime is well-developed, covering similar themes as the US and UK. It has been reviewed and revised in June 2010 in an environment of growing recognition of the role of corporate social responsibility and ‘other’ stakeholder interests in the governance of corporations. Thus, this temporal and comparative integrity also underpins the construction of the Three Relational Axes of Good Governance and Governance Factors.

---

129 See discussion in section 2.1 of chapter 2.
130 Ibid.
131 See discussion in section 7.3.1.3 – 7.3.1.3.3 of chapter 7.
133 Ibid, pp. 21-35 and Annexures 3 and 5.
135 See ibid, p 3. and Revised Principle 3, pp. 22-25.
6.4 **United States Corporate Governance Codes**

Accordingly, the thesis will note the US corporate governance reforms prompted by SOX. Following this, the chapter presents a picture of those reforms as flowing through to the stock exchange listing requirements of the current NYSE Final Rules.

6.4.1 **SOX Effects on Securities Exchange Act and NYSE Final Rules in Appendix C2**

SOX is still one of the most important reforms to US corporate governance, in particular for its consequential effects on the Securities Exchange Act of 1934 (‘SEA’) exchange rules issued by the Securities Exchange Commission (‘SEC’) and listing requirements such as the NYSE Final Rules.

Therefore, before discussing the principal governance themes and variables in US public company corporate Governance Codes, the thesis sets out in Appendix C2 (Summary of Content and Themes from SOX Reforms) the main reforms introduced by SOX. These reforms are examined there by reference to the themes and tensions underpinning the Three Relational Axes of Good Governance and the Governance Factors for the construction of those components in chapter 2.

While the SOX reforms are significant, they are not displayed *in themselves* in the following Table because SOX is clearly a ‘hard law’ instrument unlike the ‘soft law’ Governance Codes examined in this chapter. Instead, for ‘soft law’ comparability, the significance of SOX is its ‘downstream’ consequences. These comprise the detailed Governance Variables and requirements introduced by the NYSE Final Rules consequent on the passing of SOX and are presented in the following US Governance Code Table 6.4.2.

6.4.2 **US National Corporate Governance Codes**

The Table below presents the US Governance Codes listed in Table 6.1.4 of this chapter. As can be seen from the Table, the Governance Variables are based on those in global codes so as to further build up the landscape of variables to create a comparative scheme in table-form for comparing Governance Codes. Significantly, the Table represents in table-form how the

---

136 SOX, above n 10.
138 SEA, above n 11.
139 For a detailed discussion of the main reforms introduced by SOX and their perceived effects and criticisms, see the references listed in Appendix C3, Evaluations of the SOX Reforms.
140 See discussion in sections 2.3.1 – 2.3.3 of chapter 2.
141 See section 1.7.1 of chapter 1 for the Governance Factors which are explained and justified in sections 2.6.1 – 2.6.8 of chapter 2.
142 See discussion in section 6.1.3.1 of this chapter 6.
SOX reform requirements summarised in the SOX Summary Table in Appendix C2 have been incorporated into the NYSE Final Rules.\textsuperscript{143}

**US Governance Code Table 6.4.2:**
**US National Corporate Governance Codes**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>External Governmental Legal and Governance Structure/Compliance:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>i  Appropriate legal structures/agencies</td>
<td></td>
<td></td>
<td>IX</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ii Governance structures and practices consistent with law and transparent/enforceable</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>iii Demarcation and transparency for governmental and regulatory agencies</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2.</td>
<td>Owner Shareholding and Participation Rights:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>i Ownership and transfer structures</td>
<td></td>
<td></td>
<td></td>
<td>B7, C8.1-7, C9.1-7</td>
</tr>
<tr>
<td></td>
<td>ii Participation in profits</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>iii Timely/regular disclosure of information</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>iv Questions and voting in meetings including re:</td>
<td></td>
<td></td>
<td></td>
<td>B4, B4.1-16, C2.3b, j, C7.1-6</td>
</tr>
<tr>
<td></td>
<td>a. Appointment/removal of directors</td>
<td></td>
<td></td>
<td>VIII</td>
<td>B7, B7.1-10, C8.3-4, C9.7</td>
</tr>
<tr>
<td></td>
<td>b. Key/extraordinary changes</td>
<td></td>
<td></td>
<td>VIII1</td>
<td>B7.2</td>
</tr>
<tr>
<td></td>
<td>c. Corporate governance</td>
<td></td>
<td></td>
<td>VIII1</td>
<td>C8.3.3</td>
</tr>
<tr>
<td></td>
<td>d. External audit</td>
<td></td>
<td></td>
<td></td>
<td>C8.2</td>
</tr>
<tr>
<td></td>
<td>e. Remuneration policy re board/execs</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>v Disclosure of disproportionate control structures/arrangements</td>
<td>.08</td>
<td>I, IV</td>
<td></td>
<td>B3, B3.1-7, C5.1-8</td>
</tr>
<tr>
<td></td>
<td>vi Protection for market for corporate control</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>vii Disclosure of institutional shareholder governance/voting policies and conflicts</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>viii Participation of institutional shareholders</td>
<td></td>
<td></td>
<td></td>
<td>C8, C9</td>
</tr>
<tr>
<td>3.</td>
<td>Fairness:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>i Ability to bring action for breach of shareholder rights</td>
<td></td>
<td></td>
<td></td>
<td>C8.5</td>
</tr>
<tr>
<td></td>
<td>ii Equality within share classes</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>iii Safeguards for minority</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>iv Prohibition re inside/self dealings</td>
<td></td>
<td></td>
<td></td>
<td>C2.3g, C2.11</td>
</tr>
<tr>
<td></td>
<td>v Interested or conflicted director disclosure</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>.10</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>.01, .02a-b, .10</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td>Stakeholder Participation:</td>
<td></td>
<td></td>
<td></td>
<td>B6</td>
</tr>
<tr>
<td></td>
<td>i Identification, consultation and participation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>ii Ability to bring action for breach of enforceable stakeholder rights</td>
<td></td>
<td>III, IV</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### 5. Access/Transparency of Information:

- **Timely disclosure of material information including:**
  - results
  - remuneration policies
  - director qualifications/independence
  - risk factors
  - governance codes/policies

- **Quality and integrity of Information**

- **Independent/external audit**

- **Access/Transparency of Information**:
  - Timely disclosure of material information including:
    - results
    - remuneration policies
    - director qualifications/independence
    - risk factors
    - governance codes/policies

### 6. Board Functions and Independence:

- **Compliance with statutory and legal duties on organisation/directors**
- **Fair and ethical decision making and corporate social responsibility**
- **Reduction of stakeholder interests**
- **Principal Responsibilities:**
  - Strategic/long-term planning; budget; performance review
  - Corporate governance compliance
  - Selection and monitoring of key management
  - Fair and open election of directors
  - Interested director or management conflicts or transactions
  - Reporting, audit, financial/operational control, risk management
  - Disclosure of information
  - Independent from management:
    - Non-executive/independent directors
    - Responsibilities of Board sub-committees delineated and disclosed
  - Board access to accurate/timely info
  - Competency/experience and skills of directors
  - Disclosure of director contribution/independence
  - Board/director performance review
  - Use of Technology
  - Evaluation of Solvency
  - Director term of office
  - Board size
  - Independent investigation of management
  - Company Secretary
  - Board Diversity

### 7. Maximising Profits/Value

### 8. Enforcement/disclosure of non-compliance with best practice
6.4.2.1 US ‘Core’ Variables as a Product of Commonality

The following core Governance Variables are revealed as relatively important in all four columns of the US national Governance Codes depicted in the above Table. The chapter thus submits that these represent the major themes in US corporate governance regulation:

US Commonality Table 6.4.2.1:
‘Core’ US National Governance Variables

<table>
<thead>
<tr>
<th>No</th>
<th>Table 6.4.2 Reference</th>
<th>‘Core’ US National Governance Variable</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>3.v</td>
<td>Interested or conflicted director disclosure</td>
</tr>
<tr>
<td>2</td>
<td>5.i</td>
<td>Timely disclosure of material information including: c. director qualifications/independence e. governance codes/policies</td>
</tr>
<tr>
<td></td>
<td>5.ii</td>
<td>Independent/external audit</td>
</tr>
<tr>
<td>4</td>
<td>6</td>
<td>Board Functions and Independence: i. Compliance with statutory and legal duties on organisation/directors ii. Fair and ethical decision making and corporate social responsibility</td>
</tr>
<tr>
<td></td>
<td>6.i</td>
<td>Principal board responsibilities: b. Corporate governance compliance c. Selection and monitoring of key management d. Fair and open election of directors e. Interested director or management conflicts or transactions f. Reporting, audit, financial/operational control, risk management</td>
</tr>
<tr>
<td>7</td>
<td>6.vi</td>
<td>Competency/experience and skills of directors</td>
</tr>
<tr>
<td>8</td>
<td>6.viii</td>
<td>Disclosure of director contribution/independence</td>
</tr>
<tr>
<td>9</td>
<td>6.ix</td>
<td>Board/director performance review</td>
</tr>
<tr>
<td>10</td>
<td>6.x</td>
<td>Maintenance/review of internal controls/procedures</td>
</tr>
</tbody>
</table>

Example Governance Variables which represent these areas were presented above in relation to the global sphere.144

---

144 See discussion in sections 6.2.3.1.1 – 6.2.3.1.5 of this chapter 6. Again, these core US Governance Variables will be considered in more detail in chapters 7 – 10 in Key Field No. 4 – Empirical Studies of the Effectiveness of Governance Variables.
6.4.2.2 Summary of Content and Themes from NYSE ‘Core’ Variables in Appendix C4

In the SOX Summary Table in Appendix C2, the thesis drew together the underlying themes and tensions which arise in the case of the SOX reforms. In Appendix C4 (Summary of Content and Themes from NYSE ‘Core’ Variables), the thesis concludes the examination of the themes and tensions underlying the US corporate Governance Codes with a summary of the content and themes underpinning the core NYSE Final Rules variables. In other words, these are the core variables of US corporate governance that are contained in or taken from the NYSE Final Rules.\(^\text{145}\) As much as is practicable, the description of the content of the Governance Variables has been taken from section 303A of the Listed Company Manual\(^\text{146}\) itself.

In the next section, the chapter examines the Governance Variables that underpin the UK Governance Codes listed in Table 6.1.4. As part of this, the analysis identifies a core set of UK public company corporate Governance Variables for the purpose of identification and articulation of the Three Relational Axes of Good Governance\(^\text{147}\) and the eight Governance Factors.\(^\text{148}\)

6.5 United Kingdom Corporate Governance Codes

6.5.1 UK National Corporate Governance Codes

UK Governance Code Table 6.5.1 below represents the principal Governance Codes and variables that underpin the UK governance Codes listed in Table 6.1.4 of this chapter. Again, the Governance Variables are based on those in the global sphere to create a comparative scheme in table-form for comparing Governance Codes.

---

145 NYSE Final Rules, above n 12. See Appendix C4, Summary of Content and Themes from NYSE ‘Core’ Variables.
146 Ibid.
147 See discussion in sections 2.3.1 – 2.3.3 of chapter 2.
148 See discussion in section 1.7.1 of chapter 1 for the Governance Factors which are discussed in sections 2.6.1 – 2.6.8 of chapter 2.
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>External Governmental Legal and Governance Structure/Compliance:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>i</td>
<td>Appropriate legal structures/agencies</td>
<td></td>
<td>D1-2</td>
</tr>
<tr>
<td></td>
<td>ii</td>
<td>Governance structures and practices consistent with law and transparent/enforceable</td>
<td></td>
<td>C1, C1.1-3, E1, E1.1-2</td>
</tr>
<tr>
<td></td>
<td>iii</td>
<td>Demarcation and transparency for governmental and regulatory agencies</td>
<td></td>
<td>E2, E2.1-4</td>
</tr>
<tr>
<td></td>
<td>iv</td>
<td>Questions and voting in meetings including re:</td>
<td></td>
<td>B7, B7.1-2</td>
</tr>
<tr>
<td></td>
<td>v</td>
<td>b. Key/extraordinary changes</td>
<td>6.5-8</td>
<td>E3</td>
</tr>
<tr>
<td></td>
<td>v</td>
<td>c. Corporate governance</td>
<td>6.1, 6.6</td>
<td>A7.1-2</td>
</tr>
<tr>
<td></td>
<td>v</td>
<td>d. External audit</td>
<td>6.1</td>
<td>D2.3</td>
</tr>
<tr>
<td></td>
<td>v</td>
<td>e. Remuneration policy re board/execs</td>
<td>4.40, 4.43-5</td>
<td></td>
</tr>
<tr>
<td></td>
<td>vi</td>
<td>Disclosure of disproportionate control structures/arrangements</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>vii</td>
<td>Protection for market for corporate control</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>viii</td>
<td>Disclosure of institutional shareholder governance/voting policies and conflicts</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>viii</td>
<td>Participation of institutional shareholders</td>
<td>6.9-12, 6.15-16</td>
<td>D, D1.1-2, E1-3</td>
</tr>
<tr>
<td>3.</td>
<td>Fairness:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>i</td>
<td>Ability to bring action for breach of shareholder rights</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>ii</td>
<td>Equality within share classes</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>iii</td>
<td>Safeguards for minority</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>iv</td>
<td>Prohibition re inside/self dealings</td>
<td>6.14</td>
<td>A3.1</td>
</tr>
<tr>
<td></td>
<td>v</td>
<td>Interested or conflicted director disclosure</td>
<td>4.6</td>
<td>B1.1</td>
</tr>
<tr>
<td>4.</td>
<td>Stakeholder Participation:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>i</td>
<td>Identification, consultation and participation</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>ii</td>
<td>Ability to bring action for breach of enforceable stakeholder rights</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>iii</td>
<td>Timely disclosure of information</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>iv</td>
<td>Employee/management/director incentive and participation schemes</td>
<td>4.40</td>
<td>B1-2</td>
</tr>
<tr>
<td>5.</td>
<td>Access/Transparency of Information:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>i</td>
<td>Timely disclosure of material information including:</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>a.</td>
<td>results</td>
<td></td>
<td>C1, D1-2, E1-2</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>C1, C1.1-3, E1, E1.1-2</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td>---</td>
<td></td>
<td></td>
</tr>
<tr>
<td>b. remuneration policies</td>
<td>A1, B1-2, Sch A</td>
<td>A4, D1, D1.1-5, Sch A, D2, D2.1-4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>c. director qualifications/independence</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>d. risk factors</td>
<td>4.11, 4.29</td>
<td>E2, Sch C</td>
<td></td>
<td></td>
</tr>
<tr>
<td>e. governance codes/policies</td>
<td>4.35, 5.1-37</td>
<td>A1, C3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ii Independent/external audit</td>
<td></td>
<td>C3, C3.1-8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>iii Quality and integrity of information</td>
<td>4.31, 4.47-9</td>
<td>A5</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>C1, C1.1-3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Board Functions and Independence:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>i Complaince with statutory and legal duties on organisation/directors</td>
<td>A1</td>
<td>A1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ii Fair and ethical decision making; corporate social responsibility and codes of conduct</td>
<td>4.11</td>
<td>A4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>iii Recognition of stakeholder interests</td>
<td>4.29</td>
<td>C1, C1.1-3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>iv Principal Responsibilities:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b. Corporate governance compliance</td>
<td></td>
<td>A4, A4.2, B1.1, B1.1-3, A2.1, A3.2, A3.3, B3, B5.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>c. Selection and monitoring of key management</td>
<td>4.5, 4.11</td>
<td>B6, B6.1-3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>e. Interested director or management conflicts or transactions</td>
<td>4.28, 4.35</td>
<td>A1, A3.1-3, B1.2, B2.1, B3, C3.1-8, D1.1-5, C3, D2, D2.1-4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>v Independence from management:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ix Board/director performance review</td>
<td>4</td>
<td>A6, A7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>x Maintenance/review of internal controls/procedures</td>
<td>4.31-2, 4.39, 5.16</td>
<td>C2, A4, C2.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>xi Use of Technology</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>xii Evaluation of Solvency</td>
<td>5.18-22</td>
<td>C1.2, C1, C1.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>xiii Director term of office</td>
<td>4.16, 4.41</td>
<td>A7.1, B7, B7.1-2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>xiv Board size</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>xv Independent investigation of management</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>xvi Company Secretary</td>
<td>4.25-27</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>xvii Board Diversity</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. Maximising Profits/value</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8. Enforcement/Disclosure of non-compliance with best practice</td>
<td>ss. 1.10, 3.7-3.10 and 3.13-3.16</td>
<td>Preamble ss. 2-4 Comply or Explain ss. 1-6 pp. 4-5</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
6.5.1.1  UK ‘Core’ Variables as a Product of Commonality

In this section, the core Governance Variables from United Kingdom Governance Codes will be drawn from the Cadbury Report, the UK Combined Code and the UK Corporate Governance Code 2010-12:

UK Commonality Table 6.5.1.1: ‘Core’ UK National Governance Variables

<table>
<thead>
<tr>
<th>No</th>
<th>Table 6.5.1 Reference</th>
<th>‘Core’ UK National Governance Variable</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2.iii</td>
<td>Timely/regular disclosure of information</td>
</tr>
<tr>
<td>2</td>
<td>2.iv a.</td>
<td>Questions and voting in meetings including re: a. Appointment/removal of directors</td>
</tr>
<tr>
<td>3</td>
<td>3.v</td>
<td>Interested or conflicted director disclosure</td>
</tr>
<tr>
<td>4</td>
<td>4.iv</td>
<td>Employee/management/director incentive and participation schemes</td>
</tr>
<tr>
<td>5</td>
<td>5.i e.</td>
<td>Timely disclosure of material information including: e. governance codes/policies</td>
</tr>
<tr>
<td>6</td>
<td>5.ii</td>
<td>Independent/external audit</td>
</tr>
<tr>
<td>7</td>
<td>5.iii</td>
<td>Quality and integrity of information</td>
</tr>
<tr>
<td>8</td>
<td>6.iv e.</td>
<td>Principal board responsibilities: e. Interested director or management conflicts or transactions</td>
</tr>
<tr>
<td>10</td>
<td>6.vii</td>
<td>Competency/experience and skills of directors</td>
</tr>
<tr>
<td>11</td>
<td>6.ix</td>
<td>Board/director performance review</td>
</tr>
<tr>
<td>12</td>
<td>6.x</td>
<td>Maintenance/review of internal controls/procedures</td>
</tr>
<tr>
<td>13</td>
<td>6.xii</td>
<td>Evaluation of solvency</td>
</tr>
<tr>
<td>14</td>
<td>6.xiii</td>
<td>Director term of office</td>
</tr>
<tr>
<td>15</td>
<td>8</td>
<td>Enforcement/disclosure of non-compliance with best practice</td>
</tr>
</tbody>
</table>

That the list of variables in UK Commonality Table 6.5.1.1 covers so many areas is not, of course, surprising as both the UK Combined Code and UK Corporate Governance Code 2010-12 are, in effect, direct descendants of the Cadbury Report. Because the latter Codes have

149 FRC UK Governance Approach 2006, above n 33, p. 4.
developed from the former, there is much commonality. But that commonality still displays an important feature - that these Codes have remained consistent during periods of reform.

6.6 **Australian Corporate Governance Codes**

6.6.1 **ASX 2003 Best Practice Recommendations, ASX 2007-10 Revised Principles and IFSA Blue Book**

Australian Governance Code Table 6.6.1 below represents the principal governance themes and variables which underpin the Australian national Governance Codes listed in Table 6.1.4. Here, no commonality table will follow as the ASX Codes are virtually identical, the ASX 2007-10 Revised Principles containing some re-arrangement of their predecessor but with some important additions in 2007 and 2010. The IFSA Blue Book, too, is complimentary to the ASX Codes, its Guidelines explaining in relation to the ‘Disclosure Standard’ that:

> over time, a number of the Guidelines have been incorporated into the law, and they are reflected in the ASX Corporate Governance Principles and Recommendations.

In relation to the ‘Guidelines for Corporations’, again the IFSA Blue Book states it is complimentary to the ASX Codes. As a result, the Australian Governance Codes in the following Table 6.6.1 display significant overlap. Thus, a commonality table is not required to demonstrate their extensive consistency and convergence aspects.

---

150 'ASX 2010 Marked-Up Amendments, above n 30 and ASX 2010 Summary Table, above n 30.
151 IFSA Blue Book, above n 28, Guideline 9.4.1, p. 11.
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td><strong>Australian Governance Code Table 6.6.1:</strong> Australian Corporate Governance Codes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>External Governmental Legal and Governance Structure/Compliance:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>i</td>
<td>Appropriate legal structures/agencies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ii</td>
<td>Governance structures and practices consistent with law and transparent/enforceable</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>iii</td>
<td>Demarcation and transparency for governmental and regulatory agencies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2.</td>
<td><strong>Owner Shareholding and Participation Rights:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Ownership and transfer structures</td>
<td>6, 6.1</td>
<td>6, 6.1</td>
<td>8.1.3, 8.2.15, 11.16, 11.16.1-6</td>
</tr>
<tr>
<td></td>
<td>Participation in profits</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Timely/regular disclosure of information</td>
<td>6, Attach A</td>
<td>6</td>
<td>8.2.15, 10.2, 10.4, 10.4.1, 11.16, 11.16.1-6</td>
</tr>
<tr>
<td></td>
<td>Questions and voting in meetings including re:</td>
<td>2.4</td>
<td>2.4</td>
<td>8.2.17, 11.18</td>
</tr>
<tr>
<td></td>
<td>a. Appointment/removal of directors</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>b. Key/extraordinary changes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>c. Corporate governance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>d. External audit</td>
<td>6.2</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>e. Remuneration policy re board/execs</td>
<td>9.1</td>
<td>5.1-2, 8, 8.1-4</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Disclosure of disproportionate control structures/arrangements</td>
<td></td>
<td></td>
<td>10.4.1</td>
</tr>
<tr>
<td></td>
<td>Protection for market for corporate control</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Disclosure of institutional shareholder governance/voting policies and conflicts</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Participation of institutional shareholders</td>
<td></td>
<td></td>
<td>8.2.16, 11.17</td>
</tr>
<tr>
<td></td>
<td>Disclosure of beneficial shareholder information</td>
<td></td>
<td></td>
<td>10.4.1</td>
</tr>
<tr>
<td></td>
<td>Development of policies and procedures to ensure lawful securities lending activity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.</td>
<td><strong>Fairness:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Ability to bring action for breach of shareholder rights</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Equality within share classes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Safeguards for minority</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Prohibition re inside/self dealings</td>
<td>3, 3.2</td>
<td>3, 3.2</td>
<td>8.2.12, 10.3.5, 11.13</td>
</tr>
<tr>
<td></td>
<td>Interested or conflicted director disclosure</td>
<td>2.1, 3.1-3</td>
<td>2.1, 3.1-3</td>
<td>8.2.12, 11.13</td>
</tr>
<tr>
<td>4.</td>
<td><strong>Stakeholder Participation:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Identification, consultation and participation</td>
<td>10</td>
<td>3</td>
<td>8.1.5, 10.6</td>
</tr>
<tr>
<td></td>
<td>Ability to bring action for breach of enforceable stakeholder rights</td>
<td>10.1</td>
<td>3.1-2, 7.1</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Timely disclosure of information</td>
<td>5, 5.1-2</td>
<td>5, 5.1-2, 7.1</td>
<td>8.2.11, 8.2.14, 11.12, 11.15, 11.15.1</td>
</tr>
<tr>
<td></td>
<td>Employee/management/director incentive and participation schemes</td>
<td>9.1-5</td>
<td>8, 8.1-4</td>
<td></td>
</tr>
</tbody>
</table>
5. **Access/Transparency of Information:**

i Timely disclosure of material information including:
   a. results
   b. remuneration policies
   c. director qualifications/independence
   d. risk factors
   e. governance codes/policies
   f. diversity
   g. gender diversity

ii Independent/external audit

iii Quality and integrity of information

iv Electronic communications

v Website

vi Briefings

vii Direct contact with companies senior management and board members

viii Reporting to client of voting and other corporate governance activities

6. **Board Functions and Independence:**

i Compliance with statutory and legal duties on organisation/directors

ii Fair and ethical decision making; corporate social responsibility and codes of conduct

iii Recognition of stakeholder interests

iv Principal Responsibilities:
   a. Strategic/long-term planning; budget; performance review
   b. Corporate governance compliance
   c. Selection and monitoring of key management
   d. Fair and open election of directors
   e. Interested director or management conflicts or transactions
   f. Reporting, audit, financial/operational control, risk management
   g. Disclosure of information
   h. Provision of resources for management

V Independence from management:
   a. Non-executive/Independent directors
   b. Responsibilities of Board sub-committees delineated and disclosed
   c. Distinguish/specify board and management roles

vi Board access to accurate timely info

vii Competency/experience and skills of directors

viii Disclosure of director contribution/ independence

ix Board/director performance review

x Maintenance/review of internal controls/procedures

xi Use of Technology

xii Evaluation of Solvency

xiii Director term of office

xiv Board size

xv Independent investigation of management

xvi Company Secretary

xvii Board Diversity

xviii Limiting number of outside board positions
6.7  ‘Core’ National Listed Governance Variables

6.7.1 Comparison of US, UK and Australian National Listed Corporate Governance Codes

In this section, the thesis will display continuity (across codes, over time and developmentally) and centrality in US, UK and Australian national Governance Codes.

Again, the thesis adopts the measure of the commonality of Governance Variables across the various Governance Code Tables. However, the relevant Commonality Table will compare only one Code from the relevant national Governance Code Tables - the national Codes that are:

- currently in force/operation; and
- backed with an enforcement or disclosure regime stemming from the Listing Rules of the relevant stock or securities exchanges.

This approach has been adopted in order to ensure that the chapter is drawing out Governance Variables that have similar currency and national standing. Therefore, the following National Listed Commonality Table 6.7.1 represents the principal Governance Variables common to all three of the national corporate Governance Codes which are currently in operation and which are underpinned by Listing Rule enforcement or disclosure regimes – the NYSE Final Rules153, the UK Corporate Governance Code 2010-12154 and the ASX 2007-10 Revised Principles155:

National Listed Commonality Table 6.7.1: ‘Core’ National Listed Governance Variables

<table>
<thead>
<tr>
<th>No</th>
<th>Table 6.6.1 Reference</th>
<th>‘Core’ National Listed Governance Variable</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2.iv d.</td>
<td>Questions and voting in meetings including re: d. External audit</td>
</tr>
<tr>
<td>2</td>
<td>3.v</td>
<td>Interested or conflicted director disclosure</td>
</tr>
<tr>
<td>3</td>
<td>4.iv</td>
<td>Employee/management/director incentive and participation schemes</td>
</tr>
<tr>
<td>4</td>
<td>5.i b.</td>
<td>Timely disclosure of material information including: b. remuneration policies</td>
</tr>
</tbody>
</table>

153 See above n 12.
154 See above n 6.
155 See above n 30.
6.8  **Conclusion - Core Features and Aspects of Corporate Governance Codes**

In this final section 6.8, the thesis’ examination of the relative importance of underpinning themes in corporate Governance Codes culminates with the comparison in subsection 6.8.1. This is a comparison of the core national listed Governance Variables derived from the US, UK and Australia in National Listed Commonality Table 6.7.1 above with their counterpart core variables from the global/cross-border sector.

### 6.8.1 Core Features – Global and National Listed Governance Codes Combined

All of the Governance Variables listed in National Listed Commonality Table 6.7.1 above are important recurring themes in the policy and practice of corporate governance. Of the Governance Variables appearing in the Commonality Tables 6.2.3.1 (global core variables) and 6.7.1 (core national listed variables), the Governance Variables that have been prominent in all columns of those Tables are:

- Questions and voting in meetings (item 2.iv);
- Interested or conflicted director disclosure (items 3.v and 6.iv.e);
- Employee/management/director incentive and participation schemes (item 4.iv);
- Timely disclosure of material information including remuneration policies (item 5.i.b);
- Independent/external audit (item 5.ii);
- Board Functions and Independence: Compliance with statutory and legal duties on organisation/directors (item 6.i);
- Principal board responsibilities: Corporate governance compliance and interested director or management conflicts or transactions (item 6.iv.e);
- Independence from management: Non-executive/independent directors and responsibilities of board subcommittees delineated and disclosed (items 6.v.a and 6.v.b);
- Competency/experience and skills of directors (item 6.vii);
- Board/director performance review (item 6.ix);
- Maintenance/review of internal controls/procedures (item 6.x);
- Director term of office (item 6.xiii);
- Enforcement/disclosure of non-compliance with best practice (item 8).
• Independent/external audit (item 5.ii);

• Board functions and independence - compliance with statutory and legal duties on organisation/directors (item 6.i);

• Principal board responsibilities - corporate governance compliance (items 6.iv.b);

• Principal board responsibilities - interested director or management conflicts or transactions (item 6.iv.e);

• Independence from management - non-executive/independent directors (item 6.v.a);

and

• Independence from management - responsibilities of board sub-committees delineated and disclosed (item 6.v.b).

On the basis of this commonality, the chapter hypothesises that these could be the most important Governance Variables in corporate or for-profit Governance Code discourse. They have already been used in chapter 2 for the identification, design and articulation of the Three Relational Axes of Good Governance\textsuperscript{156} and the Governance Factors.\textsuperscript{157}

In the following chapters 7 – 10, the thesis begins its analysis of the nature, content and behaviour of individual Governance Variables. This is achieved through the examination of Key Field No. 4 - Empirical Studies of the Effectiveness of Governance Variables. Most important in chapters 7 – 10 is to hypothesise the relational effect path of each Governance Variable. This is the evaluation of the number of Governance Factors affected by each Governance Variable and the direction of that effect. This relational effect path was summarised in the Coverage Table 3.3.1 and ultimately translated into a relational proximity Rating (rprox) in the Relational Proximity Table 3.3.2.1. This Rating depicts the relative importance of the Governance Variables in affecting agency costs and the long-term efficiency and sustainability of the for-profit firm.

\textsuperscript{156} See discussion in sections 2.3.1 – 2.3.3 of chapter 2.

\textsuperscript{157} See discussion in sections 2.6.1 – 2.6.8 of chapter 2.
CHAPTER 7
EMPIRICAL STUDIES KEY FIELD NO. 4 (PART 1):
NATIONAL SHAREHOLDER PROTECTION REGIME AND BOARD FACTORS I

7.1 Aims and Purpose of Chapter 7

In chapter 6, the thesis examined the Governance Variables in the context in which they primarily operate – the Governance Codes of the global/cross-border sector and the national sectors of the US, UK and Australia. The chapter developed a comparative scheme in table-form for comparing Governance Codes called a Governance Code Table. From this analysis, the chapter identified a ‘core’ set of Governance Variables for each sector. To do so, the Governance Codes were analysed to determine which Governance Variables recur over time throughout the development and reform of these Codes. The process of identifying which Governance Variables recur in each sector and across all sectors over time was called ‘commonality’. The list of recurring variables was called a Commonality Table.

In this chapter, the thesis begins the process of examining the Governance Variables taken from the Governance Codes. Chapter 7 reviews in detail law, economic and econometric literature from the US, UK, Europe and Australia that comprises empirical studies outlined in Key Field No. 4. In chapter 2, the thesis introduced the perceived general effects said to flow from the adoption of Governance Variables in the for-profit sphere. This was not challenged at that time. Beginning in this chapter 7, Key Field No. 4 examines the firm-specific benefits or, on the contrary, costs or disadvantages argued to flow from these variables. This will be done by reference to empirical studies of the effectiveness of Governance Variables in reducing agency costs and enhancing the long-term survival of the firm. Such efficiency and survival – an over-arching purpose of the relational approach - is assessed in these studies principally by measures of firm operating performance/profit and firm value. Other firm-specific outcomes such as ‘shareholder payout’, the cost of equity capital and the probability of earnings manipulation are also examined.

There are three types of empirical studies examined in chapter 7. First, chapter 7 examines questions relating to whether a particular group of Governance Variables together improve firm operating performance, firm value and shareholder payout. The studies suggest that these measures may be improved by groupings of Governance Variables including board and committee size, a high level of attendance at board meetings, director independence and the proportion of executive directors, the presence and operation of the Audit Committee, Nomination Committee and Compensation Committee and the equity compensation (including options) for directors and executives. Similarly important in these favourable groupings are the board skills ‘mix’, the external audit function, annual board review, ‘outside’ advisors for the board, the absence of anti-takeover mechanisms such as staggered board elections, blockholder activism and the outside board positions of independent directors.

The second group of studies in chapter 7 examine the strength of the national shareholder protection regime. The studies examine first whether increases in the level of national

---

1 See discussion in section 2.2 of chapter 2.
3 See discussion in section 7.3.1.2 of this chapter 7.
4 See discussion in section 7.3.1.3 of this chapter 7.
shareholder protection improve firm performance and firm value. The second issue is whether common law origin shareholder protection regimes provide a higher level of protection than civil code origin regimes.

The final group of studies examines the effects on firm operating performance and firm value of a number of individual Governance Variables – the board skills ‘mix’\(^5\), the independence of directors\(^6\), the proportion of non-executive/independent directors, annual review of the board, a high attendance level at board meetings and external advisors to the board.\(^7\)

Of course, a large number of factors – economic and otherwise – combine to affect firm performance and firm value. It is, accordingly, sometimes difficult to separate the effect of individual Governance Variables on these measures. Thus, the examination in this chapter will often highlight conflicting results relating to how those Governance Variables affect the economic actors inside and outside the corporation. But the chapter does not contrast the methodology of opposing studies in the text or footnotes. The relational approach does not rely on the empirical studies for their results *per se*. Instead, the empirical studies are used as a springboard to construct the relational effect path of each Governance Variable.

The relational effect path for each individual Governance Variable is constructed from the empirical studies examined in chapters 7 - 10 in combination with the Interrelationship Scheme representing the shareholder primacy model.\(^8\) A relational effect path is a component which represents an hypothesised interrelationship between a Governance Variable and one or more of the following Governance Factors and, thus in turn, other Governance Variables:

<table>
<thead>
<tr>
<th>No.1</th>
<th>Reporting - Transparency, Timing and Integrity of Financial and Other Reports;</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. 2</td>
<td>Compliance - Corporate Governance and Legal Compliance;</td>
</tr>
<tr>
<td>No. 3</td>
<td>Alignment - Alignment of Management and Shareholder Interests;</td>
</tr>
<tr>
<td>No. 4</td>
<td>Compensation - Board, CEO and Management Compensation and Incentives;</td>
</tr>
<tr>
<td>No. 5</td>
<td>Monitoring &amp; Audit - Internal and External/Audit Monitoring Quality;</td>
</tr>
<tr>
<td>No. 6</td>
<td>Stakeholders - Identification, Participation and Protection of Stakeholder Interests;</td>
</tr>
<tr>
<td>No. 7</td>
<td>Decision-making - Quality of Board, CEO and Management Decision-Making; and</td>
</tr>
<tr>
<td>No. 8</td>
<td>Responsibility - Delineation and Disclosure of Powers, Duties and Lines of Responsibility.</td>
</tr>
</tbody>
</table>

---

\(^5\) See discussion in section 7.3.1.2.1-2 of this chapter 7.

\(^6\) See discussion in section 7.3.2.1 of this chapter 7.

\(^7\) See discussion in section 7.3.2.1.2

\(^8\) See Figure 2.7.2A in section 2.7.2 of chapter 2.
The greater the number of Governance Factors affected (in either direction) by a Governance Variable, then the greater is its relational proximity Rating on a scale of -100.00 to +100.00 \textit{rprox} units depicted in the Relational Proximity Table 3.3.2.1. Thus, in turn, the greater is the Governance Variable in affecting (in either direction) Jensen and Meckling’s agency costs\textsuperscript{9} and the survival/sustainability of the corporation.

The relational effect path presented is not the only operational zone of effect for a Governance Variable. Instead, it is a pathway suggested by the empirical studies presented in chapters 7 – 10 and the analysis of significant interrelationships employed in the selection and design of the Governance Factors.\textsuperscript{10} These interrelationships are summarised in the Shareholder Primacy Interrelationship Scheme in Figure 2.7.2A. In other words, the starting point of the relational effect path will be provided by the empirical studies presented here and the shareholder model of corporate governance. And the relevant relational effect path will seek to be the most ‘direct’ route between the Governance Factors it represents. Over time, for future research, it will be possible to amass a wide range of different relational effect paths for the same Governance Variable for a complete profile of its zone of effect and behaviour.

Given its exppanse, the Empirical Studies Key Field No. 4 has 4 parts. Part 1, in this chapter, comprises studies of ‘overall’ governance (or groupings of Governance Variables), board skills, the strength of the relevant national shareholder protection regime and ‘Board Factors I’ – independence or the proportion of non-executive/independent directors.

In chapter 8, Board Factors II – board size and ‘outside’ board positions – are contained in Part 2. This Part also examines studies relating to staggered board elections and other anti-takeover mechanisms, the audit subcommittee, ‘block’ and institutional shareholdings and division in the CEO/Chairperson role.

In chapter 9, Part 3 comprises a large number of firm-specific variables with a different measure of survival/sustainability – the probability of earnings manipulation.

In the fourth and final part of the Empirical Studies Key Field No. 4 found in chapter 10, the thesis examines variables relating to director, CEO and management compensation including performance-based compensation, equity and (particularly) short-term option holdings and say-on-pay initiatives.

\textbf{7.2 Structure and Approach of Chapter 7}

Chapter 7 will now undertake the examination of the perceived firm-specific effects (whether positive or negative) of ‘good’ Governance Variables as follows:


\textsuperscript{10} See discussion in subsections 2.6.1 – 2.6.8 of chapter 2.
7.3 Firm-Specific Effects of ‘Good’ Corporate Governance – Firm Value and Operating Performance

In chapters 7 - 10, the thesis concentrates its focus on an evaluation of the firm-specific benefits or effects suggested to arise in the for-profit sphere from the adoption of ‘good’ corporate Governance Variables. The purpose of the examination in these chapters is to identify and evaluate the nature, operation and effect of these variables in order to assess their contribution (if any and whether positive or negative) to the long-term efficiency and sustainability of the for-profit corporation.

While the comparison of many of the studies may reveal contradictory results or explanations or lack of causative effect, the present purpose of the examination of these studies is to build-up a normative landscape of Governance Variables which commentators have investigated or emphasised for the purposes of maintaining or improving the economic value or operating performance of general for-profit organisations. As part of this, commentator explanations, sometimes contradictory, for the operation of the relevant variables will be discussed.

---


For an earlier working paper version of sections 7.3.1 – 7.3.1.2 by de Zwart, see Francesco de Zwart (90% author) and George Gilligan, "Comparative Corporate Governance Schemes and their Relevance for the Sporting Sector", Monash University Department of Business Law and Taxation, Working Paper No. 16, (November 2008), available at http://ssrn.com.abstract=1295682, 8 – 12. See also Francesco de Zwart (95% author) and George Gilligan, “Sustainable Governance in Sporting Organisations” in Placido Rodriguez, Stefan Kesenne and Helmut Dietl (editors), Social Responsibility and Sustainability in Sports, Ediciones de la Universidad de Oviedo, 2009.
7.3.1 ‘Overall’ Governance Structure and the Level and Strength of the National Shareholder Protection Regime

The [NationGov] (+) Variable: National Governance/Shareholder Protection Regime

The first two Governance Variables to be examined will be the ‘overall’ governance structure of the firm (measured by sets or groupings of Governance Variables) and the level of shareholder protection or otherwise provided by the national regulatory regime.

The following studies measure firm operating performance and value as a product of the existence and interaction of a group or ‘slate’ of Governance Variables. In other words, which Governance Variables operating in conjunction with other variables affect operating performance and/or firm value? And what are the perceived beneficial combinations or groupings of variables?

The analysis in chapter 6 (Key Field No. 3 - Comparative Corporate Governance Codes) highlighted the importance of board and director-related Governance Variables. The empirical studies of board variables confirms the analysis in chapter 6. Summarising the findings, the thesis’ review of studies suggests that increases in the level of national regime governance or shareholder protection (at least, to a certain point) improve firm performance and that common law regimes appear to provide the highest level of protection. In addition, firm-specific Governance Variables appear to be able to perform a ‘gap filling’ function in relation to deficiencies in the national regime.

7.3.1.1 ‘Overall’ Governance Structure and Level

In the case of ‘multi-variable’ governance studies, the observations relating to those variables are limited to the case of the particular combinations or groupings of variables in which they are found. In other words, as these studies examine multiple variables at the same time, more tentative are conclusions relating to those variables than in the case of individual variable studies. However, the thesis demonstrates that certain groupings of variables relating to the board and directors appear as central in positively affecting firm operating performance and/or firm value. The studies will now be reviewed in more detail.

7.3.1.2 Detailed ‘Overall’ Governance Studies

In an influential study in 2004, Brown and Caylor undertook a detailed examination of the relationship between 51 corporate Governance Variables and ‘operating performance’, ‘valuation’ and ‘shareholder payout’. The authors conclude that “better-governed firms are relatively more profitable, more valuable, and pay out more cash to their shareholders.” Among these conclusions, the authors noted that:

the 13 factors associated most often with good performance are all directors attended at least 75% of board meetings or had a valid excuse for non-attendance, board is controlled by more than 50% independent outside directors, nominating committee is independent, governance committee meets once a year, board guidelines are in each proxy statement, option re-pricing did not occur in the last

---

12 Brown and Caylor, above n 2.
13 Ibid, Abstract, 1 and Section VIII, Summary and Implications, 28-32.
three years, option burn rate is not excessive, option re-pricing is prohibited, executives are subject to stock ownership guidelines, directors are subject to stock ownership guidelines, mandatory retirement age for directors exists, performance of the board is reviewed regularly, and board has outside advisors.\(^{14}\)

Governance Variables representing a high attendance level at board meetings ([BrdAttend] \(^{15}\)), the annual review of the board ([BrdReview] \(^{16}\)) and outside board advisors ([OutBrdAdv] \(^{17}\)) are presented below.

Later, in 2005, Brown and Caylor identified seven variables positively linked to firm value\(^{18}\) and, in 2006, several variables linked to operating performance.\(^{19}\) On a similar multi-variable theme, Larcker, Richardson and Tuna identified fourteen ‘constructs’ (i.e., groups) from thirty-nine variables that affect future operating performance.\(^{20}\)

\(^{14}\) Ibid, 29.

\(^{15}\) Board – Attendance Level (High) – see discussion in section 7.3.2.1.2 of this chapter 7.

\(^{16}\) Board – Annual Review – see discussion in section 7.3.2.1.2 of this chapter 7.

\(^{17}\) Outside/External Board Advisors – see discussion in section 7.3.2.1.2 of this chapter 7.

\(^{18}\) L D Brown and M L Caylor, "Corporate Governance and Firm Valuation", (December 20, 2005), available at SSRN: http://ssrn.com/abstract=754484, 3. The 7 variables positively linked to firm value include (at 3):

1. annual election of directors (rather than staggered board elections);
2. absence of a ‘poison pill’;
3. no option re-pricing in the last 3 years;
4. the company did not grant options exceeding 3% of all shares in the prior 3 years;
5. 75% board attendance for all directors;
6. board governance guidelines contained in the proxy statement; and
7. share ownership guidelines for directors.


1. only independent directors sit on the nominating committee;
2. director participation in an education program; and
3. the company did not grant options exceeding 3% of all shares in the prior 3 years.

\(^{20}\) D F Larcker, S A Richardson and A I Tuna, "How Important is Corporate Governance?", (May 2005), available at SSRN: http://ssrn.com/abstract=595821, 3 and 48 and Tables 2 and 3 thereto. The authors consider that the following 14 ‘constructs’ derived from the 39 variables affect future operating performance (at 3 and 48 and Tables 2 and 3 thereto):

1. ‘activist variables’;
2. ‘blockholding’;
3. ‘affiliation’ of the directors;
4. directors appointed by ‘inside’ directors;
5. ‘compensation mix’ of the CEO;
6. board, audit committee and compensation committee meetings;
7. whether there is a ‘lead’ director or executive ‘insider’ chairperson;
8. anti-takeover provisions and mechanisms (e.g., ‘poison pill’, staggered board elections rather than whole board);
9. age of directors exceeding 70;
10. debt ratios;
11. proportion of executive/‘insider’ directors on the board;
12. the size of the board, compensation and audit committees;
13. further anti-takeover mechanisms including ‘supermajority’ for voting on takeovers; and
14. the number of outside board positions directors hold.
Not surprisingly, given the implications of agency theory\(^{21}\), a review of the variables identified by Brown and Caylor, as well as Larcker, Richardson and Tuna, highlights the prominent presence and operation of board and director-related governance mechanisms. While these will be reviewed individually in more detail below in order to identify more precisely their individual nature and operation, for present purposes it is important to identify what from chapters 4 (Key Field No. 1 – Application of Principal Theories of the Firm to the Relational Approach) and 6 (Key Field No. 3 – Comparative Corporate Governance Codes) are recurring themes.

**Important Groupings or Combinations in Multi-Variable Studies**

Here, the studies by Brown and Caylor and, separately, Larcker et al, highlight the importance of groupings or combinations that include (some or all) variables taken from the following (noted here with the name of the relevant Governance Variable and section of discussion in the thesis):

- Board and committee size – \([\text{BrdCmSize}]^\pm\)\(^{22}\);
- A high level of attendance at board meetings – \([\text{BrdAttend}]^\pm\)\(^{23}\);
- Director independence and the proportion of executive directors – \([\text{BrdIndMon}]^\pm, [\text{BrdIndInfo}]^\pm, [\text{AudIndMon}]^\pm, [\text{AudIndFreq}]^\pm\)\(^{24, 25, 26, 27}\);
- The presence and operation (including frequency of meeting) of board committees - in particular, the:
  - audit committee \([\text{AudCom}]^\pm\)\(^{29}\)
  - nominating committee \([\text{NomCom}]^\pm, [\text{NomInd}]^\pm\)\(^{30, 31}\)
  - compensation committee \([\text{CompCom}]^\pm\)\(^{32}\)
- The equity (including option) compensation and/or holdings of directors and executives – \([\text{DirCEO}]^\pm, [\text{EqOptIncent}]^\pm, [\text{EqOptEntrch}]^\pm, [\text{ShortTOpts}]^\pm\)\(^{33, 34, 35, 36}\).

---

\(^{21}\) See discussion in sections 4.2.3 - 4.2.4.1 of chapter 4.

\(^{22}\) Board and Committee Size – see discussion in sections 8.2 – 8.2.2.2 of chapter 8.

\(^{23}\) Board – Attendance Level (High) – see discussion in section 7.3.2.1.2 of this chapter 7.

\(^{24}\) Board Independent Director: Executive Director Proportion – Monitoring Effect – see discussion in section 7.3.2.1.1-2 of this chapter 7.

\(^{25}\) Board Independent Director: Executive Director Proportion – Information Flow and Decision Quality ‘Trade-off’ – see discussion in section 7.3.2.1.2 of this chapter 7.

\(^{26}\) Audit Committee - Independence - Monitoring Effect – see discussion in section 8.4.3 of chapter 8.

\(^{27}\) Audit Committee - Independence - Information Flow and Decision Quality ‘Trade-off’ – see discussion in section 8.4.3 of chapter 8.

\(^{28}\) Audit Committee – Independence in Combination with Frequency of Meeting – Reduction in Earnings Manipulation Effect – see discussion in section 9.2.1 of chapter 9.

\(^{29}\) Audit Committee – Presence, Operation and Frequency - see discussion in section 8.4.2 of chapter 8.

\(^{30}\) Nominating Committee – Presence, Operation and Frequency – see discussion in section 7.3.1.2.2 of this chapter 7.

\(^{31}\) Nominating Committee – Independence Proportion – see discussion in section 7.3.1.2.2 of this chapter 7.

\(^{32}\) Compensation Committee – Presence, Operation and Frequency – see discussion in section 10.2.4.1 of chapter 10.

\(^{33}\) Director/CEO Compensation Levels – see discussion in section 10.2.4 of chapter 10.
• Board skills ‘mix’ – [BrdSkills](+);  
• External audit function – [ExtAudEarn] (+);  
• The annual review of the board - [BrdReview] (+);  
• The board has ‘outside’ board advisors - [OutBrdAdv] (+);  
• Annual election of directors instead of staggered board elections – Staggered Board Elections – [StagBrdElect] (-);  
• Absence of other anti-takeover mechanisms – Other Anti-Takeover Mechanisms (excludes staggered board elections) – [OtherATMs] (-);  
• Blockholding and activism variables - [BlockMon] (+) and [BlockCosts] (-); and  
• Outside board positions held by independent directors – [OutBrdPos] (-).

As an additional indicator of the relative importance of board and director-related Governance Variables to firm sustainability, the Governance Variables in these bullet-points represent over one-half (24 out of 39) of the variables examined in the thesis. Their individual relative importance is examined below.

Continuing the review of multi-variable studies, in a well-known study, Gompers, Ishii and Metrick examine the relationship between an index of 24 Governance Variables comprised in the Investor Responsibility Research Center (‘IRRC’) index and various measures of firm

---

34 Equity/Option Plans and Holdings of Directors/Executives – Incentive/Alignment’ Effect (excludes short-term options) – see discussion in section 10.2.4 of chapter 10.  
35 Equity/Option Plans and Holdings of Directors/Executives – ‘Entrenchment’ Effect (excludes short-term options) – see discussion in section 10.2.4 of chapter 10.  
36 Short-Term Option Holdings/Plans of Directors and Executives – see discussion in section 10.2.5.1 of chapter 10.  
37 Board – Director Skills ‘Mix’ – see discussion in section 7.3.1.2.1 of this chapter 7.  
38 External/Independent Audit Function – see discussion in section 9.2.3.3 of chapter 9.  
39 Board – Annual Review – see discussion in section 7.3.2.1.2 of this chapter 7.  
40 Outside/External Board Advisors – see discussion in section 7.3.2.1.2 of this chapter 7.  
41 Staggered Board Elections – see discussion in sections 8.3.1.1 of chapter 8.  
42 Other Anti-Takeover Mechanisms (excludes staggered board elections) – see discussion in section 8.3.1.1 chapter 8.  
43 Block Shareholding - Monitoring Effect – see discussion in sections 8.5.1-2 of chapter 8.  
44 Block Shareholding – Other Shareholder Agency Costs - see discussion in sections 8.5.1-2 of chapter 8.  
45 Outside Board Positions of Independent Directors – see discussion in section 8.2.3.1 of chapter 8.  
value and performance. The authors found that returns for ‘strong’ governance firms exceeded returns for ‘weak’ governance firms by more than 9%. They also found that strong governance firms had better performance than weak governance firms during the 1990s and “some significant evidence” of stronger governance firms having higher performance.

On a similar theme, Goldman Sachs JBWere (‘GSJBW’) produced a Research Report in 2006 entitled Good Corporate Governance = Good Investment Returns. In the Research Report, GSJBW concluded in relation to the Australian market that there was “a good relationship between corporate governance ratings and share price performance for [financial year 2006].”

In this respect, in terms of quantitative results, GSJBW stated that:

- The top rated, “Board Skills”, “Overall Board”, “Audit” and “Remuneration” companies have outperformed and, conversely, the bottom rated stocks under each of these categories have underperformed. Specifically, we find that an investment strategy investing long in top rated companies and selling short bottom rated companies would have generated the following “alpha” (ie return in addition to a passive market return) for each governance category: Overall Governance +10.9%, Board Skills +10.9%, Overall Board +10.0%, Remuneration +7.1%.

Thus, there was a significant advantage to investors in purchasing the shares of companies which scored high ratings in the Overall Governance, Board Skills, Overall Board and Remuneration categories and, as a corollary, selling the shares of companies with low scores in these categories. Flowing from this, board skills, board-specific variables, audit and remuneration variables are examined individually in this thesis.

Again, as with the studies undertaken by Brown and Caylor and, separately, Larcker et al, the GSJBW study lends significant weight to the prominence of board and director variables. Here, however, a further refinement is present in the case of the board and highlighted by GSJBW – the board skills ‘mix’. The board skills variable, [BrdSkills] (+), and its relational effect path are examined in the next section.

In addition, but outside the board and director-related category, the position of external audit, [ExtAudEarn] (+), as an important plank of governance is emphasised by the findings of this study and its individual operation will also be examined below. The individual director and

---

48 Ibid, 13.
50 Ibid, 21.
53 Ibid, Key Points, 4.
54 Board – Director Skills ‘Mix’
55 See discussion in section 7.3.1.2.1 of this chapter 7.
56 External/Independent Audit Function.
57 See discussion in section 9.2.3.3 of chapter 9.
CEO compensation and remuneration variables, including \[\text{DirCEO}\] (+/−), \[\text{EqOptIncent}\] (+), \[\text{EqOptEntrch}\] (−) and \[\text{ShortTOpts}\] (−) are examined in chapter 10.

In the case of profit results, GSJBW also reviewed ‘earnings surprise’, which it defined as “results above or below market expectations”62, observing in relation to the financial year 2005 that:

> top rated “Board Skills” companies reported average earnings surprise of +2.6% versus an average disappointment of -0.4% for low rated companies. For a longer term perspective since the inception of the data in 2001, top rated board skills companies have reported an average earnings surprise of +4.3% versus only +0.7% for low rated companies. Our research indicates that “Overall Governance”, “Overall Board” and “Board Skills” ratings are likely to be useful indicators to identify potential earnings surprise.63

The implication from the GSJBW study is that ‘overall’ or multi-variable good governance in firms – particularly in the case of board and director-related variables - seems to be good for ratios of return on investment capital.

In 2007, the indices used by Gompers, Ishii and Metrick (‘GIM’), as well as those used by Brown and Caylor (and others), were considered in a study by Bhagat and Bolton who conclude:

> we find that better governance as measured by the GIM and [other] indices, stock ownership of board members, and CEO-Chair separation is significantly positively correlated with better contemporaneous and subsequent operating performance.64

Yet, Bhagat and Bolton disagree with the conclusions reached by Caylor and Brown in their studies:

> additionally, better governance as measured by Brown and Caylor, and [other] is not significantly correlated with better contemporaneous or subsequent operating performance.65

Recent Studies Support Link Between Good Governance and Firm Value and Performance But Precise Groupings Uncertain

In 2010, Ammann, Oesch and Schmid examined 64 governance attributes classified into six categories being:

- board accountability;

---

58 Director/CEO Compensation Levels – see discussion in sections 10.1.1 and 10.2.2 – 10.2.4 of chapter 10.
59 Equity/Option Plans and Holdings of Directors/Executives – Incentive/Alignment Effect (excludes short-term options) – see discussion in section 10.2.4 of chapter 10.
60 Equity/Option Plans and Holdings of Directors/Executives – ‘Entrenchment’ Effect (excludes short-term options) – see discussion in section 10.2.4 of chapter 10.
61 Short-Term Option Holdings/Plans of Directors and Executives – see discussion in section 10.2.5.1 of chapter 10.
63 Ibid.
65 Ibid, 5-6 (emphasis added).
• financial disclosure and internal control;
• shareholder rights;
• remuneration;
• market for control; and
• corporate behavior.66

The authors conclude that good corporate governance enhances firm value, increases cash flow and lowers the cost of capital:

[our results indicate that better corporate governance practices are reflected in statistically and economically significantly higher market values. Hence, at least for the average firm in our sample, the costs of the implementation of the corporate governance mechanisms seem to be smaller than the monitoring benefits, resulting in higher cash flows accruing to investors and lower costs of capital for the firms.67]

Cuñat, Gine and Guadalupe68 in 2010 (revised in February 2012) investigated the market effects of the passing of governance-related proposals at meetings finding a positive relationship with firm value:

on average, the market reacts to the passage of a governance-related shareholder proposal with positive abnormal returns of around 1.3% on the day of the vote. This reflects an increase in market value of 2.8% per implemented proposal. 69

The authors found the effect:

more pronounced among firms with concentrated ownership, high pre-existing antitakeover provisions, high R&D expenditures and stronger shareholder pressure, and for proposals made by institutional shareholders rather than by individuals. However, while positive, the magnitude of our estimated effects is between one-third and one-half of the estimates in Gompers, Ishii, and Metrick (2003).70

Thus, a cautionary note for this thesis’ adoption and description of Governance Variables as enhancing firm survival, is that while governance indexes may be of use in the determination of ‘overall’ good governance (and, the argument follows, positive operating performance71), the precise make-up or constitution of those indexes remains a matter for contention.

69 Ibid, 30.
70 Ibid, 30-31. The 2003 study by Gompers, Ishii, and Metrick is discussed at n 47 above.
71 The direction of the causality is, however, disputed by Hermalin who states:

[profits and strength of governance will, therefore, be positively correlated. But note carefully the direction of causality: firms are not more profitable because they have better governance; rather, they have better governance because they will be more profitable.

Today – Bebchuk, Cohen and Wang’s Caveat on the Use of Multi-Variable Studies

To conclude the multi-variable examination, there is a suggestion that some difficulty may now exist for the use of governance indexes as a basis for a trading strategy. In a study more recently published on SSRN in 2011 and in the *Journal of Financial Economics* in 2013, Bebchuk, Cohen and Wang\(^\text{72}\) concluded that the association that existed between ‘good’ governance indexes and abnormal returns in the 1990s had disappeared during the 2000s due to:

market participants’ learning during the 1990s to appreciate the difference between firms scoring well and poorly on the governance indices.\(^{73}\)

For the authors, consistent with this was that, among other findings:

(i) the disappearance of the governance-return correlation was associated with an increase in the attention to governance by a wide range of market participants;
(ii) the structural break in the returns to governance strategies corresponded to the timing of the sharp rise in the attention to governance;
(iii) until the beginning of the 2000s, but not subsequently, stock market reactions to earning announcements reflected the market’s being more positive surprised by the earning announcements of good-governance firms than by those of poor-governance firms; [and]
(iv) analysts were also more positively surprised by the earning announcements of good-governance firms than by those of poor-governance firms until the beginning of the 2000s but not afterwards…\(^{74}\)

Thus, the explanatory power of multi-variable governance indices studies would appear – for these authors – to be problematic at this time in pursuing a trading strategy based on abnormal returns. Yet the authors confirm that such indices are still of value in determining links with firm performance:

[It should be stressed that the disappearance of the association between governance and returns does not undermine the practical significance of the G and E indices for research on corporate governance and corporate finance with data from the 2000s and beyond. To the contrary, the relationship between G and Tobin’s Q documented by GIM [Gompers, Ishii and Metrick] for 1990-1999, as well as the relationship between E and Tobin’s Q documented by Bebchuk, Cohen, and Ferrell for 1990-2003, remained strong throughout 2008 (and, if anything, becomes more significant in the 2002-2008 period). Thus, while governance indices may no longer be able to provide a basis for a profitable trading strategy, they should remain valuable tools for researchers, investors, and policy-makers interested in governance and its relationship with firm performance.\(^{75}\)]

---


\(^{73}\) Ibid, 35.

\(^{74}\) Ibid (formatting changed).

\(^{75}\) Ibid, 5.


- Agency problems (at 1)
- Inside ownership (at 3)
- Monitoring (at 6)
  - Large shareholders (at 6)
Thus studies on the use of such indices and how public information on companies is interpreted and used to determine them and the relationship with firm performance remain relevant in determining the relational effect path of Governance Variables in the relational approach.

7.3.1.2.1 The ‘Spine’ of Relational Effect Paths and the Comparator Variable: [BrdSkills] (+)

With that caveat, the studies in the previous section highlight the importance within the ‘grouped’ variables of the skills ‘mix’ of the board. Looking ahead, the analysis in this thesis indicates that the interrelationships depicted in the relational effect path for this Governance Variable are used as the model or spine for many Governance Variables.

The studies in the previous section seek to link, most directly, this skills mix with both enhancement of the monitoring function (Monitoring & Audit Factor No. 576) and the quality of decision-making (Decision-making Factor No. 777). As this thesis has demonstrated78 the interrelationship between these Governance Factors is a close one in which the two themes inform and shape each other in a continuous cycle. Indeed, the Monitoring & Audit Factor No. 5 and the Decision-making Factor No. 7 are part of the following configuration of Governance Factors which forms the ‘spine’ of the relational effect paths of a large number of Governance Variables:

- Boards (at 8)
- Shareholder rights (at 10)
  - Governance regulation (at 14)
  - Family firms (at 17)

76 See discussion in section 2.6.5 of chapter 2.
77 See discussion in section 2.6.7 of chapter 2.
78 See discussion in section 2.7.2 of chapter 2.


This spine of the relational effect paths is, like all relational effect paths, derived from the Shareholder Primacy Interrelationship Scheme in Figure 2.7.2A (albeit depicted in a simplified manner for explanatory purposes). Now, from that Interrelationship Scheme, the Reporting Factor No. 179 and Responsibility Factor No. 880 are the additional Factors in the spine.

As demonstrated earlier, the maintenance and enhancement of the Reporting Factor No. 1 is dependent on the effectiveness of all the components of the Monitoring & Audit Factor No. 5. Again demonstrated earlier, the Responsibility Factor No. 8 is critical to the operation of many other Governance Factors, in particular the Decision-making Factor No. 7 and the Monitoring & Audit Factor No. 5. As the thesis shows in the following section, this spinal configuration of interrelationships between Governance Factors Nos. 1, 5, 8 and 7 is the foundation of the \[\text{BrdSkills} \ (+)\] variable. Thus, this Governance Variable will be used as a foundation-block in the construction and analysis of many other Governance Variables.

**Board Skills Mix Variable: [BrdSkills] (\+)\textsuperscript{82} Variable Relational Effect Path**

Thus, the \[\text{BrdSkills} \ \text{variable’s\ relational\ effect\ path\ is\ positive\ (\+)\ and\ begins\ with\ the\ Monitoring\ &\ Audit\ Factor\ No.\ 5\ and\ the\ Decision-making\ Factor\ No.\ 7.\ As\ noted\ above,\ each\ of\ these\ Governance\ Factors\ has\ a\ reflexive\ relationship\ with\ the\ other\ as\ described\ in\ subsection\ 2.6.7\ and\ the\ Shareholder\ Primacy\ Interrelationship\ Scheme\ in\ Figure\ 2.7.2A\ of\ chapter\ 2.\ The\ Factors\ are\ depicted\ as\ follows:**

\[\text{GF 1} \quad \Rightarrow \quad \text{GF 5} \quad \Leftarrow \quad \text{GF 8} \quad \Rightarrow \quad \text{GF 7}\]
In the Shareholder Primacy Interrelationship Scheme in Figure 2.7.2A, there is a reflexive relationship between the Monitoring & Audit Factor No. 5 and the Reporting Factor No. 1 as described in subsection 2.6.5 of chapter 2. The effect of the Decision-making Factor No. 7 is hypothesised to be both significant and extensive. It extends to all other Governance Factors except the overriding nature of the Compliance Factor No. 283 (as shown in the Compliance Factor No. 2 Interrelationships in Figure 2.6.2 and section 2.6.2). Compliance with corporate governance and legal requirements on the company - an obligation which remains constant by force of ‘hard’, ‘soft’ or ‘hybrid’ laws – is hypothesised not to be affected by the skills mix of the board. The Compliance Factor No. 2 remains constant and cannot be modified by the decision-making or actions of the directors. The Decision-making Factor No. 7’s zone of effect reflexively affects the Alignment Factor No. 3, the Compensation Factor No. 4 and the Responsibility Factor No. 8. The Decision-making Factor No. 7 also directly affects in a single direction the Stakeholders Factor No. 6.

What is the effect of this within the company? An example would be a company which has devoted resources to the internal monitoring, internal audit and external audit functions (Monitoring & Audit Factor No. 5). The diagram shows that such a company is more likely to have more timely reports with higher information quality, transparency and integrity (Reporting Factor No. 1). Such reporting will thus increase the quality of external or market monitoring of the company with consequential improvement in internal monitoring and, again, improvement in the transparency and timing of financial and other reports. Thus, the diagram shows that the Monitoring & Audit Factor No. 5 affects the Reporting Factor No. 1 in a reflexive manner, i.e., these Factors affect each other. But how is the monitoring, internal audit and external audit functions improved in the first place? The diagram shows that skills of the board affect these functions in a positive direction beginning with the Monitoring & Audit Factor No. 5. Thus, increases in board skills (the \textit{[BrdSkills]} \(+) \) variable will positively affect both monitoring and audit within and outside the company and the transparency, quality and timing of reporting.

83 See discussion in section 2.6.2 of chapter 2.
Therefore, the \textbf{[BrdSkills] (+)} variable is hypothesised to affect all Governance Factors except the overriding Compliance Factor No. 2 (Corporate Governance and Legal Compliance). This equates to a Coverage/Rating of +7/87.50 rprox in the Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

7.3.1.2.2 Board Skills Mix Dependent on Existence and Independence of Nominating Committee

\textit{Nominating Committee – Presence, Operation and Frequency: [NomCom] (+/-) Relational Effect Path}

The discussion of the ‘overall’ or grouped-variable governance level above highlighted, among other Governance Variables, the presence and operation (including frequency of meeting) of board committees - in particular, the audit committee ([AudCom]\textsuperscript{84}), the nominating committee ([NomCom]\textsuperscript{85} and [NomInd]\textsuperscript{86}) and the compensation committee ([CompCom]\textsuperscript{87}).

The structure and operation of the \textbf{[BrdSkills] (+)} variable is itself dependent on the operation and structure of the \textbf{[NomCom]} variable as the composition – and therefore skills mix – of the board flows from the nominating committee. For example, in a study further examined below, Weisbach and Hermelin suggest that “board independence declines over the course of a CEO’s tenure”\textsuperscript{88} on account of studies which explain that the decrease of independence over time is due to the CEO’s participation in or control over the director nomination and appointment process.\textsuperscript{89}

Therefore, the \textbf{[NomCom]} variable has a dual direction marker (+/-) as the board’s skill mix will be affected positively or negatively by the operation of this Governance Variable. Further, as the operation of the \textbf{[NomCom]} (+/-) variable directly precipitates the operation of the \textbf{[BrdSkills] (+)} variable, \textbf{[NomCom]} (+/-) has an identical relational effect path to \textbf{[BrdSkills]} (+) but in both directions. Therefore, the \textbf{[NomCom]} (+/-) variable affects all Governance Factors with the exception of the overriding Compliance Factor No. 2 which remains constant and is not affected. This equates to a Coverage/Rating of +/- 7/87.50 rprox in the Relational Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

\textsuperscript{84} Audit Committee – Presence, Operation and Frequency - see discussion in section 8.4.2 of chapter 8.
\textsuperscript{85} Nominating Committee – Presence, Operation and Frequency – see discussion in this section 7.3.1.2.2 of this chapter 7.
\textsuperscript{86} Nominating Committee – Independence Proportion – see discussion in this section 7.3.1.2.2 of this chapter 7.
\textsuperscript{87} Compensation Committee – Presence, Operation and Frequency – see discussion in section 10.2.4.1 of chapter 10.
\textsuperscript{89} Ibid, 27-28.

Nominating Committee – Independence Proportion: [NomInd] (+) Relational Effect Path

As will be demonstrated from studies below, the [BrdIndMon] (+) variable has a positive effect on the quality of monitoring of management (Monitoring & Audit Factor No. 5) and the quality of decision-making (Decision-making Factor No. 7). Here, by analogy to the studies considered by Weisbach and Hermalin in relation to the [NomCom] (+/-) variable, increases in the independence proportion of the nominating committee ([NomInd]) will similarly have a positive effect on the monitoring and decision-making – and therefore board skills – attributes of directors nominated by that committee. Thus, like [NomCom] (+/-), as the operation of the [NomInd] (+) variable directly precipitates the operation of the [BrdSkills] (+) variable, [NomInd] (+) has an identical relational effect path but only in the positive direction. This equates to a Coverage/Rating of +7/87.50 rprox in the Relational Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

7.3.1.3 The Strength of the National Shareholder Protection Regime

The implication of studies relating to the strength or otherwise of shareholder protection provided by the national regulatory regime in which the firm operates suggest that increases in the level of national regime governance/protection (at least, to a certain point) improve firm performance and that common law regimes appear to provide the highest level of protection. In addition, firm-specific Governance Variables appear to be able to perform a ‘gap filling’ function in relation to omissions from, or weaknesses in, the national regulatory regime.

7.3.1.3.1 Detailed National Regime Studies

Indicative of this conclusion, for Bruno and Claessens, there is a positive relationship between firm performance and the level of shareholder protection provided by the national governance regime. This is supported by a 2007 study by Ng, Gul and Mensah where the authors observe the effects of the US’ Sarbanes-Oxley Act (SOX) reforms and the relative value of firms:

in the Post-SOX period, there is no longer such a relative undervaluation of firms with poor corporate governance. We interpret our findings as supporting the notion that investors treat the stronger regulatory regime imposed by SOX as a near-perfect substitute for good internal corporate governance, at least within three years of the passage of SOX.

Thus, for the authors, increases in the level of shareholder protection flowing from the national governance regime during the relevant period enhance firm value.

---

90 See discussion in section 7.3.2.1.2 of this chapter 7.
91 Board Independent Director: Executive Director Proportion – Monitoring Effect – see discussion in sections 7.3.2.1.1-2 of this chapter 7.
Bruno and Claessens further find that, for a positive effect on firm value, improvements in company-specific Governance Variables can compensate (‘substitution effect’) for deficiencies in the national regime. In this respect, the authors considered that:

excessive regulation can harm valuation, consistent with the hypothesis that excessive regulation can harm managerial initiative and generate lower returns.

Klapper and Love also found a positive relationship between firm-specific and national regime governance and investor protection. Similarly to Bruno and Claessens, they find that “better corporate governance is associated with higher operating performance” and conclude that:

recommending to firms to adopt good governance practices is even more important in countries with weak legal systems.

The implication is that companies in weak-protection countries should adopt Governance Variables from strong-protection countries to improve their operating performance and firm value. This helps to explain the harmonisation or convergence effect relating to corporate Governance Variables demonstrated in chapter 6.


[w]e find that firm-specific variables are more informative about firm-level governance for firms from more developed countries...In particular, firm characteristics are not significant in explaining the S&P ratings in the countries with low development, but they are significant in countries with high development.

For a discussion of whether firm characteristics or country characteristics are relatively more important in explaining governance ratings variances for firms in emerging economies, see Andrea Hugill and Jordan I Siegel, “Which Does More to Determine the Quality of Corporate Governance in Emerging Economies, Firms or Countries?”, Harvard Business School Strategy Unit Working Paper No. 13-055, (March 26, 2013) available at SSRN: http://ssrn.com/abstract=2192460.

La Porta, et al - Common Law Origin of ‘Strong’ Governance Countries

In Bratton and McCahery’s comparison of ‘market’ and ‘blockholder’ share-ownership and governance systems, the authors discuss the well-known and seminal investor protection study by La Porta, Lopez-de-Silances, Shleifer and Vishny\(^{101}\) concluding in relation to that study:

(a) common law countries provide the strongest protection for investors; (b) France and similar civil law countries provide the weakest level of protection; and (c) Germany and similar civil law countries provide an intermediate level of protection.\(^{102}\)

Similarly, Gugler, Mueller and Yurtoglu examine as a Governance Variable the origin of the national corporate governance regime.\(^{103}\) In a 2003 study of 61 countries, the authors


La Porta, Lopez-de-Silanes, Shleifer and Vishny themselves observe:

[empirically, strong investor protection is associated with effective corporate governance, as reflected in valuable and broad financial markets, dispersed ownership of shares, and efficient allocation of capital across firms. Using investor protection as the starting point appears to be a more fruitful way to describe differences in corporate governance regimes across countries than some of the more customary classifications such as bank- or market-centeredness.


\[^{102}\] Bratton and McCahery, ibid, 10 (footnote omitted).


conclude that “…English-origin legal systems produce corporate governance systems that better protect shareholders against managers than other systems”. For the authors, the origin of the national corporate governance regime had greater explanatory power than ‘ownership structures’ in relation to company returns on investment. Consistent with Alignment Factor No. 3, the authors conclude that:

[strong corporate governance institutions help to align managerial and shareholder interests, and prevent dominant individual or family shareholders from exploiting minority shareholders.]

This result accords with the study by Bris and Cabolis who found firm value was increased in the case of “acquisitions of firms in weaker shareholder protection countries by firms in stronger protective regimes”.

### 7.3.1.3.2 Global Corporate Governance Rankings

La Porta et al’s findings are reflected in a 2006 ranking of “global corporate governance ratings” where Australia was ranked third, behind only Canada and the UK. Interestingly, the US was ranked fourth, with Germany ranked sixteenth and France thirty-fifth. These positions, as well as those of Australia and the UK, would accord with Bratton and McCahery’s summary of the study by La Porta et al into the strength of investor protection noted above.

---


More recently, Austrade's Benchmark Report 2011\textsuperscript{110} has described global corporate governance ratings as at September 2010.\textsuperscript{111} At that time, Australia had slipped to sixth place with a rating of 6.65 (average = 4.88). The US has improved to fourth place. Germany has improved to twelfth place and France has improved markedly into nineteenth place. Despite the changes in position, the principal common-law countries still lead the civil code jurisdictions in these ratings:

\begin{table}[h]
\centering
\small
\begin{tabular}{|c|c|c|}
\hline
\textbf{Ranking} & \textbf{Country} & \textbf{Rating} \\
\hline
1 & United Kingdom & 7.60 \\
2 & Canada & 7.36 \\
3 & Ireland & 7.21 \\
4 & USA & 7.16 \\
5 & New Zealand & 6.70 \\
6 & Australia & 6.65 \\
7 & Netherlands & 6.45 \\
10 & Sweden & 5.88 \\
12 & Germany & 5.80 \\
14 & Italy & 5.25 \\
19 & France & 4.70 \\
\hline
\end{tabular}
\caption{Global Corporate Governance Ratings\textsuperscript{112}}
\end{table}

\subsection*{7.3.1.3.3 The [NationGov] (+)\textsuperscript{113} Variable Relational Effect Path}

The review of the perceived effects of the strength of the national shareholder protection regime adds support to the proposition that firm performance and the national level of shareholder protection/governance may well turn out to be positively related.

Of course, to what degree is likely to be dependent on the characteristics of the particular regime and the individual circumstances of each firm. It would appear from the commentator studies and global rankings, at least, that common law regimes appear to provide the highest


\textsuperscript{111} Ibid, Section 6 Stable Environment, p. 66.

\textsuperscript{112} Ibid.

\textsuperscript{113} National Governance/Shareholder Protection Regime.
level of protection. Beyond this, it would be difficult to draw any firmer conclusions based on the available data and studies.

**Summary - Studies Indicate Positive Direction for [NationGov] Variable.**

The above examination thus signifies a positive (+) effect for the direction of the [NationGov] variable. In other words, improvements in this Governance Variable normatively should enhance the profitability and, thus survival, of the firm. Compliance Factor No. 2 (Corporate Governance and Legal Compliance) is an overriding requirement of all Governance Factors as explained in chapter 2. These overriding legal provisions provide the content of the national shareholder protection regime. In the case of the [BrdSkills] (+) variable, it was hypothesised that, through the Decision-making Factor No. 7, all Governance Factors were affected with the exception of the overriding nature of the Compliance Factor No. 2 which is not itself affected by the skills mix of the board. The Compliance Factor No. 2 was there said to be constant. However, in the case of [NationGov] (+), changes in the content of this Governance Variable will actually change the requirements of the law, whether ‘hard’, ‘soft’ or ‘hybrid’.

Thus, the relational effect path for the [NationGov] (+) variable affects all Governance Factors in a manner identical to Figure 2.6.2 (Compliance Factor No. 2 Interrelationships) reproduced here:

**Reproduction of Figure 2.6.2: Compliance Factor No. 2 Interrelationships**

This gives rise to a Coverage/Rating of +8/100.00 rprox for the [NationGov] (+) variable in the Relational Coverage Table 3.3.1 and Relational Proximity Table 3.3.2.1.

---

114 See discussion in section 2.6.2 of chapter 2.
Having now concluded the examination of ‘overall’ or multi-variable governance studies, the thesis now turns to consider studies on the nature and operation of individual board and director Governance Variables.

7.3.2 Board Factors I – ‘Independence’, the Proportion of Non-Executive/Independent Directors and Equity Ownership

In attempting to measure firm operating performance and/or firm value as a product of individual board and director-related Governance Variables, the principal Governance Variables to be examined are:

- board and director independence and the proportion of non-executive/independent directors – \([\text{BrdIndMon}]^{116}\) and \([\text{BrdIndInfo}]^{117}\);
- the annual board review \([\text{BrdReview}]^{118}\); and
- director equity ownership – \([\text{EqOptIncent}]^{119}\) and \([\text{EqOptEntrch}]^{120}\).

Summary of Director Independence Studies

It is often argued that enhancing board and director independence improves the quality of monitoring of management and thus reduce agency costs. However, this result is by no means certain. In particular, the negative effect of such an independent monitoring structure may be to curtail the information flow (particularly that which is firm-specific or manager-specific) to the board in turn reducing the quality of board decision-making.

---

115 The discussion of board factors in this chapter is centred on “unitary” boards. Turnbull tells us that such a board structure exists for most listed companies in the US, UK, Canada and Australia. See Shann Turnbull, "Why Unitary Boards Are Not Best Practice: A Case for Compound Boards", (November 2000), available at SSRN: http://ssrn.com/abstract=253803, 2.


116 Board Independent Director: Executive Director Proportion – Monitoring Effect – see discussion in section 7.3.2.1.1-2 of this chapter 7.

117 Board Independent Director: Executive Director Proportion – Information Flow and Decision-Quality ‘Trade-off’ – see discussion in section 7.3.2.1.3 of this chapter 7.

118 Board – Annual Review – see discussion in section 7.3.2.1.2 of this chapter 7.

119 Equity/Option Plans and Holdings of Directors/Executives – Incentive/Alignment Effect (excludes short-term options) – see discussion in section 10.2.4 of chapter 10.

120 Equity/Option Plans and Holdings of Directors/Executives – ‘Entrenchment Effect’ (excludes short-term options) – see discussion in section 10.2.4 of chapter 10.
In the case of the perceived relationship between board or director independence and firm operating performance and/or firm value, there are conflicting results. In the case of both firm performance and value, many studies find no link with the degree of independence. Though fewer studies suggest a positive relationship, these are often affected by intervening or complicating variables such as the degree of director equity ownership and firm size.

Similarly, in the case of the proportion of equity held by inside directors and/or management, little can be predicted on account of two counterbalancing effects of this Governance Variable. An important study\textsuperscript{121} suggests that, on the one hand, parallel interests between directors and outside shareholders result from such equity holdings. However, after a certain point, increasing the size of management ownership may well harm outsider interests.

7.3.2.1 Director Independence

The studies examined below indicate that a wide range of results have been obtained for this Governance Variable. Consequently, only tentative conclusions can be drawn from the studies overall.

7.3.2.1.1 Improvements in the Quality of Monitoring are Not Certain

The forthcoming studies show that the result of increasing board or director independence on the board's supervisory function is uncertain. While some studies suggest a beneficial or positive (+) effect of greater independence among board members on the quality of board monitoring (the \text{BrdIndMon} (+)\textsuperscript{122} variable), this is difficult to ensure due to a perceived negative effect in terms of information flow to the board with consequent negative (-) effects on the quality of board decision-making (the \text{BrdIndInfo} (-)\textsuperscript{123} variable).

In the positive direction, board or director independence is often cited as one of the most important Governance Variables for enhancing the monitoring of management (Monitoring & Audit Factor No. 5) in the dispersed-shareholding public company.\textsuperscript{124} As Black and Kim


\textsuperscript{122} Board Independent Director: Executive Director Proportion – Monitoring Effect – see discussion in sections 7.3.2.1.1-2 of this chapter 7.

\textsuperscript{123} Board Independent Director: Executive Director Proportion – Information Flow and Decision-Quality ‘Trade-off’ – see discussion in section 7.3.2.1.3 of this chapter 7.

explain, the probability of firing the CEO after poor performance is an important indicator of the
quality of board monitoring:

[board independence predicts firm behavior in a variety of ways: For example, more independent
boards make better acquisition decisions, are more likely to choose an outsider as CEO, are more likely
to resist a takeover bid, and are more likely to fire the CEO following poor performance.125

This suggests that a company with improved monitoring is more likely to improve the quality of
its decision-making in relation to acquisitions but also the quality of decision-making in relation
to the make-up of its monitoring structures.

Thus, in a 2007 study by Bhagat and Bolton, a positive relationship was found between
‘disciplinary management turnover’ and both board independence and director shareholdings in
times of poor performance.126 Similarly, under a model proposed by Weisbach and Hermalin
referred to above, “CEO turnover is more sensitive to performance when the board is more
independent” and “[t]he probability of independent directors being added to the board rises
following poor firm performance”.127 The authors noted empirical support for both
propositions128 and for the proposition that:

board independence declines over the course of a CEO’s tenure.129

In the case of the third proposition, the authors point to studies which explain that the decrease
of independence over time is due to the CEO’s participation in or control over the director
nomination and appointment process.130

Despite the argued monitoring improvements, in a 2012 paper, Erkens, Hung and Matos found
that, in the Global Financial Crisis (GFC), stock returns were worse for companies with more
independent boards and higher institutional ownership because:
(1) firms with higher institutional ownership took more risk prior to the crisis, which resulted in larger shareholder losses during the crisis period, and (2) firms with more independent board members raised more equity capital during the crisis, which led to a wealth transfer from existing shareholders to debtholders...131

Asking whether this was because “independent directors and institutional shareholders encouraged managers to increase shareholder returns through greater risk-taking prior to the crisis”132, the authors confirmed the conclusion in relation to institutional ownership but not independent directors.133 An alternative explanation for the authors for independent directors was:

that independent directors pressured managers into raising equity capital during the crisis to ensure capital adequacy and reduce bankruptcy risk. Capital raisings at depressed stock prices may have led to a significant wealth transfer from shareholders to debtholders during the crisis period.134

For the authors, these equity raisings increased the likelihood that the firms with independent directors would survive the crisis.135 One implication for the authors is that independent boards made better financing decisions in relation to debt/equity ratios in times of poor performance.136 The second is that the effect of the structure of the board is more significant during crises events than in day-to-day management of the firm’s business as suggested by an earlier study by Hermalin and Weisbach.137

A complicating governance factor in the CEO turnover measure is likely to be the ‘relative importance’ of the CEO in the organisation. In a 2007 study discussed further in Chapter 10138, Cremers, Bebchuk and Peyer find a negative relationship between ‘CEO centrality’ and firm value.139 The authors also find that CEO centrality results in “lower CEO turnover”140 which “might reflect governance problems”.141

---

132 Ibid, 2.
133 Ibid, 3.
134 Ibid, 3.
135 Ibid, 4.
136 Ibid, 4.
137 Ibid, 6.
138 See discussion in section 10.2.3 of chapter 10.
139 Martijn Cremers, Lucian Bebchuk and Urs Peyer, “CEO Centrality”, Harvard Law and Economics Discussion Paper No. 601, (December 2007, Revised May 2008), available at SSRN: http://ssrn.com/abstract=1030107, 1. The authors define “CEO Centrality” as the relative importance of the CEO in the corporation’s upper management as measured by the ‘CEO’s pay slice’ or ‘CPS’ being the percentage of the total compensation of the top 5 executives captured by the CEO (at 1):

Our proxy for CEO centrality is the CEO’s pay slice (CPS), which we define as the percentage of the aggregate compensation awarded to the firm’s top five executives captured by the CEO. Because higher CPS will tend to reflect a greater relative importance of the CEO within the top executive team, CPS can serve as a proxy for the CEO’s centrality within this team.

140 Ibid.
141 Ibid, 3
CPS (CEO’s Pay Slice) is associated with CEO turnover. The probability of CEO turnover is lower if CEO centrality is higher controlling for the CEO’s length of service and performance.\textsuperscript{142}

Weir, Laing and McKnight emphasize the necessary characteristics of non-executive directors which, \textit{it is argued}, safeguard the interests of shareholders in separation of ownership and/or agency theory – independence and (relying on the work of Fama and Jensen) reputational constraints.\textsuperscript{143}

Fuerst and Kang, however, cite the well-known work of Jensen to identify the problems which may flow from the pivotal role of the board in such separation theories:

\begin{quote}
Jensen (1993) attributes the BOD’s governance failures to factors such as CEO’s agenda-setting power, low equity ownership of the board members, overcrowding of the board, and a board culture that encourages consent rather than dissent.\textsuperscript{144}
\end{quote}

This would suggest that ‘independence’ and ‘reputational constraints’ as suggested by Weir, Laing and McKnight are themselves open to erosion from a wide collection of factors.

Turning away from the functions of monitoring and advising management, a third important role for the board highlighted by Ruigrok, Peck and Keller is strategic decision-making.\textsuperscript{145} The authors found that, in Swiss companies, independence did \textit{not} reduce the participation of directors in strategic decision-making and but that such participation was \textit{reduced} by increases in board size and by ‘powerful CEOs’.\textsuperscript{146}

\textbf{References:}


\textsuperscript{144} Fuerst and Kang, above n 121, 8. The authors cite Michael C Jensen, "The Modern Industrial Revolution, Exit, and The Failure of Internal Control Systems" (1993) 48 \textit{Journal of Finance} 831-880.


\textsuperscript{146} Ibid, 1218. See also section 8.6.3 of chapter 8 in relation to the authors’ discussion of the effects of a dual CEO/Chairperson role. For other factors affecting participation in strategic decision-making, see D Ravasi and A Zattoni, "Exploring the Political Side of Board Involvement in Strategy: A Study of Mixed-Ownership Institutions" (2006) 43(8) \textit{Journal of Management Studies} 1671-1702, available at SSRN: \url{http://ssrn.com/abstract=950075}.

The authors state, at 1672:

variables of a cognitive (members’ possession of relevant knowledge) and political nature (heterogeneity of represented interests, presence of ex-ante conflict resolution mechanisms) combined in explaining if and how board members engaged in strategy making and how strategic decisions were taken.

See also, K V S N Jawahar Babu, "Role of Corporate Governance in Strategic Management", (December 3, 2012), available at SSRN: \url{http://ssrn.com/abstract=2184235}. 

7.3.2.1.2 [BrdIndMon] (+), [BrdReview] (+) [BrdAttend] (+) and [OutBrdAdv] (+)
Variables Relational Effect Paths


The behaviour of the [BrdIndMon] variable is identical to the [BrdSkills] (+) variable. In this case, however, the effect of this Governance Variable is predicted to be significant on the Reporting Factor No. 1, the Monitoring & Audit Factor No. 5, the Decision-making Factor No. 7 and the Responsibility Factor No. 8 on account of the substantial guidance in Governance Codes in chapter 6 relating to director independence. Director independence was found in that chapter to be a core variable/feature of global/cross-border and national Governance Codes. Thus, like the [BrdSkills] (+) variable, the [BrdIndMon] (+) variable affects all Governance Factors except the overriding effect of Compliance Factor No. 2 (as described in section 2.6.2). Similarly to the [BrdSkills] (+) variable, compliance with corporate governance and legal requirements on the company – an obligation which remains constant by force of law – is not affected by the independence element of the board. The Compliance Factor No. 2 thus remains constant for this variable. This equates to a Coverage/Rating of +7/87.50 rprox in the Relational Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

[BrdReview] (+): Board – Annual Review

The [BrdReview] variable acts as a ‘strong-form’ version of the [BrdIndMon] (+). The term ‘strong-form’ here means that the monitoring effect of the variable is greater or more escalated than in the case of the [BrdIndMon] (+) variable. This is because [BrdReview] concentrates on the monitoring or supervision (Monitoring & Audit Factor No. 5) of the board itself while the monitoring function of [BrdIndMon] (+) is applied to all levels of the company which is an expansive area. Having a stronger or more concentrated monitoring effect than [BrdIndMon] (+), it therefore has a positive directional marker identical to that for [BrdIndMon] (+) and with an identical relational effect path. This equates to a Coverage/Rating of +7/87.50 rprox for [BrdReview] (+) in the Relational Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

[BrdAttend] (+): Board – Attendance Level (High)

The [BrdAttend] variable – denoting a high attendance level at board meetings – also acts as a ‘strong-form’ version of the [BrdIndMon] (+) variable as it (again) concentrates on the monitoring function of directors on the board (Monitoring & Audit Factor No. 5). As the time spent in review improves both the quality of monitoring (Monitoring & Audit Factor No. 5) and the quality of decision-making (Decision-making Factor No. 7), [BrdAttend] has a positive directional marker and is hypothesised to have an identical relational effect path to that for [BrdIndMon] (+). This equates to a Coverage/Rating of +7/87.50 rprox for [BrdAttend] (+) in the Relational Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

---

147 See discussion in section 7.3.1.2.1 of this chapter 7.
148 See discussion in section 6.8.1 of chapter 6.
**[OutBrdAdv] (+): Outside/External Board Advisors**

Like [BrdReview] (+) and [BrdAttend] (+), the outside or independent advisors to the board variable is a ‘strong-form’ version of the [BrdIndMon] (+) variable. Again, the use of such advisors – drawing on their independent and expert natures - is hypothesised to improve both the quality of monitoring (Monitoring & Audit Factor No. 5) and the quality of decision-making by the board (Decision-making Factor No. 7). Thus, [OutBrdAdv] has a positive directional marker and – again drawing on the independence aspect - is hypothesised to have an identical relational effect path to that for [BrdIndMon] (+). This equates to a Coverage/Rating of +7/87.50 rprox for the [OutBrdAdv] (+) variable in the Relational Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

### 7.3.2.1.3 [BrdIndInfo] (-)

#### Variable Relational Effect Path

**Negative Effect of Independence On Information-Flow to the Board**

Contrary to the above studies as to the beneficial effects of greater independence among board members on the quality of board monitoring, there may well be drawbacks for the firm in terms of information flow. This comes from two sources. First, Adams considers that there is a ‘trade-off’ between the consequences for management on the one hand and the flow of information to the board on the other in the case of the board’s ‘dual’ functions of monitoring as opposed to advising management. As Adams explains, while the board can improve the quality of its advice to management if it receives more detailed and transparent information, this may consequently enable the board to revise downward its opinion of particular managers leading, eventually, to a reduction in ‘firm specific’ information flow to the board. The degree of independence of the board is also a factor in the ‘trade-off’ for Adams and Ferreira. The authors consider that “independent boards monitor more intensively” with the result that “the CEO will not communicate firm specific information to a board which is too independent”.

Secondly, for Professor Hill, independent directors may lack the depth of understanding of the company’s business or operations that inside directors bring. For Hill:

> "[t]he vision of independence under the 2002 [SOX] reforms is interesting because it seems to encompass not only independence from management, but also independence from stakeholders, who may have strong incentives to monitor. From this perspective, it cuts across much accepted wisdom in contemporary corporate governance, concerning capacity and incentives of outside directors to function as effective monitors. Particularly problematic is the danger that genuine independence may often be accompanied by ignorance and ineffectiveness."

---

149 Board Independent Director: Executive Director Proportion – Information Flow and Decision Quality ‘Trade-off’.
151 Ibid.
153 Hill, above n 124.
154 Ibid, 389 (footnote omitted).
This is explained below by Duchin, Matsusaka and Ozbas as a form of ‘inferior information’ or information asymmetry of independent directors compared to inside directors.\textsuperscript{155}

What are the consequences for the $\text{[BrdIndInfo]} (-)$ variable in light of the trade-off on information-flow to the board and Hill’s risk of ignorance? The implication is that the relational effect path for the $\text{[BrdIndInfo]} (-)$ variable is not predicted to be merely the same as the preceding path for $\text{[BrdIndMon]} (+)$ but with a negative direction. The negative zone of effect of this Governance Variable is much narrower than its positive counterpart. Primarily and significantly, the reviewed studies show that the important Decision-making Factor No. 7 is negatively affected. But this negative effect is likely to extend to a significant degree only to the board component of the three-level decision-making hierarchy of the board, CEO and management contemplated by Decision-making Factor No. 7. In other words, the decision-making quality of the CEO and management are not affected by limitations on the information supplied to the board and deficiencies in the knowledge of independent directors. Thus, the relational effect path for $\text{[BrdIndInfo]} (-)$ is as follows:

\begin{figure}[h]
\centering
\includegraphics[width=0.5\textwidth]{figure7.3.2.1.3.png}
\caption{[BrdIndInfo] (-) Relational Effect Path}
\end{figure}

Thus, in terms of Figure 7.3.1.2.1B (the $\text{[BrdSkills]} (+)$ variable relational effect path), it is difficult to conceive of any significant negative ‘flow-on’ effects (on account of withholding ‘manager-specific’ and ‘firm-specific’ information) from the Decision-making Factor No. 7 to the Alignment Factor No. 3, the Compensation Factor No. 4 and the Stakeholders Factor No. 6. This is because the themes contained in these Governance Factors are submitted to be outside the nature of the ‘manager-specific’ and ‘firm-specific’ information contemplated by the negative effect identified in the relevant studies. Thus, these Governance Factors are omitted from the $\text{[BrdIndInfo]} (-)$ relational effect path. The overriding nature of the legal and corporate governance requirements contemplated by Compliance Factor No. 2 is again unaffected by the board’s decision-making actions and so is omitted. Thus the zone of effect of the $\text{[BrdIndInfo]} (-)$ variable is hypothesised to extend to only four Governance Factors giving a Coverage/Rating of -4/50.00 rprox.

Enhancing the Quality of Monitoring by Less Independence?

Commentators have also noted some further negative effects of the \([\text{BrdIndInfo}] (-)\) variable, this time in relation to the independence of the board itself. In terms of effective governance, and considering a single-tier board model, Adams and Ferreira observe that:

> specifically, to encourage the manager to share information, shareholders may optimally elect a less independent or friendlier board which does not monitor the CEO too intensively.\(^{156}\)

For Dent, too, the monitoring ability (or even desire) of the board is questionable. The author, in stating that the ‘reality’ of corporate governance lies in ‘CEO domination’ rather than any other model, considers that the ‘overwhelming’ evidence is that:

> most boards are passive, dominated by CEOs who exert their power in their own interests.\(^{157}\)

Dent gives reasons including the CEO’s role in recommending directors for board vacancies, the view that (purported) outside directors who are themselves CEOs ‘defer’ to one another as a reciprocal practice and loyalty by outside directors to the person who nominated them.\(^{158}\)

---

\(^{156}\) Adams and Ferreira, above n 152, 2.


> [I]taken together, these results imply that the fraction of top executives and board members appointed during a CEO’s tenure (1) is a critical factor in assessing a firm’s likelihood of engaging in wrongdoing, (2) has effects that are not mitigated by standard monitoring mechanisms, except for audit committee independence, and thus (3) is worth the close attention of investors, regulators, and governance specialists. Further, our results underscore the importance of CEO connections built through personnel decisions in assessing the quality of governance and managing risk, as the connections seem to magnify the risk of corporate fraud.


Summary of Trade-Off Effect of Independence on Monitoring and Information-Flow

In summary, then, board or director independence has received considerable support in the literature as one of the most important Governance Variables for enhancing the monitoring of management in the dispersed-shareholding public company. Such independence is argued to improve the quality of acquisitions and the likelihood of replacement of a CEO in times of falling profitability. However, the literature also warns that greater independence may well have negative effects in terms of ‘manager-specific’ and ‘firm-specific’ information flow to board level. On top of this, independent directors may bring less knowledge of the company’s business or operations to the board table than inside directors.

7.3.2.1.4 Conflicting Results for Independence, Firm Value and Operating Performance

Important for the firm-specific benefits or effects of good governance in enhancing the long-term efficiency and sustainability of the for-profit corporation, is whether an increase in the proportion of independent directors increases firm value and/or operating performance? An overview of the following studies delivers particularly conflicting results\(^{159}\) for this independence variable.

Studies Showing No Link between Independence and Firm Performance/Value

For Adams and Mehran (who examine banking industry firms), the independence proportion does not affect firm performance\(^{160}\) and, in relation to firms generally, the same is the case for the first large-sample study by Bhagat and Black who found no evidentiary link between independence and firm performance.\(^{161}\) Indeed, in the 2007 study by Bhagat and (this time) Bolton already discussed in section 7.3.1.2, the independence factor was found to have a negative effect on firm operating performance:

> board independence is negatively correlated with contemporaneous and subsequent operating performance. This is especially relevant in light of the prominence that board independence has received in the recent NYSE and NASDAQ corporate governance listing requirements.\(^{162}\)

Weir, Laing and McKnight\(^{163}\) examine UK companies where they note that, unlike the US, the majority of directors are executive directors rather than independent.\(^{164}\) They find that company performance is not linked to the proportion of non-executive directors or their


\(^{162}\) Bhagat and Bolton, above n 64, 6 (emphasis in original and footnote omitted).

\(^{163}\) Weir, Laing and McKnight, above n 143, 5-11, 18-21, 27-28.

\(^{164}\) Ibid, 18.
independence and this is also noted in the literature review undertaken by Weisbach and Hermalin.

In the case of firm value, Brick, Palia and Wang similarly find no link with board independence and this is supported by the findings of Lasfer and Faccio who found no link between management shareholdings and the value of the company. The thesis’ overarching purpose of enhancing the long-term sustainability of the firm is, on one view, partly a natural consequence of continual firm operating performance and/or value. Yet Buckland found “no evidence” of any substantial link between compliance with the Cadbury Report requirements (including director independence) and company ‘survival’.

Studies Showing Positive Link between Independence and Firm Performance/Value are Fewer

Despite the above findings, several (though, it is conceded, fewer) studies identify a positive relationship between firm performance and/or value and the independence proportion. For Bruno and Claessens, a positive relationship exists between firm performance and several factors including board independence. Hutchinson found, too, that increases in the proportion of independent directors improve monitoring quality (and therefore performance) in relation to investment opportunities. Similarly, for studies including Aggarwal, Erel, Stulz and Williamson, an increase in board independence is a factor increasing firm value.

More recently in 2009, Bebchuk and Weisbach review the literature to explain that while initial studies found no link between independence and higher firm value:

there is a growing body of empirical research indicating that director independence is associated with improved decisions with respect to some specific types of decisions...In particular, it has been shown that director independence has an impact on CEO turnover..., executive compensation decisions..., the incidence of fraud..., and on the incidence of opportunistic timing of stock option grants.

Of course, these decision areas include two of the most controversial in governance discourse.

---

165 Ibid, 19.
166 Weisbach and Hermalin, above n 88, 2.
170 Bruno and Claessens, above n 92, 4.
Both executive compensation and the granting of stock options are examined in chapter 10.

**Increases in Inside Directors may Increase Likelihood of Firm Failure**

In terms of the incidence of corporate failures, Hsu and Wu distinguish between inside, outside and ‘grey’ directors – ie, non-independent non-executive directors\(^{174}\):

\[
\text{[unlike prior literatures, which often treat executive (inside) directors and grey directors as a single class (affiliated directors), this research distinguishes executive directors, grey directors and outside directors in the analyses since grey directors are not independent of management or company, but, according to the governance codes, they are generally expected to play a monitoring role as independent (outside) directors.}^{175}\]

The authors conclude that increases in the number of outside directors on the board and audit committee do not reduce the likelihood of corporate failure but that increases in inside directors do increase that likelihood of failure.\(^{176}\)

**7.3.2.1.5 Intervening or Confounding Factors for Director Independence**

**Equity Ownership May be an Intervening Factor On the Effects of Director Independence**

The study by Fuerst and Kang introduces a complicating (or intervening) factor to the independence variable and is therefore best considered on its own. For Fuerst and Kang, the number or proportion of independent directors alone is not sufficiently explanatory. Questions of equity ownership (to be discussed in more detail in chapter 10\(^{177}\)) must also be considered.

**Fuerst and Kang: Equity Ownership of Independent Directors Enhances Firm Performance and Value**

The authors concluded that firm performance and value is generally increased by (1) shareholdings by the CEO, executives and ‘inside’ directors and (2) greater shareholdings by independent directors.\(^{178}\) By contrast, firm performance is reduced by (1) a rise in the number of independent directors (unless accompanied by a rise in equity holdings by those directors)\(^{179}\); (2) a rise in number of total directors\(^{180}\); (3) large (>5%) shareholdings by independent/non-management shareholders\(^{181}\) and (4) increases in the CEO’s term of office.\(^{182}\)

---


\(^{175}\) Ibid, 21.

\(^{176}\) Ibid.

\(^{177}\) Ibid, 21-22.

\(^{178}\) Ibid.

\(^{179}\) Ibid, 4.

\(^{180}\) Ibid.

\(^{181}\) Ibid.

\(^{182}\) Ibid.
The Size of the Firm is an Intervening Factor on the Effects of Director Independence

Another complicating or intervening factor in a consideration of the independence variable is the size of the firm. In this respect, Chhaochharia and Grinstein\(^{183}\) find that the effect of board independence in turn depends on the size factor:

small firms with less board independence underperform small firms with more board independence by 12%-18% during the announcement year. In contrast, we do not observe underperformance in large firms. In fact, large firms with less board independence outperform large firms with more board independence by about 18%\(^{184}\).

By contrast to Chhaochharia and Grinstein, in the emerging market of Korea, Black and Kim found an opposite result for large companies. The authors found a positive causal connection between governance rules requiring ‘large’ companies to have at least half the board independent (and an audit committee with an independent chair and 2/3 independent directors) and both market value and later year increased profitability and dividend payments.\(^{185}\)

7.3.2.1.6 Summary for Studies of the Director Independence Variable.

Given the number of studies, it would be premature to draw any conclusions relating to the seemingly financially negative effect of rising director independence for large firms identified by Chhaochharia and Grinstein. However, in the case of the positive effect identified by Black and Kim in an emerging market, the finding is not surprising given the ‘substitution’ or ‘gap-filling’ effect previously discussed in relation to firm-specific Governance Variables and, in this case, possible weaknesses in the shareholder protection regime in comparison to common-law regimes.\(^{186}\)

Given the conflicting results for the effect of director independence on firm value and performance, Duchin, Matsusaka and Ozbas sought in a 2008 study to explain the results for this effect in terms of the ‘inferior information’ (i.e., asymmetric information) of independent directors when compared to insiders:

‘[t]heoretically, it has long been recognized that the effectiveness of outside directors is limited by their inferior information compared to corporate insiders, and the notion that outsiders cannot effectively monitor and control agency problems has been a central premise of corporate finance research for decades (Berle and Means, 1932; Fama and Jensen, 1983; Jensen, 1993).’\(^{187}\)

This also accords with the views of Hill noted above in relation to the likelihood that independent directors bring less in-depth knowledge of the company’s business and operations than in the case of inside directors.\(^{188}\) Studying a sample of firms which were required to increase the number of independent directors on their boards consequent on recent US corporate governance rules including SOX\(^{189}\) and the NYSE Final Rules\(^{190}\), Duchin et al.


\(^{184}\) Ibid, 3.

\(^{185}\) Black and Kim, above n 125, 2-3.

\(^{186}\) See discussion in sections 7.3.1.3 – 7.3.1.3.3 of this chapter 7.

\(^{187}\) Duchin, Matsusaka and Ozbas, above n 155, 1.

\(^{188}\) Hill, above n124, 389. See discussion in section 7.3.2.1.3 of this chapter 7.

\(^{189}\) SOX, above n 93.
concluded that a positive (or negative) effect on firm performance was dependent on the low (or high) cost of acquiring information relating to the firm:

"[o]ur main finding is that adding outside directors to the board does not help or hurt performance on average, consistent with the previous literature (even after controlling for endogeneity), but that outsiders significantly improve performance when their information cost is low, and hurt performance when their information cost is high."^191

For the authors, this cost is reflected in the number of outsiders on the board with 'high' information cost firms having comparatively less outsiders. Bebchuk and Weisbach, too, recognise the inferior information problem of independent directors:

"[a]n important, and necessary, condition for directors to be able to be effective is the amount and nature of information that they have. If directors only have access to publicly-available information, it is hard to imagine that they will be able to evaluate management better than an outside shareholder. In addition, the mere fact that directors do not have superior information would in itself likely be the consequence of a strained relationship with management, since presumably no information of value would have been transmitted during board meetings. The informational advantage of directors over outsiders thus presumably provides a measure of the potential for these directors to add value."^193

Thus, inferior information problems reduce the effectiveness of outside directors in monitoring and evaluating management in a similar manner to the reduction in 'firm-specific' and 'manager-specific' information flow to the board described for the \([\text{BrdIndInfo}] (-)\) variable.\(^{194}\)

In summary then, in the case of the perceived relationship between board or director independence and firm operating performance and/or firm value, there are conflicting results. In the case of both firm performance and value, many studies find no link with the degree of independence. Thus, the importance of director independence as an individual Governance Variable (rather than as part of a slate of variables) in governance discourse is not, at this time, supported by the empirical results. Though fewer studies suggest a positive relationship, these are often affected by intervening or complicating variables, in particular:

- the degree of equity ownership – for the CEO, executives and both ‘inside’ and independent directors; and
- firm size.

Additionally, the direction (positive or negative) of the effect of director ownership on firm performance is suggested, in one study, to be dependent on the costs of acquiring information for outside directors to remedy asymmetric information problems. The first of the intervening variables – the degree of equity ownership – is examined in chapter 10 relating to ‘good’


^191 Duchin, Matsusaka and Ozbas, above n 155, 4 (emphasis added).

^192 Ibid, 5.

^193 Bebchuk and Weisbach, above n 173, 8.

^194 Board Independent Director: Executive Director Proportion – Information Flow and Decision Quality ‘Trade-off’. See discussion in section 7.3.2.1.3 of this chapter 7.
governance and director, CEO and management compensation. The second, firm size, is discussed in chapter 8 below as part of the discussion of board size.

### 7.3.2.1.7 Conclusion for Board Factors I - ‘Independence’ and the Proportion of Non-Executive/Independent Directors

A summary of the empirical studies and Governance Variables examined in this chapter are contained in Appendix D1, Recurring Themes and Tensions in Empirical Studies Key Field No. 4 (Parts 1 and 2). This section concludes its examination of the first slate of individual board factors with little conclusive support for the perceived benefits that were suggested by the earlier examination of the ‘overall’ or multi-variable governance level.

In the case of the director independence variable, an elegant case is argued that one of the perceived benefits may include enhanced monitoring. However, other studies suggest that possible resultant problems in the quality of the information flow to board level may well arise with detrimental effects on the quality of board decision-making. This does not mean, of course, that the independence variable should be abandoned altogether. This thesis’ methodology does not consider the governance review of any organisation to be a ‘box-ticking’ exercise. For the relational approach, the overarching purpose of Governance Variables is to seek to balance a number of competing interests across various relational axes in order to achieve long-term efficiency and sustainability of the for-profit corporation. While the independence of directors may well, all things being equal, enhance the quality of monitoring, it is equally important to recognise the beneficial effects in terms of the quality of information and decision-making which is brought to the table by the more in-depth operational knowledge of executive directors.

Thus, in terms of the balancing of competing interests across the various relational axes which the relational approach calls for, the circumstances of each individual firm, the executive or independent nature of its directors and the dynamics of the interaction between board, CEO and management will require close examination in order to determine the optimal board structure to maximise the monitoring: board information flow ‘trade-off’ and the information asymmetry of independent directors.

**Positive Effects of Director Independence Likely to Depend on Size of the Board and Equity Holdings of CEO, Management and Both Inside and Independent Directors**

In the case of the perceived positive link between the independence variable and firm operating performance and/or firm value, results are conflicting with many of the studies examined finding no such relation. An insufficient number of studies with positive findings have been identified to draw any confident conclusions. However, the size of the board would appear to be an intervening factor with, at this time, inconclusive results. Another intervening factor is the level of equity holdings – for the CEO, management and both inside and independent directors. This is examined in chapter 10.

---

195 See discussion in section 10.2.1 of chapter 10.
196 See discussion in section 8.2 – 8.2.2.2 of chapter 8.
197 See discussion in section 10.2.1 of chapter 10.
This concludes the examination of Part 1 of four of the Empirical Studies Key Field No. 4. It is the first of four chapters which deal with empirical studies of Governance Variables in reducing (or increasing) agency costs and enhancing (or reducing) the long-term efficiency and sustainability of the firm. In this chapter, that efficiency and sustainability was measured principally by firm value and/or operating performance. This has been the first chapter which deals with the ‘nuts and bolts’ of the relational approach – the relational effect path for each Governance Variable which describes the number and identity of the Governance Factors (established in chapter 2) affected by each Governance Variable and the direction of the effect. The relational effect paths were summarised in the operational tables of the thesis – the Coverage Table 3.3.1 and the ultimate Relational Proximity Table 3.3.2.1.

So the relational effect paths are critical, first, as an interpretation or translation of the empirical studies into the components of the relational approach. Second, the relational effect paths are critical for the explanatory power of the over-arching hypothesis – the determination of the relative importance of a Governance Variable in reducing (or increasing) agency costs and enhancing (or reducing) firm efficiency and sustainability. The greater the number of Governance Factors affected by a Governance Variable, the greater is that Variable’s relative importance compared to other Governance Variables.

In the next chapter 8, the thesis examines Part 2 of the Empirical Studies Key Field No. 4. Again, a wide range of Governance Variables are presented and their relational effect paths tracked. This includes studies on board size and ‘outside’ board positions and studies relating to anti-takeover mechanisms, the audit subcommittee, ‘block’ and institutional shareholdings and division in the CEO/Chairperson role. Again, the long-term efficiency and sustainability of the firm will be measured principally by firm value and/or operating performance.
CHAPTER 8
EMPIRICAL STUDIES KEY FIELD NO. 4 (PART 2):
BOARD FACTORS II AND OTHER FIRM-SPECIFIC VARIABLES

8.1 Aims and Approach of Chapter 8

The aims and approach of this chapter 8 mirror those of chapter 7 which considered the effectiveness of Governance Variables drawn from Part 1 of Key Field No. 4 – National Shareholder Protection Regime and Board Factors I. This included firm-specific Governance Variables relating to ‘overall’ governance structure, the level and strength of the national shareholder protection regime, director independence and the proportion of non-executive/independent directors. The effectiveness of firm-specific Governance Variables was assessed principally by studies with measures of firm operating performance and firm value. These measures were used as proxies for the long-term efficiency and sustainability of the firm. The studies were used in combination with the Shareholder Primacy Interrelationship Scheme depicted in Figure 2.7.2A to construct a relational effect path for each individual Governance Variable.

In chapter 8, the effectiveness of firm-specific Governance Variables will again be assessed principally by studies with measures of firm operating performance and firm value as proxies for the long-term efficiency and sustainability of the firm. Chapter 8 continues with the process of examining empirical studies as follows:

- Board Factors II – Board Size and Outside Board Positions;
- Anti-Takeover Mechanisms and the Market for Corporate Control – ‘Whole’ Board and ‘Staggered’ Board Elections;
- Audit Sub-Committee – Presence, Independence and Expertise;
- ‘Block’ and Institutional Shareholdings; and
- Division in the CEO/Chairperson Roles.

Again, a relational effect path for each variable will be constructed from relevant empirical studies and the Shareholder Primacy Interrelationship Scheme. This means that the greater the number of Governance Factors\(^1\) affected by a Governance Variable in either direction,

\(^1\) See section 1.7.1 of chapter 1 for the eight Governance Factors which are discussed in sections 2.6.1 – 2.6.8 of chapter 2:

<table>
<thead>
<tr>
<th>No.</th>
<th>Reporting Factor</th>
<th>Compliance Factor</th>
<th>Alignment Factor</th>
<th>Compensation Factor</th>
<th>Monitoring &amp; Audit Factor</th>
<th>Stakeholders Factor</th>
<th>Decision-Making Factor</th>
<th>Responsibility Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Reporting Factor</td>
<td>Compliance Factor</td>
<td>Alignment Factor</td>
<td>Compensation Factor</td>
<td>Monitoring &amp; Audit Factor</td>
<td>Stakeholders Factor</td>
<td>Decision-Making Factor</td>
<td>Responsibility Factor</td>
</tr>
<tr>
<td>2</td>
<td>Reporting Factor</td>
<td>Compliance Factor</td>
<td>Alignment Factor</td>
<td>Compensation Factor</td>
<td>Monitoring &amp; Audit Factor</td>
<td>Stakeholders Factor</td>
<td>Decision-Making Factor</td>
<td>Responsibility Factor</td>
</tr>
<tr>
<td>3</td>
<td>Reporting Factor</td>
<td>Compliance Factor</td>
<td>Alignment Factor</td>
<td>Compensation Factor</td>
<td>Monitoring &amp; Audit Factor</td>
<td>Stakeholders Factor</td>
<td>Decision-Making Factor</td>
<td>Responsibility Factor</td>
</tr>
<tr>
<td>4</td>
<td>Reporting Factor</td>
<td>Compliance Factor</td>
<td>Alignment Factor</td>
<td>Compensation Factor</td>
<td>Monitoring &amp; Audit Factor</td>
<td>Stakeholders Factor</td>
<td>Decision-Making Factor</td>
<td>Responsibility Factor</td>
</tr>
<tr>
<td>5</td>
<td>Reporting Factor</td>
<td>Compliance Factor</td>
<td>Alignment Factor</td>
<td>Compensation Factor</td>
<td>Monitoring &amp; Audit Factor</td>
<td>Stakeholders Factor</td>
<td>Decision-Making Factor</td>
<td>Responsibility Factor</td>
</tr>
<tr>
<td>6</td>
<td>Reporting Factor</td>
<td>Compliance Factor</td>
<td>Alignment Factor</td>
<td>Compensation Factor</td>
<td>Monitoring &amp; Audit Factor</td>
<td>Stakeholders Factor</td>
<td>Decision-Making Factor</td>
<td>Responsibility Factor</td>
</tr>
<tr>
<td>7</td>
<td>Reporting Factor</td>
<td>Compliance Factor</td>
<td>Alignment Factor</td>
<td>Compensation Factor</td>
<td>Monitoring &amp; Audit Factor</td>
<td>Stakeholders Factor</td>
<td>Decision-Making Factor</td>
<td>Responsibility Factor</td>
</tr>
<tr>
<td>8</td>
<td>Reporting Factor</td>
<td>Compliance Factor</td>
<td>Alignment Factor</td>
<td>Compensation Factor</td>
<td>Monitoring &amp; Audit Factor</td>
<td>Stakeholders Factor</td>
<td>Decision-Making Factor</td>
<td>Responsibility Factor</td>
</tr>
</tbody>
</table>
then the greater is its relational proximity Rating and its effect on agency costs and the sustainability of the firm.

8.2 Board Factors II - Board Size and Outside Board Positions

The thesis now examines a selection of studies that attempt to measure the firm-specific effects of a second group of individual board and director-related Governance Variables. The first variables to be examined are board size ([BrdCmSize] (+/-2)) and outside board positions of independent directors ([OutBrdPos] (-)).

A review of studies below reveals that a significant number of factors would appear to affect the size of the board. Some of these factors are exogenous (imposed from outside the firm) such as the national/statutory Governance Code or regime requirements and the practicability of ‘external verification’ or monitoring. Other factors are endogenous depending on the individual characteristics of the firm such as the compatibility of insider and outside shareholder interests, the size of the firm and the level of firm ‘diversification’/complexity and debt.

8.2.1 Determinants of Optimum Board Size

Raheja has proposed a model to determine optimal board size and composition (proportion of insiders vs outsiders):

first, firms in which the incentives of insiders are better aligned with shareholders, such as those in very competitive industries or firms with high inside ownership, require smaller-sized boards. The smaller boards save on the coordination costs to outsiders while still being able to motivate insiders to reveal their private information because of insiders’ better incentives. Second, with respect to board composition, firms in which it is easier for outsiders to verify projects...will optimally have a higher proportion of outsiders on the board.

Thus, the author seeks to combine considerations relating to the alignment of insider interests with those of shareholders and the ease or otherwise of external verification of the firm’s activities. The first consideration is straightforward. Better alignment between outsiders and the incentives of insiders (such as performance-based compensation, equity holdings and option grants for inside directors) means that the shareholders require fewer insiders than otherwise would be the case to effectively align their interests – for example, in relation to firm operating performance and firm value.

The second consideration can be explained in terms of the phenomenon explained in chapter 7 – that increases in the number of outside/independent directors on the board can lead to a reduction in the ‘firm-specific’ and ‘manager-specific’ information-flow to the board. Additionally, for commentators like Hill and Duchin et al, there may be ‘inferior information’ or information asymmetry on the part of outside directors compared to inside directors. Thus, a

---

2 Board and Committee Size – see discussion in section 8.2.2.2 of this chapter 8.
3 Outside Board Positions of Independent Directors – see discussion in section 8.2.3.1 of this chapter 8.
5 Ibid, 4.
6 See discussion in section 7.3.2.1.3 of chapter 7.
7 Ibid.
company in which financial and operational matters are easier for an outside director to verify – i.e., matters which require no or little insider information – will sustain more outside directors. For example, the company’s share price at any time is a matter of public information and so can be verified by outside directors. Similarly, material customer contracts may be inspected and examined. But it is otherwise in relation to the company’s suppliers. The reliability, suitability and viability of those suppliers is likely to be insider information. The more specialized and complex the company’s financial (including debt) and operational profile, the more reliant that outside directors are on CEO and management information and thus the lower the proportion of outside directors.

Board size has also been shown to be dependent on the size of the firm and governance regime requirements. Lehn, Patro and Zhao find that the major determinant of board size and the proportion of insiders is the size of the firm. Linck, Netter and Yang found that as firm size increases, board size and the proportion of independent directors both increase. In addition, as inside ownership increases, board size and the proportion of independent directors reduces. The authors also found that the requirements of SOX and consequential mandatory NYSE Final Rule changes have caused board size and proportion of independent directors to both increase.

Coles, Daniel and Naveen found, too, that board size increases with the size of the firm and, in addition, with the ‘level of diversification’ and ‘leverage’ concluding that:

firms that are diversified, large, and have high debt have 2 more board members, who are outsiders.

Thus, the board size factor appears to be itself affected by a wide range of other factors. Accordingly, optimal board size cannot be determined in isolation of individual firm, industry and regulatory characteristics. The results would appear to coincide with intuitive arguments in relation to factors which affect the quality and difficulty of the monitoring, advisory and strategic decision-making functions of the board – that the wider the gap between insider and outsider interests, the more difficult the practicability of external monitoring, the larger the firm’s operations, their diversity and/or complexity and debt level, the larger the size of the board.

---

12 Linck, Netter and Yang, above n 9, 2.
8.2.2  The Relationship between Board Size and Firm Operating Performance/Value is Inconclusive

What is the effect on firm operating performance and/or value of changes in the size of the board? A review of the studies below displays conflicting results. Accordingly, no consistent or conclusive result can be confidently predicted in relation to the relationship between board size and firm operating performance and/or firm value.

8.2.2.1  Conflicting Results for Board Size and Firm Performance/Value

Adams and Mehran found that (banking) firm performance was positively influenced by an increase in the size of the board.14 For Fuerst and Kang, however, firm performance is reduced by a number of factors including a rise in the number of total directors.15 Bhagat and Black, however, found “no consistent correlation” between firm performance and the size of the board.16

Mak and Kusnadi investigate the link between firm value and the size of the board in Singapore and Malaysia.17 After noting that the corporate Governance Codes in those countries are based on the UK Combined Code18, the authors refer to a 1993 study by Jensen in relation to an argued negative relationship between board size and consequent board effectiveness:

Jensen (1993) argues that boards with more than about 7 to 8 members are unlikely to be effective. According to him, large boards result in less effective coordination, communication and decision-making, and are more likely to be controlled by the CEO.19

Of course, the size of the company is relevant. For Mak and Kusnadi, also relevant is leverage and the total fixed asset ratio. Thus, what might be an effective size of board for a small company may be too few given the size, complexity and leverage of a large company. In Mak and Kusnadi’s study:

for our Singapore sample, firm size (SIZE), measured as the sum of market value of equity, book value of preferred stock and debt, has a mean (median) of S$2.19 billion ($244 million). On average, Singapore firms have a debt to total assets ratio (LEVERAGE) of 0.48, a total fixed asset ratio (TFARATIO) of 0.32... Firms in our Malaysia sample (Panel B) has a mean SIZE of about RM 2 billion, mean LEVERAGE of 0.55, mean TFARATIO of 0.35...20

18 Ibid, 3.
20 Mak and Kusnadi, above n 17, 13-14.
In the case of these Singapore and Malaysian companies, the authors found that increases in board size after five directors reduced firm value.\textsuperscript{21} Important for this section of the thesis is the effects of increases in board size on the effectiveness of the board as a governance structure:

Research in organizational behavior has consistently shown that large groups are less effective than small groups in decision-making (e.g., Hackman, 1990). The greater risk of large boards being captured by management (Jensen, 1993) would appear to be similar regardless of the corporate governance framework. In addition to large boards generally costing more in terms of directors’ remuneration (which has a direct impact on firm value), large boards may be indicative of a tendency of boards to add directors rather than to replace directors. Therefore, large boards may have a tendency to rubber-stamp the re-appointment of existing directors, and where new directors are required, these new directors supplement, rather than substitute, existing directors.\textsuperscript{22}

This suggests that, not only is the effectiveness of decision-making reduced by increases in the size of the board, but so too is the board’s likelihood of replacing a director with a more suitable candidate.

8.2.2.2 \([\text{BrdCmSize}] (+/-)\)\textsuperscript{23} Variable Relational Effect Path

Perceived Negative Relationship between Board Size Above ‘Optimal’ Level and Board Effectiveness

Intuitively, arguments concerning a perceived negative relationship between board size above a particular point and board effectiveness appeal. The difficulty given the wide range of firms which exist would appear to be determining that ‘optimal’ point. This would appear to be dependent, at the very least, on the following factors:\textsuperscript{24}:

- compatibility of insider and outside shareholder interests;
- practicability of ‘external verification’ or monitoring;
- size of the firm;
- national/statutory Governance Code or regime requirements; and
- level of firm ‘diversification’/complexity and debt.

The analysis therefore suggests that the \([\text{BrdCmSize}]\) direction of effect may be either positive or negative (+/-) depending upon the point for the ‘optimal’ number of directors for that particular firm. Taking Jensen’s 1993 view as the starting point, notions of the effectiveness of coordination, communication and decision-making raise squarely the Decision-making Factor No. 7 as follows:

\textsuperscript{21} Ibid, 4.
\textsuperscript{23} Board and Committee Size.
\textsuperscript{24} These factors are also described in section 8.2.1 of this chapter 8.
The analysis and relational effect path for [BrdCmSize] (+/-) is in part similar to that for the [BrdIndMon] (+) variable (which is itself based on the relational effect path for the [BrdSkills] (+) variable). Additionally, the size of the board, which Linck, Netter and Yang find is affected by mandatory statutory and exchange rules, is thus affected by the Compliance Factor No. 2 (Corporate Governance and Legal Compliance).

The reflexive relationship between the Decision-making Factor No. 7 and the Responsibility Factor No. 8 is employed in relation to the [BrdIndMon] (+) variable. Conceivably, this reflexive relationship could operate here. But it is difficult to make a sufficiently compelling hypothesis (even on intuitive grounds) that matters of board size should have a similar effect on the Responsibility Factor No. 8 as opposed to director independence. It will be recalled that, in the case of the [BrdIndMon] (+) variable, director independence is hypothesised to affect the Responsibility Factor No. 8 on account of the significance afforded to director independence in Governance Codes in chapter 6. In other words, director independence cuts across the delineation of different monitoring and responsibility organs, whether the board or committee. By contrast, while board size affects the efficacy of decision-making (Decision-making Factor No. 7), it is unlikely to affect the delineation and disclosure of powers, duties and lines of responsibility of those organs.

Similar considerations apply for the thesis to exclude any significant hypothetical effect of board size on the Stakeholders Factor No. 6 (Identification, Participation and Protection of Stakeholder Interests). In other words, increases in board size should not normatively affect the ability of the board to identify, facilitate participation and to protect stakeholder interests. This is unless one hypothesises that there is some sort of ‘crowding-out’ effect on (non-

---

25 Board Independent Director: Executive Director Proportion – Monitoring Effect – see discussion in sections 7.3.2.1.1-2 of chapter 7.
26 Board – Director Skills ‘Mix’ – see discussion in section 7.3.1.2.1 of chapter 7.
27 Linck, Netter and Yang, above n 9, 2.
28 Delineation and Disclosure of Powers, Duties and Lines of Responsibility – see discussion in section 2.6.8 of chapter 2.
29 See discussion in section 6.8.1 of chapter 6 and section 7.3.2.1.2 of chapter 7.
shareholder) stakeholder interests by increases in board size. This seems very unlikely given the assumption of a constant independent/non-executive director proportion. If this proportion remains constant, then there is no greater or lesser consideration of non-shareholder stakeholder interests by the board or committees.

This is by contrast to the effect of increases in the size of the board on the alignment of management and shareholder interests (Alignment Factor No. 3). Again taking the relational effect path of the \([\text{BrdIndMon}]^{(+)}\) variable\(^{30}\), the reflexive relationship between the Decision-making Factor No. 7 and the Alignment Factor No. 3 remains in place and operative. This is because of Raheja's identification of the compatibility (or alignment) of insider and outside shareholder interests as one of the determinants of board size.\(^{31}\)

Taking these considerations together, the relational effect path for \([\text{BrdCmSize}]^{(+/-)}\) affects all Governance Factors except the Responsibility Factor No. 8 and the Stakeholders Factor No. 6. This results in a Coverage/Rating of +/- 6/75.00 \(rprox\) for the \([\text{BrdCmSize}]^{(+/-)}\) variable in the Coverage Table 3.3.1 and Relational Proximity Table 3.3.2.1.

### 8.2.3 Do Board Positions of Outside Directors Reduce Monitoring Quality?

This section highlights four studies. The first in 2002 suggests that multiple directorships do not cause directors to monitor less effectively nor to avoid time commitments such as serving on board committees. The second study in 2004 suggests that increases in the number of outside positions held by outside directors may reduce the effectiveness of the board’s monitoring function. The third study in 2008 suggests that ‘busy’ directors have more absences from board meetings which may reduce firm performance while the final study suggests some benefit from outside directorships – that networking through outside board positions may increase firm performance.

The relationship between the time commitment of multiple directorships and the quality of board monitoring and service on committees was examined by Pritchard, Ferris and Jagannathan in 2002:

> [o]ur study tests the hypothesis that directors who serve on multiple boards become so busy that they cannot monitor management adequately. What we call the Busyness Hypothesis of corporate directorships postulates that serving on multiple boards over-commits an individual. As a consequence, such individuals shirk their responsibilities as directors. For example, over-committed directors might serve less frequently on important board committees such as the audit or the compensation committees.\(^{32}\)

The authors find that “[d]irectors who serve larger firms and sit on larger boards are more likely to attract additional directorships”.\(^{33}\) Indeed, the authors suggest that there is a ‘reputational effect’ – that favourable financial results at a firm increase the likelihood of further directorships:

> [w]e also find that firm performance has a positive effect on the number of board seats subsequently held by a director. This finding suggests that reputation matters in the market for directors. Specifically, offers of

---

\(^{30}\) Board Independent Director: Executive Director Proportion – Monitoring Effect – see discussion in sections 7.3.2.1.1-2 of chapter 7.

\(^{31}\) Raheja, above n 4.


\(^{33}\) Ibid, 20.
employment as a director appear to be conditioned by the quality of previous board service as measured by the firm’s financial performance. For executives, offers of board membership correlate with the performance of the firm that they manage. Thus, our results support Fama and Jensen’s (1983) contention that there is a reputational effect in the market for directors.34

Not surprising given this finding, Pritchard et al further find that multiple directorships do not reduce future firm performance nor do such directors ‘shirk’ (in an agency cost sense35) committee responsibilities or increase the likelihood of securities fraud litigation against the company.36

A 2004 study by Fich and Shivdasani examines the relationship between the number of board positions held by outside directors and the level of firm governance.37 The implication from the study is that an excessive number of outside board positions held by outside directors may reduce the quality of board monitoring. This monitoring has previously been argued to be enhanced by increases in the proportion of outside directors.38

The authors find that ‘busy’ outside directors are associated with weaker firm governance.39 More particularly, the authors find that their governance measure is reduced “where a majority of outside directors hold three or more board seats”.40 The authors also find:

that boards where the majority of outside directors hold three or more directorships are less likely to remove a CEO for poor performance. We confirm results of prior research that finds that independent boards are more likely to remove CEOs for poor performance than non-independent boards.41

Thus, while more independent boards increase the probability of removal of the CEO after poor performance, this probability may well fall with increases in the number of outside board positions of those directors.

The more recent 2008 study by Jiraporn, Davidson, Ning and DaDalt42 examines whether busy directors have more absences from board meetings:

[d]irectors holding too many board seats may find it difficult to “show up” at all board meetings. Failure to attend meetings may interfere with the directors’ ability to do their job effectively as board meeting frequency has been linked to firm value.43

The authors find that the likelihood of board absences increases with the number of outside board positions:44

35 See discussion in section 4.2.3 of chapter 4.
36 Pritchard, Ferris and Jagannathan, above n 32, 20.
38 See discussion in sections 7.3.2.1.1 – 7.3.2.1.2 of chapter 7.
39 Fich and Shivdasani, above n 37, 2-3.
40 Ibid, 2.
41 Ibid, 3.
43 Ibid, 4 (footnote omitted).
44 Ibid, 4-5 and 21.
[This is consistent with the notion that directors who sit on multiple boards are so overstretched they have a hard time showing up for board meetings. Given prior evidence that board meetings are critical to firm performance...this finding is important.]

However, for the authors, this relationship disappeared after the passing of the SOX reforms on account of the additional focus on directors:

Moreover, given the sweeping reforms introduced by the Sarbanes-Oxley Act of 2002 (SOX), we find that busy directors are more likely to have better attendance post-SOX, possibly due to more intense attention on the role of directors.

Despite the two negative studies above, there may be benefits of outside board positions. In this respect, Larcker, So and Wang consider the advantages of the “boardroom network formed by shared board directorates”. The authors suggest that the advantages of these connections include that they foster communication of information that enhances strategic decision-making, reduce information asymmetry in designing contracts, provide useful contacts for business relationships and other economic benefits and facilitate value-enhancing innovation in areas such as corporate governance, technology and compensation contracts.

The authors conclude that ‘well-connectedness’ enhances firm performance:

We find that boards with relatively better-connected boards earn significantly higher future returns than those with less-connected boards. This association holds after controlling for the influence of industry membership, size, book-to-market, and momentum. The centrality-return association is more pronounced in firms that are young, or have high growth opportunities, or low ROA, or low stock momentum, suggesting that board networks may matter most for firms with large future growth opportunities or firms confronting adverse circumstances.

Thus, in the design of the board, the counterbalancing effects of outside board positions must be weighed. Reductions in the probability of dismissing the CEO after poor performance must be matched against the improvements that ‘well-connectedness’ brings to the firm.

8.2.3.1 [OutBrdPos] (-)

Thus, while Fich and Shivdasani’s 2004 study would support the thesis’ earlier discussion that independent boards increase the likelihood of replacement of a CEO in times of falling profitability, it also contains a cautionary finding that increases in the number of outside positions held by outside directors may reduce the effectiveness of the board’s monitoring function. The 2008 study by Jiraporn, Davidson, Ning and DaDalt suggests that busy directors have more absences from board meetings, a factor which may reduce firm performance. In the positive direction, the 2002 study by Pritchard, Ferris and Jagannathan

46 Ibid, 22.
49 Ibid.
50 Ibid, 29.
51 Outside Board Positions of Independent Directors.
52 Fich and Shivdasani, above n 37.
53 See discussion in section 7.3.2.1.1 of chapter 7.
54 Jiraporn, Davidson III, Ning and DaDalt, above n 42.
55 Pritchard, Ferris and Jagannathan, above n 32.
suggests that multiple directorships do not affect the quality of monitoring nor cause directors to shirk.

Based on the 2004 and 2008 studies, the relational effect path for the [OutBrdPos] variable is hypothesised to be negative (-). Clearly, the negative studies outweigh the positive studies by only one. Putting that aside, the zone of effect for [OutBrdPos] (-) begins at the Monitoring & Audit Factor No. 5. The relational effect path is then follows the pathway for [BrdSkills] (+)\textsuperscript{56} and [BrdIndMon] (+)\textsuperscript{57} with one exception. The number of outside positions of independent directors is unlikely to affect to a significant degree the Responsibility Factor No. 8 (Delineation and Disclosure of Powers, Duties and Lines of Responsibility) and so it is omitted:

![Figure 8.2.3.1: [BrdOutPos] (-) Relational Effect Path](image)

Again, the Compliance Factor No. 2 (Corporate Governance and Legal Compliance) is omitted as the legal obligations and requirements contemplated by this Governance Factor – whether ‘hard’, ‘soft’ of ‘hybrid’ laws – remain constant and are not affected by the outside board positions of independent directors. Thus, the Compliance Factor No. 2 remains constant for this variable. \textsuperscript{58} Accordingly, [OutBrdPos] (-) is hypothesised not to affect the Compliance Factor No. 2 and the Responsibility Factor No. 8 and so has a Coverage/Rating of -6/75.00 rprox in the Coverage Table and Relational Proximity Table. \textsuperscript{59}

8.3 Anti-Takeover Mechanisms and Market for Corporate Control – ‘Whole’ Board and ‘Staggered’ Board Elections

This section begins with a discussion of the argued effects of a number of anti-takeover mechanisms, particularly on the market for corporate control. The examination will then focus on a selection of studies which attempt to measure the firm-specific effects of a particular anti-takeover mechanism related to the election of directors – the holding of a ‘staggered’ board

\textsuperscript{56} Board – Director Skills ‘Mix’ - see discussion in section 7.3.1.2.1 of this chapter 7.
\textsuperscript{57} Board Independent Director: Executive Director Proportion – Monitoring Effect - see discussion in sections 7.3.2.1.1-2 of chapter 7.
\textsuperscript{58} See discussion for [BrdSkills] (+) in section 7.3.1.2.1 and [BrdIndMon] (+) in 7.3.2.1.2 of chapter 7.
\textsuperscript{59} See the Coverage Table in section 3.3.1 and the Relational Proximity Table in section 3.3.2.1 of chapter 3.
election. This is where a proportion only of the directors in office face a re-election vote as opposed to the whole board. As less than the entire board (perhaps only one-third) is due for reelection at any general meeting, this means that shareholders cannot remove all the directors at once even in times of poor performance. Thus, the staggered board election is an entrenching mechanism against removal as shareholders cannot vote in an entire set of new directors.

8.3.1 Overview – Anti-Takeover Mechanisms May Reduce the Effectiveness of the Market for Corporate Control and May Reduce Firm Value

Anti-takeover mechanisms may reduce the effectiveness of the market for corporate control by interfering with its disciplinary ‘management replacement’ function thus reducing firm value. More specifically, in terms of the elements of the nexus of contracts theory described in chapter 4, anti-takeover provisions thus constitute, for shareholders, ‘welfare-reducing’ terms of the voluntary ‘contract’ between inside managers and those shareholders. This causes a reduction in market price and, therefore, return on investment causing investors to seek more profitable investments.

The relevance of the market for corporate control as a Governance Variable where there is a separation of ownership and control of a company has also been discussed in detail in chapter 4. For Cremers and Nair, the market for corporate control is an important ‘external governance mechanism’, the authors observing that “[t]he importance of internal governance crucially depends on the extent of external governance and vice versa.”

Importantly, Masulis, Wang and Xie, observe that anti-takeover mechanisms reduce shareholder value by shielding management who acquire investments at an over-value from the market for corporate control. This shielding effect is significant in terms of the perceived governance effect which the market for corporate control brings in the public for-profit sphere. Weir, Laing and McKnight, for example, found that the market for corporate control was a stronger mechanism than firm-specific Governance Variables.

8.3.1.1 Types of Anti-Takeover Mechanisms Likely to Reduce Value

The nature of anti-takeover provisions likely to cause a reduction in firm value is described by Bebchuk, Cohen and Ferrell. The authors examine the staggered board and, in addition, five

---

60 See discussion in section 4.2.2 of chapter 4.
61 Ibid.
63 The acquisition of an asset at an over-value means that the company has paid out more than the asset’s true value (putting aside how that value is calculated). Consequently, there is a reduction of the net asset value of the company. Thus, such behaviour amounts to a ‘residual’ cost in Jensen and Meckling’s theory of agency costs. See discussion in section 4.2.3.1 of chapter 4.
other ‘entrenching provisions’ in the period 1990 – 2003. The relevant anti-takeover variables tested were:

- staggered boards;
- limits to shareholder amendments of the bylaws;
- supermajority requirements for mergers;
- supermajority requirements for charter amendments;
- poison pills; and
- golden parachute arrangements.

The authors concluded that each of these variables individually and in aggregate was negatively linked to both firm value and share price returns during that period. It appears that the anti-takeover provisions identified by Bebchuk, Cohen and Ferrell may have a similarly negative effect on firm value as that identified by Masulis, Wang and Xie. An important connecting factor between the studies may be the effect identified by the latter study – that anti-takeover mechanisms may reduce the ‘effectiveness’ of the market for corporate control by interfering with or reducing its disciplinary ‘management replacement’ function. Thus, as stated above in terms of the ‘nexus of contracts’ theory, a reduction in firm value is likely to result through the market price-reducing effects of such shareholder ‘welfare-reducing’ variables.

As noted above, a common anti-takeover mechanism is the ‘staggered’ board election. As Bebchuk, Cohen and Ferrell explain:

69 See above n 64.
[when the firm has a staggered board, directors are divided into classes, almost always three, with only one class of directors coming up for reelection each year. As a result, shareholders cannot replace a majority of the directors in any given year, no matter how widespread the support among shareholders for such a change in control. This makes staggered boards a powerful defense against removal in either a proxy fight or proxy contests.]

In this respect, Bebchuk and Cohen note that staggered board elections take place for the majority of US public companies. The authors suggest that, while the effects of staggered board elections may be causative in relation to reducing firm value, this is not the only explanation such that “the association might be produced by the selection of staggered boards by low-value firms that seek to protect themselves from a takeover”. However, the authors conclude that, despite this and other possible explanations, “we…provide some suggestive evidence that staggered boards at least partly bring about, and not merely reflect, a lower firm value”. This also accords with the view of Aggarwal, Erel, Stulz and Williamson. As noted above, Aggarwal et al found that firm value increases with independence of the board. As part of the same study, they also found that such value is also enhanced by annual elections for the whole board.

Yet, in 2010 and contrary to these findings, Larcker, Ormazabal and Taylor found that regulation of staggered boards (e.g., by banning them) caused a significant negative relation between abnormal returns to these events and the presence of a staggered board…This is inconsistent with the market viewing the elimination of staggered boards as value increasing.


71 Bebchuk, Cohen and Ferrell, above n 66, 10.
73 Ibid, 2.
74 Ibid.
75 See discussion in section 7.3.2.1.4 of chapter 7.
This result is itself inconsistent with Bebchuk, Cohen and Yang who, in 2010 (revised in July 2011), investigated two Delaware court rulings (the Supreme Court ruling reversing the Chancery Court ruling) and found the results consistent with the hypothesis that staggered boards reduce firm value.\footnote{Lucian A Bebchuk, Alma Cohen and Charles C Y Wang, “Staggered Boards and the Wealth of Shareholders: Evidence from Two Natural Experiments”, Harvard Law and Economics Discussion Paper No. 697, (June 1, 2010 and revised July 2011), available at SSRN: http://ssrn.com/abstract=1706806, 23.} For the authors, the effect was more pronounced for firms which had factors which increase their exposure to control contests especially ‘underperformance’, ‘high asset pledgibility’, ‘small size’ and ‘high industry takeover intensity’.\footnote{Ibid, 14.}

In a 2013 article, Bebchuk continues his opposition to measures which - like anti-takeover defences - ‘insulate’ the board from shareholder activism:


In attacking the claims that insulating boards is beneficial in the long-term as a protection for boards and companies against shareholder ‘short-termism’, Bebchuk challenges four areas of debate including that of takeover defences and concludes that board insulation has long-term costs:

\[\text{[e]ven assuming that shareholder power to replace directors produces certain costly distortions of long-term investments, it must be taken into account that the disciplinary force generated by accountability to shareholders also produces significant benefits – both in the short term and in the long term. Without board insulation, the fear of being replaced by shareholders gives insiders incentives to avoid observable departures from shareholder interests. Board insulation eliminates or substantially weakens this important source of incentives to serve shareholders. Thus, it can be expected to increase slack, empire building, excessive pay, and other forms of private benefits. It can also be expected to make insiders more inclined to act in ways that are beneficial to or convenient for themselves but costly to shareholders.}^{81}\]

\footnote{Ibid 15-16 and 41.}

For further reasons to reject short-termism as a ground for insulating boards and CEOs, see Mark J Roe, “Corporate Short-Termism - In the Boardroom and in the Courtroom” (2013) 68 Business Lawyer 977; ECGI - Law Working Paper No. 210; Harvard Public Law Working Paper No. 13-18, (August 1, 2013) available at SSRN: http://ssrn.com/abstract=2239132. Among five grounds given by Roe (at 980) is that:

mechanisms inside the corporation may well be important sources of short-term distortions and these internal distortions can be, and would be, ex-acerbated by insulating boards further from external financial markets. CEOs will prefer that good results occur on their watch, and prefer that poor results be pushed into the future, beyond their tenure. With average overall tenure for CEOs now at seven years, the typical CEO can expect about three more years at the top. The CEO is still the most important decision maker inside the firm, and human psychology suggests a typical CEO would weigh results during his or her expected tenure above longer-term results. (And collateral costs of excessive managerial autonomy, in increasing managerial agency costs, must be added to the mix.) Senior managers not yet at the top but with an eye on their future job prospects in the labor market want strong results before the next headhunter calls them. There is considerable evidence consistent with managerial distortions being a major source of short-term focus. Boards and managers may well have leeway in setting the horizon for compensation, and that horizon may be shorter than it needs to be: the time duration for executive pay packages appears to be shorter than the duration of institutional investor holdings.
Thus, for Bebchuk, the fear of agency costs looms close on the horizon of anti-takeover mechanisms.

**Negative Effect on Firm Value for [OtherATMs] (-): Other takeover Mechanisms (excludes staggered board elections) and [StagBrdElect] (-): Staggered Board Elections**

The implication from these studies appears to be that staggered board elections have – by virtue of constituting a shareholder welfare-reducing term of the nexus of contracts - a negative effect on firm value by interfering with or reducing the effectiveness of the market for corporate control as a market-efficiency sanction. Thus the relational effect paths for both [OtherATMs] and [StagBrdElect] are negative reflecting this corresponding diminution in firm value.

Chapter 4 explained the underlying or constituent elements of the market for corporate control. The market for corporate control is itself a component of the efficient market hypothesis which (theoretically at least) disciplines or deters insider-managers that engage in value or performance-reducing behaviour by exposing them to (again, at least the risk) of hostile takeover.\(^82\)

In the design of the relational approach, the Compliance Factor No. 2\(^83\) provides the content of the national shareholder protection regime including significant provisions in relation to mergers and hostile and other takeovers. The Compliance Factor No. 2 is an overriding requirement of all Governance Factors.\(^84\) In the case of the [NationGov] (+) variable in section 7.3.1.3.3, changes in the content of this Governance Variable actually change the requirements of ‘hard’, ‘soft’ and ‘hybrid’ laws which apply to the company. Thus, Compliance Factor No. 2 is itself


[b]oard classification affects the monitoring and advising functions of boards. In theory, classified boards can be either value-destroying if they impede the effectiveness of board monitoring, or value-enhancing if they improve the advisory function of boards. Therefore, it is important to understand a firm’s environment that determines the relative importance of the costs and benefits of classified boards. Unlike previous studies, we consider that the effect of classified boards is dependent on a firm’s monitoring costs and advising needs. We argue that the advisory benefits of classified boards do outweigh the costs of managerial entrenchment when firms have a greater need for advisory services from the board and their assets are less information intensive, and vice versa. Consistent with our view, we find that classified boards are positively associated with Tobin’s q in firms with low monitoring costs and greater advising needs. The detrimental effect of classified boards is most pronounced in firms with high monitoring costs and low advising needs.

\(^82\) See discussion in section 4.2.2 of chapter 4.

\(^83\) Corporate Governance and Legal Compliance - See discussion in section 2.6.2 of chapter 2.

\(^84\) Ibid.
affected by changes in the content of the national shareholder protection regime contemplated
by the [NationGov] (+) variable. In the case of [OtherATMs] (-) and [StagBrdElect] (-), there
is a similar effect. These variables provide the content of the merger, takeover and
shareholder activism/intervention laws of the national shareholder protection regime. As the
content of those merger, takeover and shareholder activism/intervention laws change, so too
will the content of Compliance Factor No. 2.

Thus, the most direct or proximate relational effect path for the [OtherATMs] (-) and
[StagBrdElect] (-) variables is identical to that for [NationGov] but in the negative direction.
The [OtherATMs] (-) and [StagBrdElect] (-) variables affect all Governance Factors in a
manner identical to Figure 2.6.2 (Compliance Factor No. 2 Interrelationships) but again in the
negative direction. This gives rise to a Coverage/Rating of -8/100.00 rprox for each of these
variables in the Relational Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

8.4 Audit Sub-Committee – Presence, Independence and Expertise

This section focuses on studies which attempt to measure the firm-specific effects of the
presence, independence and expertise of the audit sub-committee.

Before discussing matters of firm value and performance, it is apt to note some of the structural
determinants of audit committee independence and financial expertise in order to identify
underlying factors or variables which may affect the ability of firms to effect changes or
modifications to the structure of audit committees.

Statutory and Governance Code Mandated Requirements

First, requirements as to audit committee presence, independence and financial literacy may
be mandated by relevant corporate governance legislation or Governance Codes. In this
respect, significant changes to US corporate governance requirements in relation to audit
committee composition, independence and financial expertise were introduced through the
reforms of SOX85 and the NYSE Final Rules.86

Secondly, while only a single study, Beasley and Salterio explain that, in Canada, an increase
in outside directors on the audit committee in excess of compulsory minimum requirements is
positively related to:

(1) an increase in the percentage of outsiders on the board;

(2) division of CEO and Chairperson functions; and

(3) increases in the size of the board.87

85 SOX, above n 10.
86 NYSE Final Rules, above n 11.
87 M S Beasley and S E Salterio, “The Relationship Between Board Characteristics and Voluntary Improvements
in Audit Committee Composition and Experience”, (February 28, 2001), available at SSRN:
These same three factors are also related to increases in audit committee financial expertise of outsiders. In respect of audit committee financial expertise, some corporate Governance Codes specify that audit committee members be financially literate. For example, the Commentary to Section 303A.7(a) of the NYSE Final Rules requires that:

\[
\text{[e]ach member of the audit committee must be financially literate, as such qualification is interpreted by the listed company's board in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee. In addition, at least one member of the audit committee must have accounting or related financial management expertise, as the listed company's board interprets such qualification in its business judgment.} \]

As noted in chapter 6, the NYSE Final Rules are a downstream effect of SOX. Yet for Nosworthy, Symes and Le Mire, the US' Securities Exchange Commission (SEC) watered-down the original financial expertise requirement of the SOX provisions:

\[
\text{[t]he Sarbanes-Oxley Act reforms that followed the momentous Enron collapse in 2001, included the requirement that audit committees must contain at least one member with financial expertise. This financial expert was initially defined by the SEC, as a person with 'education and experience' of an accounting or auditing type. Subsequent controversy led this definition to be broadened to include those who had experience in 'supervising employees with financial reporting responsibilities, overseeing the performance of companies, and other relevant experience'.}
\]

Putting this question aside, what then is the effect of audit committee independence and financial expertise on firm value and firm operating performance?

### 8.4.1 Effect of Audit Committee Independence and Financial Expertise on Firm Value and Operating Performance

The perceived link between audit committee independence and firm value and/or operating performance remains, at this time, a matter for debate.

As noted above, independence of the audit committee (along with board independence) was one of the factors that Black and Kim found in the emerging market of Korea to be positively connected with both market value and later year increased profitability and dividend payments of 'large' companies. However, as suggested earlier, the 'gap-filling' function of internal governance measures such as these may well be compensating for possible weaknesses in

---

88 Ibid, 2-3.
89 NYSE Final Rules, above n 11.
91 See discussion in section 6.4.1 of chapter 6.
the national governance regime thus overstating the value-enhancing and performance-enhancing effect of this variable in comparison to a developed market or a common-law regulatory regime. Still, for Aggarwal, Erel, Stulz and Williamson, too, firm value increases with annual ratification of the audit committee and composition of the audit committee of five ‘outsiders’.94

On a similar theme but different measure, Ashbaugh-Skaife, Collins and LaFond find that agency risk and, consequently, cost of equity capital reduces with greater audit committee and board independence.95 It is also suggested by Smith that the quality of monitoring of management is enhanced both by independence of the audit committee as well as the number of meetings.96

However, not all studies have found a link between company performance and/or value and audit committee independence. In their study of UK firms, Weir, Laing and McKnight found that firm value was not significantly linked to the existence of an audit committee97 and that firm performance was not significantly linked to the quality or composition (proportion of non-executive/independent directors) of the audit committee.98

Clearly, the [AudCom] (+)99 and [AudIndMon] (+)100 variables have intuitive appeal – that increases in the independence of the audit committee and the number of meetings enhances the committee's quality of monitoring. Yet, given the conflicting results, further empirical investigation will be required to confirm a significant causal relationship.

---

94 Aggarwal, Erel, Stulz and Williamson, above n 76, 4-5.
97 Weir, Laing and McKnight, above n 65, 19.

In a 2005 study posted in January 2012, Dionne and Triki find independence has no effect on risk management activity, this being affected only by the degree of financial knowledge/education (at 24):

We find that the new requirements concerning the audit committee size and independence incite firms to seek more hedging while the requirement of a majority of unrelated directors in the board has no effect on the risk management activity. Likewise, directors with a financial activity and those with an accounting background seem to play no active role in the hedging policy. Interestingly, firms whose audit committee is entirely composed of financially educated directors and those whose board has a majority of financially educated directors manage more the risks they face. Therefore, only the directors' financial education affects the risk management activity.


99 Audit Committee – Presence, Operation and Frequency.
100 Audit Committee – Independence – Monitoring Effect.
8.4.2 \([\text{AudCom}] (+)\) Variable Relational Effect Path

Subject to this important caveat, the \([\text{AudCom}] (+)\) variable should exert a positive effect on six Governance Factors with a Coverage/Rating of +6/75.00 in the Relational Coverage Table and the Relational Proximity Table. Corporate governance statutes and Governance Codes contain – as depicted in the Governance Code Tables in chapter 6 – significant input and guidance in relation to audit committee powers and functions. Thus, the themes in the Compliance Factor No. 2\(^{102}\) have significant effect on the audit committee. If, following the results of some of the above studies, the presence and frequency of meeting of the audit committee enhances the quality of monitoring, the starting point for this relational effect path is the Monitoring & Audit Factor No. 5.\(^{103}\) The most direct or proximate links are two-pronged.

First is the reflexive relationship between the Monitoring & Audit Factor No. 5 and the Decision-making Factor No. 7.\(^{104}\) The second prong is the also reflexive relationship between (again) the Monitoring & Audit Factor No. 5 and the Reporting Factor No. 1.\(^{105}\)

\textbf{Figure 8.4.2: \([\text{AudCom}] (+)\) Variable Relational Effect Path}

The Decision-making Factor No. 7 itself has two other reflexive relationships depicted in the Shareholder Primacy Interrelationship Scheme in Figure 2.7.2A. The first is an important reflexive link with the Alignment Factor No. 3\(^{106}\) that represents – through the enhancing effect of the \([\text{AudCom}] (+)\) variable – the ‘alignment’ between insider and outside interests. The other relevant link of the Decision-making Factor No. 7 for the purposes of the \([\text{AudCom}] (+)\)

\(^{101}\) Audit Committee - Presence, Operation and Frequency.
\(^{102}\) Corporate Governance and Legal Compliance – see section 2.6.2 of chapter 2.
\(^{103}\) Internal and External/Audit Monitoring Quality – see discussion in section 2.6.5 of chapter 2
\(^{104}\) Quality of Board, CEO and Management Decision-making – see discussion in section 2.6.7 of chapter 2.
\(^{105}\) Transparency, Timing and Integrity of Financial and Other Reports – see discussion in section 2.6.1 of chapter 2.
\(^{106}\) Alignment of Management and Shareholder Interests – see discussion in section 2.6.3 of chapter 2.
variable is the reflexive relationship with the Compensation Factor No. 4.\textsuperscript{107} This reflects the significance of the audit committee in disclosing – and therefore (theoretically) exposing to market and reputational constraints – the compensation and incentive themes within the Compensation Factor No. 4.

In the absence of more targeted studies and therefore following an intuitive line, it is difficult to hypothesise that the Stakeholders Factors No. 6 and the Responsibility Factor No. 8 will be influenced by the functions undertaken by the audit committee to the same order or magnitude as the other Governance Factors influenced by the [AudCom] (+) variable. Implied in this respect is that audit committee-level decision-making may be more removed or indirect in relation to these two Governance Factors (but not others) than the effect of board-level decision-making inherent in variables such as the [BrdIndMon] (+)\textsuperscript{108} variable. More on this point appears in relation to the next two variables.


In the case of the independence of the audit committee, the relational effect path of the [AudIndMon] (+) variable is, also for the reasons set out in subsections 7.3.2.1.1-2, hypothesised to be identical to the [BrdIndMon] (+)\textsuperscript{109} zone of effect. In other words, a company which has an independent audit committee is likely, through that independence, to have a positive effect on the Governance Factors in the same manner as [BrdIndMon] (+).

This equates to a Coverage/Rating of +7/87.50 rprox for the [AudIndMon] (+) variable in the Relational Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

Similarly, the relational effect path of the [AudIndInfo] (-) variable is hypothesised to be identical to the [BrdIndInfo] (-)\textsuperscript{110} variable. Again, there is a reduction of the information flow to (this time) the audit committee in relation to ‘firm-specific’ and ‘manager-specific’ information as well as information asymmetry of outside audit committee members. This equates to a Coverage/Rating of -4/50.00 rprox for the [AudIndInfo] (-) variable in the Relational Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

8.4.3.1 The Direction and Strength of the Effect in Board and Sub-Committee Counterpart Variables

That the zone of effect is hypothesised to be identical in the corresponding board and audit committee independence Governance Variables merely means that the themes underlying the relevant Governance Factors are affected in the same direction and direct/proximate path. However, it does not mean that the strength of the effect on these Governance Factors will be identical. In this respect, in discussing the direction of effect in the Interrelationship Schemes,

\textsuperscript{107} Board, CEO and Management Compensation and Incentives – see discussion in section 2.6.4 of chapter 2.

\textsuperscript{108} Board Independent Director: Executive Director Proportion – Monitoring Effect. See discussion in sections 7.3.2.1.1-2 of chapter 7.

\textsuperscript{109} Ibid.

\textsuperscript{110} Board Independent Director: Executive Director Proportion – Information Flow and Decision Quality ‘Trade-off. See discussion in section 7.3.2.1.3 of chapter 7.
it was hypothesised that while a particular governance variable may ‘impact’ a particular Governance Factor significantly, the flow-on of that governance variable may not be of the same order, magnitude or direction.\textsuperscript{111}

Thus, the hypotheses as to the zone of effect of a Governance Variable identify the number and identity of the Governance Factors affected and the direction of effect. But the thesis can also make hypotheses in relation to the causal strength of the effect in two ways. The first way relates to the observations as to the significance (in relation to firm value and/or operating performance) and/or conflicting nature or otherwise of the results for the empirical field studies comprising the Empirical Studies Key Field No. 4 in chapters 7 - 10.

The second way includes intuitive assumptions or judgments as to the ‘level’ in the company hierarchy in which the decision is made. Thus, as was suggested above in relation to the \textnormal{[AudCom]} (+) variable, the relational approach hypothesises that committee-level and lower management-level decision-making may have no or only an insignificant effect (in which case it is ignored) on a particular Governance Factor compared to a board-level decision. Of course, whether this is the case depends on the nature of the committee-level or lower management level decision. For example, an audit committee-level decision in relation to the materiality or otherwise of a reporting issue will have a significant effect on the Reporting Factor No. 1 \textbf{(Transparency, Timing and Integrity of Financial and Other Reports)} as this committee is where the most significant audit issues are discussed. This is even more so than many board-level decisions. This specialization – and complexity – in the audit committee helps to explain the accounting financial expertise requirements of Governance Codes noted above.

### 8.4.4 Likely Positive Effect between Accounting Financial Expertise and Firm Value and Operating Performance

The studies presented below in relation to the perceived link between audit committee financial expertise and firm value and/or operating performance all display positive results for this variable. In this respect, to measure the market effects of financial literacy, DeFond, Hann and Hu use positive share market reaction as a measure of the improvement in a company’s corporate governance consequent on the appointment of an accounting or non-accounting financial expert to the company’s audit committee.\textsuperscript{112} The authors found:

a significantly positive market reaction to the announcement of new directors with \textit{accounting} financial expertise, but no significant reaction to the appointment of either \textit{non-accounting} financial experts or non-financial experts. Further...we only find a positive reaction to the appointment of the \textit{accounting} financial experts when the new directors are independent and when the appointing firm has strong corporate governance prior to the appointment.\textsuperscript{113}

DeFond, Hann and Hu also highlight that \textit{independence} of the accounting expert is crucial to improvements in governance\textsuperscript{114} and that:

financial expertise \textit{complements} strong governance, perhaps because firms with strong governance are more effective in channeling the financial expertise to enhance shareholder value.\textsuperscript{115}

\textsuperscript{111} See discussion in section 2.7.2 of chapter 2.

\textsuperscript{112} M L DeFond, R N Hann and X Hu, "Does the Market Value Financial Expertise on Audit Committees of Boards of Directors?", Leventhal School of Accounting, University of Southern California, Los Angeles, California 90089-1421, (January 2004), available at SSRN: \url{http://ssrn.com/abstract=498822}, 3-4.

\textsuperscript{113} Ibid, 6.

\textsuperscript{114} Ibid, 6-7.
In terms of the market effects of improvements in audit committee financial literacy, Weil, Coates and Marais found that the returns for firms whose financial literacy improved were considerably greater than those for non-improving firms.\(^{116}\)

Thus, there is some cause for optimism that a positive link – again confirming intuitive argument – exists between audit committee financial expertise and firm value and/or operating performance on account of perceived improvements in the quality of monitoring. However, following this intuitive line and the confirming study of DeFond, Hann and Hu, it is likely that accounting expertise will be most significant again on monitoring quality grounds given the complexity of modern company accounting and reporting requirements.

In light of the above studies, there is a positive directional effect (+) for the [AudExpAcc] Governance Variable. Being a variable that affects the quality of monitoring, the starting point for this relational effect path is again the Monitoring & Audit Factor No. 5. [AudExpAcc] (+) is a variable affecting committee-level monitoring and decision-making. Thus – putting aside questions of the strength of the zone of effect - the relational effect path for [AudExpAcc] (+) is hypothesised to be identical to that for [AudCom] (+)\(^{117}\) above. On that view, the zone of effect of [AudExpAcc] (+) would extend to all Governance Factors except the Stakeholders Factor No. 6 (Identification, Participation and Protection of Stakeholder Interests) and the Responsibility Factor No. 8 (Delineation and Disclosure of Powers, Duties and Lines of Responsibility). This equates to a Coverage/Rating for the [AudExpAcc] (+) variable of +6/75.00 rprox in the Relational Coverage Table and the Relational Proximity Table.

\(^{115}\) Ibid, 7.


Dionne and Triki, above n 98, find (at 24) that financial literacy/education improves the ability to manage risk:

> [i]nterestingly, firms whose audit committee is entirely composed of financially educated directors and those whose board has a majority of financially educated directors manage more the risks they face. Therefore, only the directors' financial education affects the risk management activity. The authors also stress the university education of directors as affecting hedging activity (again at 24):

> [o]ur empirical results also show that the education of the directors sitting on the board, but not those sitting on the audit committee is an important determinant of the hedging level. Indeed, the level of hedging is found to be a decreasing function of the proportion of directors with only a bachelor degree in the board (%ba_board) and an increasing function of the percentage of directors holding a degree superior to a bachelor in the board (%supba_board). This result is the first direct evidence concerning the importance of university education for the board of directors.

Bringing together their findings, the authors conclude that a director with accounting expertise on the audit committee may not be necessary:

> [t]he implications of this study are very interesting for the SEC and stock exchanges. Our results suggest that the requirements on the audit committee size and independence are reasonable, although maintaining a majority of unrelated directors in the board and a director with an accounting background in the audit committee may not be necessary.

\(^{117}\) Audit Committee – Presence, Operation and Frequency. See discussion in section 8.4.2 of this chapter 8.
Comparing relational effect paths, this view considers that there are fewer flow-on effects extending from the Decision-making Factor No. 7 than in the case of the [BrdIndMon] (+)\textsuperscript{118} and [AudIndMon] (+)\textsuperscript{119} variables, each of which has a Coverage/Rating of +7/87.50 rprox. In other words, considering only the accounting expertise aspect of [AudExpAcc] (+) (and not any accompanying independence ingredient), it is difficult to hypothesise that this committee-level function would affect in a significant way the identification or participation of non-shareholder stakeholder interests (Stakeholders Factor No. 6). Thus, the Stakeholders No. 6 factor is omitted. By contrast, in the case of the [BrdIndMon] (+)\textsuperscript{120} and [AudIndMon] (+)\textsuperscript{121} variables, the Stakeholders Factor No. 6 is positively affected as a flow-on from the Decision-making Factor No. 7.

Of course, the interests of shareholders are hypothesised to be affected and so the reflexive relationship between the Decision-making Factor No. 7 and the Alignment Factor No. 3 is hypothesised to remain significantly operative. Also significantly operative is the reflexive relationship between the Monitoring & Audit Factor No. 5 and the Reporting Factor No. 1.

8.5 ‘Block’ and Institutional Shareholdings

In chapters 1 and 2, the traditional ‘outsiders’ to the firm were described to include small/widely-dispersed shareholders. But what is the position of large shareholders also known as ‘block-holders’? Do such shareholders display any ‘inside’ behaviour? And what is the consequence of such action?

The aim of this section is to demonstrate that, at least theoretically, ‘block’ or large institutional shareholdings may enhance the monitoring of management. However, the literature suggests that there is little evidence that this occurs in practice and no evidence of improvement in firm performance.

8.5.1 Governance Effects Both Positive and Negative

While a detailed examination of institutional shareholder activism is beyond the scope of this thesis\textsuperscript{122}, Fuerst and Kang cite a study by Shleifer and Vishny which explains that the

---

\textsuperscript{118} Board Independent Director: Executive Director Proportion – Monitoring Effect - see discussion in sections 7.3.2.1.1-2 of chapter 7.
\textsuperscript{119} Audit Committee – Independence – Monitoring Effect - see discussion in section 8.4.3 of this chapter 8.
\textsuperscript{120} Board Independent Director: Executive Director Proportion – Monitoring Effect - see discussion in sections 7.3.2.1.1-2 of this chapter 7.
\textsuperscript{121} Audit Committee – Independence – Monitoring Effect - see discussion in section 8.4.3 of this chapter 8.
governance effects of the existence of (independent) blockholders can be both positive in terms of enhancing the monitoring of management and negative in terms of the distribution of benefits:

the potential takeover threats from large outside blockholders serve as effective monitoring devices, and this reduces the firm’s agency cost and improves operating performance. On the other hand, large shareholders have incentives to redistribute wealth to themselves, by indulging their private interests to the detriment of others.123

Thus a weighing exercise confronts the relational approach in relation to blockholdings. This is resolved below by designating two variables – one positive and one negative – for the constituent elements of this variable.

For Fuerst and Kang, firm performance is reduced by large (greater than 5%) shareholdings by independent or non-management shareholders.124 Supporting the second explanation put forward in the above passage, for Ashbaugh-Skaife, Collins and LaFond, agency risk and the cost of equity capital were found to increase with the number of large blockholders.125 This, the authors note, was “consistent with blockholders increasing agency problems between themselves and dispersed shareholders”.126


124 Fuerst and Kang, above n 15, 4.

125 Ashbaugh-Skaife, Collins and LaFond, above n 95, 2-3.

126 Ibid.
Short of a takeover, Black explains that institutional shareholders may seek to engage in activism in the form of shareholder proposals or ‘jawboning’ the board or management into

Andreou et al found that institutional ownership was one of the factors that increased the propensity of a company to experience stock price crashes (at 4):

we find that future stock price crashes are positively related to institutional ownership and the percentage of directors that hold stocks consistent with the view that institutions and directors with stock ownership pressurize management to deliver short-run performance.

The authors conclude (at 32, emphasis added):

[i]n our analysis we take a broad view of governance, studying how its different facets predict stock price crashes. Specifically, we use variables that capture the ownership structure of the company, its accounting opacity, its board structure processes, and CEO incentives and power. In our analyses we find that a number of variables are important: future crashes increase with institutional ownership, the percentage of directors that hold shares and opacity in financial reports, and decrease with audit expertise, audit independence and the existence of a formal governance governance policy in the companies’ mandate. In additional analysis we find that these effects are asymmetric, and that they are stronger in less competitive industries and in companies with higher uncertainty (where governance as a monitoring mechanism is more important).


[o]verall, the findings show that ownership structure variables (institutional investors shareholdings and governmental shareholdings) and corporate governance variables (the independent directors and the audit committee size and meeting frequency) are significantly associated to the magnitude of earnings manipulation across different national settings and across different governance systems.

[w]e found a non-linear inverse U shaped relationship between institutional investors ownership and earnings management. These findings are consistent with the view that institutional investors are not a homogeneous group. Institutional investors shareholding shows a positive association with earnings manipulation for lower levels of ownership, consistently the transient view of institutional investors, mostly interested in short-term returns. For higher levels of shareholding, the association reverses and is negative, consistently with the long-term orientation view of institutional investors, playing a monitoring role over the company’s financial performance.

Katelouzou examines hedge-fund activism outside the United States to make conclusions in relation to short-termism, ‘equity decoupling’ and shareholder empowerment: (at 37):

[l]his article questions whether hedge fund activism warrants any type of legislative response, and concludes that it does not, at least insofar as the goal is shareholder value maximization. The issues of short-termism and equity decoupling are not peculiar to activist hedge funds, and regulatory reforms towards stricter disclosure rules are unlikely to affect a hedge fund’s incentive to be an activist, or its regulated status.170 Given that activist hedge funds are not mainly aggressive, and do not often seek control, hedge fund activism does not undermine the role of the board of directors as a central decision-making body, nor does it undermine shareholder empowerment proposals.

change. Black’s study, however, expresses ‘doubt’ as to whether such activism improves firm performance.

Moving forward to 2009, Armour and Cheffins present a model for hedge-fund activism and identify the ‘demand side’ factors that the authors consider affect the propensity for ‘offensive shareholder activism’. These include ‘financing costs’, ‘transaction costs’ and potential hurdles or obstacles within the ‘regulation of collective investment vehicles’. For the authors, hedge-fund activism will continue to form part of the landscape of US corporate governance but with the effects of the GFC difficult to predict.

Later in 2010, McCahery, Starks and Sautner found a majority of institutional investors in their survey engaged in shareholder activism and that these investors preferred firm-level governance mechanisms such as:


[starting with voice, recent empirical research has significantly enhanced our understanding on activism through hand-collection of data (e.g., 13D filings, private letters to management, and surveys), and further data entrepreneurship will hopefully shed even more light. In particular, while the theoretical literature typically assumes a single blockholder and an unspecified intervention action, in reality there are several types of blockholders who engage in various forms of activism, which meet with different management responses. Gathering finer data (as recent papers focusing on activist hedge funds have done) will help us understand which types of activism are successful, under which circumstances, and by which blockholders. A particular challenge is to identify causal effects, due to the lack of instruments for blockholder presence or actions. Even a question as fundamental as the impact of blockholders on firm value remains unanswered.

The exit mechanism implies a new way of thinking about blockholders – as informed traders rather than controlling entities – which gives rise to a number of new research directions linking blockholders to microstructure, and more generally, corporate finance to financial markets. Future theories could incorporate more complex features of informed trading, which have previously been analyzed in microstructure models that treat firm value as exogenous. Current exit theories consider a single trading round, but in reality there may be multiple periods across which the blockholder may trade on her information.

equity ownership of management, equity-based compensation, board independence, transparency about the holdings of large shareholders, and high free float. The responses to the survey questions suggest that institutional investors focus on issues related to reducing agency conflicts between managers and shareholders (e.g., equity-based pay) as well as between large and small shareholders (e.g., transparency about the holdings of large shareholders). Thus, the aim of the firm-specific measures favoured by blockholders resonates with the overarching aims of the relational approach – to reduce long-term agency costs.

In a 2012 paper discussed earlier in relation to director independence, Erkens, Hung and Matos found that stock returns during the financial crisis were worse for companies with higher institutional ownership because “…firms with higher institutional ownership took more risk prior to the crisis, which resulted in larger shareholder losses during the crisis period…”

Just prior to the proxy record date, we find a significant reduction in the supply of lendable shares, because institutions restrict or call back their loaned shares in order to vote. The recall of shares is higher for firms with weaker governance, weaker performance, higher institutional ownership, and when significant antitakeover or compensation-related proposals are on the ballot. The reduction in the supply of lendable shares is most pronounced when there are contentious or significant events such as, proxy fights, negative changes in recommendations by proxy advisors, close votes in the previous year, and mergers.

For a study refuting that the long-term effects of hedge fund activism are negative on operating performance, see Lucian A Bebchuk, Alon Brav and Wei Jiang, “The Long-Term Effects of Hedge Fund Activism”, Columbia Business School Research Paper No. 13-66, (July 9, 2013), available at SSRN: http://ssrn.com/abstract=2291577. The authors examine a period of 5 years after a relevant intervention and conclude (at 37):

[we] find no evidence that interventions are followed by declines in operating performance in the long term; to the contrary, activist interventions are followed by improved operating performance during the five-year period following the intervention. These improvements in long-term performance, we find, are present also when focusing on the two subsets of activist interventions that are most resisted and criticized – first, interventions that lower or constrain long-term investments by enhancing leverage, beefing up shareholder payouts, or reducing investments and, second, adversarial interventions employing hostile tactics.

[we] also find no evidence that the initial positive stock price spike accompanying activist interventions fails to appreciate their long-term costs and therefore tends to be followed by negative abnormal returns in the long term; the data is consistent with the initial spike reflecting correctly the intervention’s long-term consequences. Similarly, we find no evidence for pump- and-dump patterns in which the exit of an activist is followed by abnormal long term negative returns. Finally, we find no evidence for concerns that activist interventions during the years preceding the financial crisis rendered companies more vulnerable and that the targeted companies therefore were more adversely affected by the crisis.


Thus, the implications of this review are that, while the presence of block or institutional shareholdings presents the opportunity for enhanced monitoring of management and, consequently, improvements in firm value, current evidence points away from this conclusion and more towards such shareholdings increasing agency costs for small outside shareholders.

8.5.2 \textit{[BlockMon] (+)}\textsuperscript{137} and \textit{[BlockCosts] (-)}\textsuperscript{138} Variables Relational Effect Paths

The relational effect path for \textit{[BlockMon] (+)} is as follows:

22.2009, (September 17, 2013), available at SSRN: \url{http://ssrn.com/abstract=2322745}. The authors note that, again, there are conflicting hypotheses (at 9, footnote omitted):

that SWFs [Sovereign Wealth Funds] will have a stronger and more beneficial impact on the governance and valuation of investment targets than will other, private-sector financial investors.

An alternative hypothesis posits that, on the contrary, SWFs might refrain from taking an active corporate governance role in target companies in order not to generate political opposition or a regulatory backlash. Extant evidence indicates that SWFs play little visible role in target firm corporate governance and rarely take seats on target firm boards.

The authors (at 35) conclude that SWF ownership lowers firm value of the target:

\textit{[w]}e find that markets react positively to the news of any investment by a financial investor, but the fact that the purchaser is a SWF leads to a weaker (though still positive) reaction indicative of a ‘sovereign wealth fund discount’. The crucial implication is that, while investments by financial acquirers are typically value-increasing, the fact that the investor is a SWF leads to a lower firm value.

There are also differences in stock price performance (at 36), the authors distinguishing between ‘passive’ SWFs and those which ‘monitor’:

\textit{[w]}e also analyze long-term stock price performance of SWF investment targets over event windows spanning up to three years post-investment. Overall, no significant performance differences are observed between SWF and private-sector investment targets in aggregate analyses. Yet, distinguishing between different types of SWFs reveals that buy-and-hold abnormal returns associated with ‘passive’ SWFs and active SWFs whose managers are not truly independent are about 10% per year lower than those of the private benchmark sample, while those of ‘monitor’ SWFs are actually greater (by about 17% per year).

Thus, for the authors (at 36), SWFs which actively monitor their investments should improve stock price performance through that monitoring while ‘passive’ SWFs increase agency costs for small outside shareholders:

By being forced into passive shareholding, SWFs not only do not create value through monitoring, but may exacerbate conflicts between managers and minority shareholders by freeing the former from effective oversight.

\textsuperscript{137} Block Shareholding - Monitoring Effect

\textsuperscript{138} Block Shareholding - Other Shareholder Agency Costs.
**Figure 8.5.2: [BlockMon] (+) Relational Effect Path**

[BlockMon] is, on the first view of Fuerst and Kang in the previous subsection, hypothesised to affect the quality of monitoring (Monitoring & Audit Factor No. 5) in the positive direction (+). In other words, the presence of a blockholder enhances monitoring quality. How does this take place under the relational approach?

As shown in the diagram, there are a number of influences operating simultaneously on the Monitoring & Audit Factor No. 5. The first influence on the Monitoring & Audit Factor No. 5 is through the Alignment Factor No. 3 (Alignment of Management and Shareholder Interests). But this does not depend on blockholder activism. The underlying assumption here is that the threat of hostile takeover – in the absence of actual or positive activism – will deter management from misconduct or value-reducing behaviour or align the interests of management with those of the blockholder. This is akin to the concept of agency costs and the market for corporate control, but narrowed in effect to apply to the blockholder rather than widely-dispersed shareholders generally.139

Simultaneously with the effect of the Alignment Factor No. 3 on the Monitoring & Audit Factor No. 5 is the reflexive effect of Alignment Factor No. 3 on the Decision-making Factor No. 7 (Quality of Board, CEO and Management Decision-making). This is as depicted in Figure 2.7.2A's Shareholder Primacy Interrelationship Scheme. Thus, Governance Variables which affect issues relating to the alignment of management and shareholder interests will flow-on and affect the nature, operation and quality of decision-making at board, CEO and management level. In other words, the nature and degree of management-shareholder alignment will be reflected in those decisions. In turn, those decisions flow-back (hence, reflexively) to affect the nature and degree of management-shareholder alignment.

Also depicted in this Interrelationship Scheme is that the Decision-making Factor No. 7 has a reflexive relationship with the Responsibility Factor No. 8 (Delineation and Disclosure of

---

139 See discussion in section 4.2.2 of chapter 4.
Powers, Duties and Lines of Responsibility). But it is difficult to hypothesise on the literature or intuitively that [BlockMon] (+) will significantly affect the Responsibility Factor No. 8 even through the connection with the Decision-making Factor No. 7. Thus the Responsibility Factor No. 8 is omitted from the hypothesised relational effect path.

The Compliance Factor No. 2 (Corporate Governance and Legal Compliance)\(^{140}\) is also omitted. Clearly, the Compliance Factor No. 2 has a single-directional effect on the Decision-making Factor No. 7 in Figure 2.7.2A. Compliance Factor No. 2 provides the content for the national shareholder protection regime.\(^{141}\) Similarly to the [BrdSkills] (+), [NationGov] (+) and [BrdIndMon] (+) variables, the obligations to comply with corporate governance and legal requirements are not affected by the presence, actions or inactions of blockholders. Again, the Compliance Factor No. 2 remains constant for this variable. Thus, the zone of effect of [BlockMon] (+) extends to six Governance Factors (i.e., omitting the Responsibility Factor No. 8 and the Compliance Factor No. 2) giving rise to a Coverage/Rating of +6/75.00 rprox.

For the same reasons, the relational effect path for the [BlockCosts] (-) variable is hypothesised to be identical to the [BlockMon] (+) variable but in the negative direction. This gives rise to a Coverage/Rating of -6/75.00 rprox in the Relational Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

8.6 Division in CEO/Chairperson Roles

8.6.1 Enhanced Firm Knowledge and ‘Trade-off’ with Board Control/Monitoring

Available studies do not find any significant effect on firm value of dividing the roles of the CEO and the Chairperson. Indeed, the governance effects of combining these roles appear to be opposing and requiring a balancing of the improvements in the quality of board decision-making which inside/specific knowledge of the firm brings on the one hand with possible deficiencies in the quality of the monitoring of management on the other.

In this respect, Weir, Laing and McKnight explain the opposing arguments in the case of CEO and Chairperson ‘duality’:

"[t]he potential advantage...is that they should exhibit a greater understanding and knowledge of the company’s operating environment. In contrast, Fama and Jensen (1983) argue that boards dominated by inside directors are more difficult to control, a situation that would clearly apply to duality."\(^{142}\)

However, the authors found that, in UK companies, company value was not significantly linked to a separation or division in the CEO and Chairperson roles.\(^{143}\) Yet, in a 2007 study by Bhagat and Bolton discussed above, separation of the CEO and Chair functions was one variable which "is significantly positively correlated with better contemporaneous and subsequent operating performance."\(^{144}\)

---

\(^{140}\) See discussion in section 2.6.2 of chapter 2.

\(^{141}\) See the discussion of [BrdSkills] (+) in section 73.1.2.1, [NationGov] (+) in section 7.3.1.3.3 and [BrdIndMon] (+) in section 7.3.2.1.2 of chapter 7.


\(^{143}\) Weir, Laing and McKnight, above n 65, 19.

In a 2010 study also examined above in relation to staggered boards and later in relation to CEO pay, Larcker, Ormazabal and Taylor observed that regulation of CEO-Chair duality (eg., by banning this practice) resulted in “...no evidence of a relation between abnormal returns to these events and CEO-chairman duality”. The authors proffered alternative explanations including that the “market correctly anticipated the portion of the regulation relating to CEO-chairman duality” or, alternatively, “that CEO-chairman duality does not affect shareholder value incremental to the provisions of the regulation related to CEO pay...”.

8.6.2 [DualTrade] (+/-)

In light of these results alone, a single directional marker (in either direction) for the [DualTrade] variable is difficult to ascribe with compelling weight. The UK Corporate Governance Code 2010-12 prescribes that these roles be divided and that the chairperson be an independent director with the Australian ASX 2007-10 Revised Principles position being similar. That, by itself, however, is not conclusive in terms of the relational approach which requires hypotheses to be based on the number and identity of the Governance Factors which are affected.

This variable may act (i.e., as a net effect) either positively or negatively depending on which of the opposing effects 'outweigh' the other. For example, the advantage to the board in terms of inside/specific knowledge of a dual CEO-Chairperson would be readily apparent in a situation already considered in the thesis. Where the information is highly 'firm-specific' or 'manager-specific', there may be a reduction in information-flow to the board if the board is perceived to be 'too independent'. Yet, if the CEO and Chair are the same person, this information deficit may be lessened. In such a case, the decision-making benefits to the Board of reducing that information deficit may outweigh the agency costs of a reduced level of control over inside directors. But the situation may well be otherwise if the nature of the information is such that outside directors have no information asymmetry - for example, where the information lends itself readily to external verification. In that case, the agency costs of reduced control outweigh the information benefits. Thus, a dual-direction marker (+/-) is ascribed to this variable.

The zone of effect of the relational effect path for the [DualTrade] (+/-) variable is hypothesised to extend to all of the eight Governance Factors except the Compliance Factor No. 2 (Corporate Governance and Legal Compliance). The studies relating to the [BrdIndMon] (+) variable seek to link, most directly, the independence proportion of the board with both

145 Larcker, Ormazabal and Taylor, above n 77, 5.
146 Ibid.
147 Duality of CEO/Chair Positions – Monitoring and Decision-quality ‘Trade-off’.
150 See discussion in section 7.3.2.1.3 of chapter 7.
151 See ibid and discussion in section 8.2.1 of this chapter.
152 See discussion of ‘dual direction’ Governance Variables in section 3.3.1.2 of chapter 3.
153 See discussion in section 2.6.2 of chapter 2.
154 Board Independent Director: Executive Director Proportion – Monitoring Effect - see discussion in sections 7.3.2.1.1-2 of chapter 7.
enhancement of the monitoring function (Monitoring & Audit Factor No. 5) and enhancement of the quality of decision-making (Decision-making Factor No. 7). Thus, the [BrdIndMon] (+) variable’s relational effect path is positive (+) beginning with the Monitoring & Audit Factor No. 5 (Internal and External/Audit Monitoring Quality) and the Decision-making Factor No. 7 (Quality of Board, CEO and Management Decision-making). And both these Factors are influenced positively.

But this intersection between the Monitoring & Audit Factor No. 5 and the Decision-making Factor No. 7 is also the crux of the trade-off represented by the [DualTrade] (+/-) variable. For example, in terms of the literature above, where the benefits of insider information of a dual CEO/Chairperson outweigh the agency costs associated with a reduction in control over the board, the [DualTrade] (+/-) variable will exert a positive influence over the Decision-making Factor No. 7 which outweighs the negative effect on the Monitoring & Audit Factor No. 5. Where, instead, the information is not specialised or is readily verified externally, the agency costs of the reduction in control over the board may be greater than any benefits of insider information. In that case, the negative influence over the Monitoring & Audit Factor No. 5 will outweigh the positive influence on the Decision-making Factor No. 7. Again, this explains the dual-direction marker (+/-). Thus, [DualTrade] (+/-) has an identical relational effect path to [BrdIndMon] (+) but with a dual-direction marker (+/-) which equates to a Coverage/Rating of +/- 7/87.50 rprox.

Of course, the two Governance Variables depict a different facet to the aspect of decision-making quality (Decision-making Factor No. 7). [BrdIndMon] (+) is concerned with enhancing decision quality by the application of the more impartial judgment that independence is said to bring. The [DualTrade] (+/-) variable also concerns enhancing decision-making – but by the application of judgment more familiar with the firm’s operations, particularly where those operations are highly specialised or cannot be externally verified.

But, in the case of both variables, the positive effect on the quality of monitoring of the [BrdIndMon] (+) variable and the negative effect on the quality of monitoring of the [DualTrade] (+/-) variable arises from the presence or absence of the independence element. [BrdIndMon] (+) retains the independence element and so positively affects the Monitoring & Audit Factor No. 5. By contrast, [DualTrade] (+/-) is without the independence element and so negatively affects that Factor. Thus, the relational effect path of the [DualTrade] (+/-) variable will be identical to that for [BrdIndMon] (+) variable in section 7.3.2.1.2 (which is itself identical to [BrdSkills] (+) in Figure 7.3.1.2.1B) but with a dual-directional marker (+/-).

8.6.3 [DualDismiss] (-) and [DualStrat] (-) Variables Relational Effect Paths

In addition to the above effects, the likelihood of dismissal of a dual CEO/Chairperson is suggested to be substantially less than where these functions are separated. For Goyal and Park, central to the role of the board is its ability to monitor management measured, in their
study, by the sensitivity of CEO turnover to firm performance. The authors found that this sensitivity significantly reduced where the CEO and Chairperson roles were combined. In other words, the probability of dismissing the CEO was less in the combined-role firm for a given fall in share returns. In an Australian study, Chapple, Ferguson and Kang found that, where there is combination of the CEO and Chairperson roles, “the likelihood of fraud increases”.

Thus, the relational effect path for the [DualDismiss] variable is negative (-) beginning with a negative effect on internal monitoring quality and therefore the Monitoring & Audit Factor No. 5. Again, like [DualTrade] (+/-) above, the reduction in monitoring quality is – most directly - due to the lack of independence in the monitoring function. Thus, the relational effect path of the [DualDismiss] (-) variable will be identical to that for [BrdIndMon] (+) which, again, is identical to that for [BrdSkills] (+) but with a negative-directional marker (-). This equates to a Coverage/Rating of -7/87.50 rprox for the [DualDismiss] (-) variable in the Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

An important role for the board highlighted by Ruigrok, Peck and Keller is strategic decision-making. The authors found only ‘marginal evidence’ that the participation of directors in strategic decision-making was reduced by the dual CEO/Chairperson role, perhaps through the meeting agenda-setting function.

With the caveats that this is a single study and the evidence slight, the [DualStrat] variable is hypothesised to have a negative (-) directional marker. The relational effect path for [DualStrat] (-) is akin – in fact identical – to the zone of effect of the [BrdIndInfo] (-) relational effect path. This latter variable sought to map the effect of a reduction of manager-specific and firm-specific information flow – on the part of management - to the board on account of the presence of independent directors. The [DualStrat] (-) variable is similarly hypothesised to represent a reduction of information flow - or some type of screening or adjustment to the information flow - again on the part of executive or non-independent action encapsulated in the agenda-setting function. Thus, the [DualStrat] (-) variable is hypothesised to affect the Reporting Factor No. 1, the Monitoring & Audit Factor No. 5, the Decision-making Factor No. 7 and the Responsibility Factor No. 8 in the same manner as the [BrdIndInfo] (-)

---

164 Duality of CEO/Chair Positions – Monitoring and Decision-quality ‘Trade-off’ - see discussion in section 8.6.2 of this chapter 8.
165 Board Independent Director: Executive Director Proportion – Monitoring Effect – see discussion in sections 7.3.2.1.1-2 of chapter 7.
166 Board – Director Skills ‘Mix’ – see discussion in section 7.3.1.2.1 and Figure 7.3.1.2.1B of chapter 7.
168 Ibid, 1218-1219.
169 Board Independent Director: Executive Director Proportion – Information Flow and Decision Quality ‘Trade-Off’ - see discussion in section 7.3.2.1.3 of chapter 7.
170 See Figure 7.3.2.1.3 of chapter 7.
variable set out in Figure 7.3.2.1.3. This gives rise to a Coverage/Rating of -4/50.00 for the [DualStrat] (-) variable in the Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

In summary and like the [DualTrade] (+/-) variable in the previous subsection, the effects of combining the CEO and Chairperson roles can cut both ways. While there appears to be no significant effect on firm value by separating these functions, such separation was found in a 2007 study to increase operating performance. In addition, the likelihood of dismissal of a dual CEO/Chairperson is suggested to be substantially less than where these functions are separated, a consideration that is particularly significant where firm performance or returns are falling.

8.7 Continuation of Empirical Studies Key Field No. 4 in Chapter 9

This concludes the examination of Part 2 of the Empirical Studies Key Field No. 4. In this chapter, the thesis has examined the effects on firm operating performance and firm value of another wide variety of Governance Variables. The chapter has presented a relational effect path for Governance Variables including board size and ‘outside’ board positions, studies relating to anti-takeover mechanisms, the audit subcommittee, ‘block’ and institutional shareholdings and division in the CEO/Chairperson role.

A summary of the empirical studies and Governance Variables examined in this chapter 8 are contained in Appendix D1, Recurring Themes and Tensions in Empirical Studies Key Field No. 4 (Parts 1 and 2).

In the following chapter 9, the thesis will again examine the effectiveness of Governance Variables in reducing (or increasing) agency costs and enhancing (or reducing) the long-term efficiency and sustainability of the firm. But the measure of efficiency and sustainability is a reduction in the probability of earnings manipulation.
CHAPTER 9
EMPIRICAL STUDIES KEY FIELD NO. 4 (PART 3):
BOARD AND AUDIT COMMITTEE FACTORS AND EARNINGS MANIPULATION

9.1  Earnings Manipulation and Purpose and Approach of Chapter 9

Chapter 8 presented Part 2 of the Empirical Studies Key Field No. 4 containing empirical field studies and other studies of the effectiveness of Governance Variables in reducing agency costs and enhancing the long-term efficiency and survival of the firm. This included studies of individual Governance Variables relating to board size, outside board positions, anti-takeover mechanisms, the audit subcommittee, ‘block’ shareholdings and division in the CEO/Chairperson role. The chapter examined how these Governance Variables affected proxies for this long-term efficiency and survival in the form of firm operating performance and firm value.

This chapter 9 presents Part 3 of the detailed review of law, economic and econometric studies from the US, UK, Europe and Australia that comprises the Empirical Studies Key Field No 4. In this chapter, another measure of, or proxy for, ‘good’ governance is examined - the probability of earnings manipulation or ‘management’. Increases in earnings management represent increases in agency costs of outside shareholders and therefore a fall in firm sustainability. Again drawing upon these empirical studies and the Shareholder Primacy Interrelationship Scheme presented in Figure 2.7.2A of chapter 2, chapter 9 presents a relational effect path for a range of individual board and audit committee Governance Variables. This relational effect path describes the number and identity of the Governance Factors affected by a Governance Variable and the direction of effect. The nature and operation of many of these variables was encountered in chapters 7 and 8. But, in this chapter, this thesis examines the effect of these variables on the earnings management measure.

9.1.1 Principal Aim of Reporting – To Reduce Information Asymmetry and Agency Risk

The principal aim of reporting – and, in particular, enhanced transparency and timeliness of that reporting (Reporting Factor No. 1) – is to remedy problems associated with the information asymmetry aspects of agency costs. In other words, inside management possesses much greater knowledge than outside shareholders in relation to the firm’s business, value,

---

No. 1 Reporting Factor - Transparency, Timing and Integrity of Financial and Other Reports;
No. 2 Compliance Factor - Corporate Governance and Legal Compliance;
No. 3 Alignment Factor - Alignment of Management and Shareholder Interests;
No. 4 Compensation Factor - Board, CEO and Management Compensation and Incentives;
No. 5 Monitoring & Audit Factor - Internal and External/Audit Monitoring Quality;
No. 6 Stakeholders Factor - Identification, Participation and Protection of Stakeholder Interests;
No. 7 Decision-making Factor - Quality of Board, CEO and Management Decision-Making; and
No. 8 Responsibility Factor - Delineation and Disclosure of Powers, Duties and Lines of Responsibility.

---

1 See section 1.7.1 of chapter 1 for the eight Governance Factors which are discussed in sections 2.6.1 – 2.6.8 of chapter 2:
performance and prospects. In section 4.2.2, the thesis explained that the efficient market hypothesis assumes that a firm’s value is accurately reflected in the stock price. But Dent explains that there are three problems with this hypothesis. First, an ‘information problem’ which reduces the accuracy of information released to the market. Second, that investors have ‘bounded rationality’ in their ability to process all that information. Finally, that the market may take time to correct for new information released to it.

But asymmetric information problems also exist in relation to determining the quality of the management. Ashbaugh-Skaife, Collins and LaFond explain that this information asymmetry creates agency risk for shareholders:

[s]elf-interested managerial behavior can take several forms including shirking, consumption of perquisites, over compensation, and empire building, all of which increase agency risk…Imperfect information on the quality of management and the economic value of the firm results in greater agency risk being imposed on the shareholder. Rational investors demand a premium for bearing agency risk, effectively raising the firm’s cost of equity capital.

In this respect, the authors find that agency risk (and, again, the cost of equity capital) reduces with increased transparency and timeliness of financial reporting and Patel and Dallas are of a similar view.

Thus, in this chapter 9, the thesis will identify and analyse Governance Variables and themes relating to ‘good’ corporate governance and the reduction of the management of reported earnings by firms.

9.1.2 Transparency and the ‘Trade-Off’ Effect on the Quality of Board and Market Monitoring

Hermalin and Weisback explain the corporate governance effects of increasing transparency in terms of the benefits of a higher quality of board monitoring which must be balanced against the costs of exposing management to greater scrutiny:

---


5 Ibid, 2-3.


8 Ibid, 19.
the benefits reflect the fact that more accurate information about performance allows boards to make better personnel decisions about their executives. The costs arise because executives have to be compensated for the increased risk to their careers implicit in higher disclosure levels, as well as for the incremental costs they incur trying to distort information...These costs and benefits complement existing explanations for disclosure.9

This means that, first, the greater the firm-specific or manager-specific information10 which the CEO or management divulges to the board or market, the higher is the risk of an adverse assessment of their performance. The CEO and management will thus seek a premium for this in their compensation.11

In relation to the second point – the distortion of information - Hermalin and Weisback explain that there are three types of distorting actions or efforts the CEO can take in response to increased transparency. The authors call the first two efforts the "exaggerating effort" and the "obscuring effort":

exaggerating effort is effort designed to boost the value of the signal...Obscuring effort is effort designed to make the signal [] noisier...

[what we seek to capture by exaggerating effort are actions that the CEO might take to boost the numbers. These include activities such as timing earnings announcements, aggressive accounting, and actually "cooking the books." Obscuring effort is meant to capture activities such as aggregating reported data more, substituting into more volatile assets, or otherwise pursuing riskier strategies. 12

The third type of response by the CEO can be "concealing information" which, for the authors, resounds with corporate collapses13:

If the CEO did not know the realized value when he [was] deciding to reveal or conceal a signal, then he would wish to conceal all signals that he could: more signals means a more precise posterior estimate of his ability, which means greater career risk for him. Our model, thus, predicts that when (i) the CEO has discretion over what signals are revealed and (ii) must commit to reveal or conceal prior to learning the value of the signals, he will choose to commit to conceal all signals over which he has discretion.14

Thus, Hermalin and Weisback conclude that increases in the level of disclosure above the optimum level reduce firm value:

profits decrease both because managers will have to be paid higher salaries to compensate them for the increased career risk they face, and because greater transparency increases managerial incentives to engage in costly and counterproductive efforts to distort information.15

The implication of this study is that the effects of transparency are not absolute nor, necessarily, positive. In this respect, this finding would accord with the earlier discussion (in terms of board independence) of the argued 'trade-off' between the quality of board monitoring and possible negative effects on the quality of manager-specific and firm-specific information flow to the board which, in turn, reduces the quality of board decision-making.16

9 Ibid,1.
10 See discussion in section 7.3.2.1.3 of chapter 7.
11 Hermalin and M S Weisbach, above n 7, 2-3.
12 Ibid, 12.
13 Ibid, 18
14 Ibid.
15 Ibid, 19.
16 See discussion in section 7.3.2.1.3 of chapter 7.
Coming shortly after the Asian financial crisis, a detailed examination of the role and benefits of transparency in governance and capital markets has been undertaken by Vishwanath and Kaufmann\textsuperscript{17}. Again, the role of asymmetric information and consequent agency costs are highlighted:

```
Information imperfections in markets increase transaction costs and give rise to market failures. Though market failures hamper the working of all markets, they especially affect capital markets. In the recent financial crises literature, several references are made to ‘lack of transparency’ as one of the factors that either caused or contributed to the prolonged crises.\textsuperscript{18}
```

The authors identify several ‘attributes’ of transparency necessary for effective governance processes – access, relevance and quality and reliability:

- **Access** – Laws and regulations ensure, at least in principle, that information remains available to all... Strong equity considerations attend the need for access. Information should be accessible to all on equal terms. However, it is often profitable to delay or limit access to useful information, in which case access becomes hostage to ability to pay. Therefore there is a need to enforce timely, equitable dissemination of information.\textsuperscript{19};

- **Relevance** – “Information must be relevant”\textsuperscript{20}; and

- **Quality and Reliability** - Information should be of good quality and reliable, timely, complete, fair, consistent and represented in clear and simple terms. Standards for quality must be ensured, possibly through verification by external agencies or auditors or standard setting organizations. Consistency in the use of processes to obtain information and in the formats of information disseminated ensures comparability and so allows assessment of changes over time.\textsuperscript{21}

\textsuperscript{17} Tara Vishwanath and Daniel Kaufmann, "Towards Transparency in Finance and Governance" (September 1999), available at SSRN: http://ssrn.com/abstract=258978.

\textsuperscript{18} Ibid, 2 (footnotes omitted).

\textsuperscript{19} Ibid, 3-4

\textsuperscript{20} Ibid, 4.

\textsuperscript{21} Ibid, 4.


```
(we) find better governance is associated with a greater number of disclosures, but not more timely price discovery. This would suggest that firms with better CG substitute governance for greater transparency, proxied by more timely release of information to the market, or alternatively that market participants take longer to process the greater amount of information disclosed by better-governed firms to the market place. With regard to the level of ownership, in some estimations, family (institutional) ownership is associated with faster (slower) price discovery, although this result is sensitive to the countries included in the estimates. Firms with greater proportions of closely held shares are associated with fewer disclosures and less timely price discovery, which is consistent with the view that firms controlled by insiders are less willing to release information to outside parties.
```

Thus, the authors seek to explain the lower timeliness of information by arguing that better firm corporate governance mechanisms can be a substitute for enhanced transparency of reporting, a result contrary to previous studies. Country of origin is also related to a greater level of disclosures for common law countries, the authors finding (also at 28):

```
(In all countries, irrespective of legal origin, we find at the individual firm level, CG positively influences the level of firm disclosure, consistent with prior research for Australia (Beekes and Brown (2006). However the effect of CG on disclosure is greater in common law countries as expected. We attribute
```
As was demonstrated in chapter 6, these attributes also form the basis of the access and transparency of information provisions of a large number of international and national for-profit corporate Governance Codes. For example, the Global Governance Code Table 22 includes the following features originally drawn from the OECD Principles 23 and forming part of the thesis’ model comparative scheme:

- item 1.ii – governance structures and practices consistent with law and transparent/enforceable;
- item 1.iii – demarcation and transparency for governmental and regulatory agencies;
- items 2.iii and 4.iii – timely/regular disclosure of information;
- item 2.v – disclosure of disproportionate control structures/arrangements;
- item 2. vii – disclosure of institutional shareholder governance/voting policies and conflicts;
- item 5.i – timely disclosure of material information including:
  a. results;
  b. remuneration policies;
  c. director qualifications/independence;
  d. risk factors; and
  e. governance codes/policies;
- item 5.ii – independent/external audit;
- item 5.iii – quality and integrity of information;

For a discussion of whether boards should use social media to monitor firm performance, as an ‘early warning system’ for risk management or for corporate oversight, see David F Larcker, Sarah M Larcker and Brian Tayan, “Monitoring Risks Before They Go Viral: Is it Time for the Board to Embrace Social Media?”, Rock Center for Corporate Governance at Stanford University, Closer Look Series: Topics, Issues and Controversies in Corporate Governance No. CGRP-25, (April 5, 2012), available at SSRN: http://ssrn.com/abstract=203507.


---

22 See Global Governance Table 6.2.2 in chapter 6.
**item 6.iv – principal responsibilities:**

f. reporting, audit, financial/operational control, risk management; and
g. disclosure of information;

**item 6.viii – disclosure of director contribution/independence.**

**9.1.2.1 [TransTimeMon] (+)24 and [TransTimeRedn] (-)25 Variables Relational Effect Paths**

The preceding two sections adopt two Governance Variables to represent, on the one hand, the enhanced (+) monitoring effect of transparency and timing of reporting and, on the other, the negative (-) effects on the quality of ‘manager-specific’ and ‘firm-specific’ information flow from management to the board with consequential reductions in the quality of decision-making and monitoring of management.

The studies described in section 9.1.2 seek to link, most directly, the transparency and timing of reporting with both enhancement of the monitoring function (Monitoring & Audit Factor No. 526) and the quality of decision-making (Decision-making Factor No. 727). Given its focus on monitoring and decision-making, the [TransTimeMon] variable’s relational effect path is positive (+) and the zone of effect of that relational effect path is hypothesised to be similar to that of the [BrdSkills] (+)28 and [BrdIndMon] (+)29 variables but with an additional overriding requirement of the Compliance Factor No. 2 (Corporate Governance and Legal Compliance30). Compliance Factor No. 2 is present because of the substantial guidance in Governance Codes relating to the access, timeliness, quality and reliability of information. The features listed in the previous section from Governance Code Table 6.2.2 are examples of the width of this requirement.

The Compliance Factor No. 2 is also significant in the [TransTimeMon] (+) variable because of its (very) direct influence on the Reporting Factor No. 1 (Transparency, Timing and Integrity of Financial and Other Reports). In this respect, Compliance Factor No. 2 provides much of the (mandated and other) content for the financial and other reports contemplated by the Reporting Factor No. 1. For example, the overriding themes of Compliance Factor No. 2 include the requirements of the international/cross-border and national (US, UK and Australian) corporate Governance Codes (Comparative Corporate Governance Codes Key Field No. 3) again presented in chapter 6. Similarly direct (and strong) is the influence of the Compliance Factor No. 2 on the Monitoring & Audit Factor No. 5 as described in Figure 2.6.2 (Compliance Factor No. 2 Interrelationships31). In that diagram, the Compliance Factor No. 2 affects all other Core Field Factors.

---

26 See discussion in section 2.6.5 of chapter 2.
27 See discussion in section 2.6.7 of chapter 2.
28 Board – Director Skills ‘Mix’ - see Figure 7.3.1.2.1B and discussion in section 7.3.1.2.1 of chapter 7.
29 Board Independent Director: Executive Director Proportion – Monitoring Effect - see discussion in sections 7.3.2.1.1-2 of chapter 7.
30 See discussion in section 2.6.2 of chapter 2.
31 See discussion in section 2.6.2 of chapter 2.
An alternative way to consider the presence of the Compliance Factor No. 2 is to liken the effect of the \([\text{TransTimeMon}] (+)\) variable to the operation of the \([\text{NationGov}] (+)\) variable.\(^{32}\) In the case of the \([\text{NationGov}] (+)\) variable, the Compliance Factor No. 2 is hypothesised to be affected. This is because changes in the content of this variable will actually change the requirements of ‘hard’, ‘soft’ or ‘hybrid’ laws\(^{33}\) which apply to the company. Similarly, the nature and operation of the transparency and timing of reporting contemplated by the \([\text{TransTimeMon}] (+)\) variable can also change with changes in the law. In other words, the \([\text{TransTimeMon}] (+)\) variable is like the \([\text{NationGov}] (+)\) variable but only insofar as the provisions which govern the transparency/quality, content and timing of financial and other reports.

Thus, the relational effect path for the \([\text{TransTimeMon}] (+)\) variable is hypothesised to be as follows:

*Figure 9.1.2.1A: \([\text{TransTimeMon}] (+)\) Variable Relational Effect Path*

![Diagram](image)

What does this reveal about this variable? First, that the relational effect path of \([\text{TransTimeMon}] (+)\) is similar (but with an additional Compliance Factor No. 2) to the relational effect paths for \([\text{BrdSkills}] (+)\)\(^{34}\) and \([\text{BrdIndMon}] (+)\).\(^{35}\) But this is not to engage in ‘double-counting’. This is because both the \([\text{BrdSkills}] (+)\) and \([\text{BrdIndMon}] (+)\) variables are hypothesised to begin with the Monitoring & Audit Factor No. 5 and the Decision-making Factor No. 7. Each of these Governance Factors has a reflexive relationship with the other as described in subsection 2.6.7 of chapter 2.

So how is the \([\text{TransTimeMon}] (+)\) variable different from this? Instead and significant in the case of the \([\text{TransTimeMon}] (+)\) variable is that the relational effect path is hypothesised to

\(^{32}\) See discussion in section 7.3.1.3.3 of chapter 7.

\(^{33}\) See discussion in section 6.1.3.1 of chapter 6.

\(^{34}\) Board – Director Skills ‘Mix’ - see Figure 7.3.1.2.1B and discussion in section 7.3.1.2.1 of chapter 7.

\(^{35}\) Board Independent Director: Executive Director Proportion – Monitoring Effect - see discussion in sections 7.3.2.1.1-2 of chapter 7.
begin with the Reporting Factor No. 1 and the Compliance Factor No. 2 as the ‘drivers’ of this zone of effect. For example, as noted above, the effect of the Compliance Factor No. 2 on the Reporting Factor No. 1 is significant on account of the requirements of Governance Codes. Thus the access, relevance and quality and reliability measures of Vishwanath and Kaufmann are translated into the relational approach and flow in part from the Compliance Factor No. 2.

There is also a reflexive relationship between the Reporting Factor No. 1 and the Monitoring & Audit Factor No. 5 as described in subsection 2.6.5 of chapter 2. Thus, these two Governance Factors inform each other. For example, if the company applies additional resources to the board, CEO and management monitoring – including internal and external audit – then the thesis predicts an improvement in the quality and reliability of information which flows to the board and, therefore, the market. This, in turn, enhances the quality of external or market monitoring of the board with, it is predicted, improvements in internal monitoring. Thus, it is the Compliance Factor No. 2 and the reflexive relationship between the Reporting Factor No. 1 and the Monitoring & Audit Factor No. 5 which are hypothesised to be the ‘sources’ of the positive influence represented in Figure 9.1.2.1A above for [TransTimeMon] (+).

Therefore, the [TransTimeMon] (+) variable is hypothesised to affect all Governance Factors including the Compliance Factor No. 2’s overriding effect on the Reporting Factor No. 1 and the Monitoring & Audit Factor No. 5. This equates to a Coverage/Rating of +8/100.00 rprox in the Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

In the case of the [TransTimeRedn] (-) variable, the relational effect path of this variable is identical to the corresponding [BrdIndInfo] (-) variable:

**Figure 9.1.2.1B: [TransTimeRedn] (-) Variable Relational Effect Path**

The starting point for this relational effect path is hypothesised to be the Reporting Factor No. 1 as the ‘driver’ of this zone of effect. Again, as discussed above in relation to the [TransTimeMon] (+) variable, there is a reflexive relationship between the Reporting Factor No. 1 and the Monitoring & Audit Factor No. 5 as described in subsection 2.6.5 of chapter 2.

But the relational effect path for [TransTimeRedn] (-) is negative for two reasons. First, as described in relation to [BrdIndInfo] (-) the thesis predicts a reduction in ‘firm-specific’ and ‘manager-specific’ information flow to the board. Here, as there, more detailed and transparent information may allow the board to monitor more intensively and revise downwards its opinion

---

36 Board – Independent Director: Executive Director Proportion – Information Flow and Decision Quality ‘Trade-off’ – see discussion in section 7.3.2.1.3 of chapter 7.

37 Ibid.
of particular managers such as the CEO. Thus, the flow of such information is reduced over time. For consistency with the \textbf{BrdIndInfo} (-) variable, this negative effect is likely to extend to a significant degree only to the board component of the three-level decision-making hierarchy of the board, CEO and management contemplated by the Decision-making Factor No. 7. Again for consistency, the single-direction overriding effect of Compliance Factor No. 2 is omitted. This is for the reasons set out in relation to \textbf{BrdIndInfo} (-). There, Compliance Factor No. 2 was omitted because the themes contained in this Governance Factor are outside the type of information contemplated by the studies in that section which relate only to ‘manager-specific’ and ‘firm-specific’ information.

The second reason for a negative direction for \textbf{TransTimeRedn} (-) is based on the observations of Hermalin and Weisbach above.\textsuperscript{38} The authors there noted that the effects of enhanced timing and transparency of information are, again, to intensify board monitoring of the CEO and management. This gives rise to demands for higher compensation on the part of executives to reflect the added risk to their careers and may cause the CEO and management to engage in costly efforts to exaggerate, obscure or conceal information.

Thus the zone of effect of the \textbf{TransTimeRedn} (-) variable is hypothesised to extend to four Governance Factors giving rise to a Coverage/Rating of -4/50.00 \textit{rprox} in the Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

\subsection*{9.2 Earnings Manipulation and Board and Committee Structures}

In section 9.1.1, the examination highlighted that the principal aim of reporting – and, in particular, enhanced transparency and timeliness of that reporting – is to remedy problems associated with the information asymmetry aspects of agency costs in the agency theory component of the shareholder and stakeholder models examined in chapter 4. As is readily apparent, factors which detract from the transparency and timeliness of reporting – in other words, the integrity of reports and financial information – increase those agency costs. Thus, one purpose of ‘good’ corporate Governance Variables, structures and mechanisms is to enhance this integrity consideration.

In this respect, Klein defines earnings manipulation as “the practice of distorting the true financial performance of the company”.\textsuperscript{39} At first blush, of course, such a practice would

\textsuperscript{38} See discussion in section 9.1.2 of this chapter 9.


appear undesirable, particularly if it increases agency costs for outside shareholders. Peasnell, Pope and Young, however, explain that earnings manipulation may, at different times, benefit or disadvantage such shareholders:

> while managers and stockholders may, on occasion, agree that earnings management is desirable (e.g. to avoid political or regulatory costs), stockholders will face potential agency costs if the interests of managers and stockholders diverge and managers have opportunities for earnings management. Such conflicts of interests will most obviously arise when managers are evaluated on the basis of accounting numbers.40

Thus, earnings management is generally seen as undesirable on account of the increase in agency costs to outside shareholders. For further effects, Dallas found extensive ‘short-termism’ to have contributed to the Global Financial Crisis:

> contributing to the financial crisis was short-termism or myopia, which is defined as the excessive focus of corporate managers, asset managers, investors, and analysts on short-term results, whether quarterly earnings or short-term portfolio returns, and a repudiation of concern for long-term value creation and the fundamental value of firms. For a nonfinancial firm, it involves seeking to increase its current stock price or profits by inflating current earnings at the expense of the long-term health of the firm. This behavior may include decreasing discretionary expenses, under-investing in long-term assets, or taking on excessive risk to maximize short-term earnings... When firms use short-termism to bolster their current stock price or profits it is referred to as “earnings management” or, alternatively, “managerial myopia”.41

Dallas, too, identifies some further incentives to engage in earnings management:

> Inadequate market signals and structural factors motivate managers to engage in earnings management. Business motivations that are stock-driven exist for firms to meet earnings targets, such as to build the firm’s credibility with capital markets, maintain or increase their stock prices, convey future growth prospects, and achieve desired credit ratings.42

For a discussion of the factors affecting earnings manipulation including ‘controllable’ factors such as internal controls and firm corporate governance and ‘non-controllable’ factors, see Ilia Dichev, John R Graham, Campbell R Harvey and Shivaram A Rajgopal, "Guide to Earnings Quality", (October 30, 2013), available at SSRN: http://ssrn.com/abstract=2347428.


42 Dallas, ibid, 270.


> this effect of conservatism on manipulation implies that firms with stronger over-sight over financial reporting choose more conservative accounting. The optimality of conservative accounting depends on boards being able to effectively monitor reporting to mitigate the negative side effects of conservatism. Firms with weaker reporting oversight cannot directly curb manipulation, and therefore choose more aggressive accounting systems to reduce managers' manipulation incentives.
Thus, many studies have now been undertaken with respect to understanding the relationship, if any, between good governance and minimising earnings manipulation or management by a company. In this respect, and taking as the focus the risk of agency costs identified by Peasnell, Pope and Young in the above passage, the purpose of the following subsections of this section 9.2 is to identify and examine the Governance Variables which seek to eliminate or reduce the potential for management to engage in earnings manipulation.

9.2.1 Board and Audit Committee Independence, Time, Financial Expertise and Duality of CEO/Chairperson

As in the case of firm value and operating performance, audit committee independence and board independence are again often cited as important variables that can reduce earnings manipulation. Independence requirements for company boards and audit committees are contained in the international/cross-border and national (US, UK and Australian) corporate Governance Codes (Comparative Corporate Governance Codes Key Field No. 3) in chapter 6. Here, instead, this thesis reviews empirical studies in relation to the effects of these variables on earnings manipulation and results remain inconclusive.

A review of the studies below provides some (but inconclusive) support for a positive relationship between independence alone of the board or audit committee and the quality or integrity of a company's financial information (Reporting Factor No. 1).

However, some factors or trends which recur in combination with the independence factor appear to affect the likelihood of earnings manipulation, in particular:

- time spent in review or number of audit committee meetings – [AudIndFreq] (+)43;
- financial expertise of the relevant directors and/or committee – [AudAccEarn] (+)44; and
- combination or separation (as the case may be) of the CEO/Chairperson roles – [DualEarn] (-)45.

Turning to the studies in detail, for Klein, there is a positive relationship between independence and a reduction in earnings manipulation on account of enhanced monitoring (Monitoring & Audit Factor No. 546). Klein's study concludes that independent boards and audit committees

Paradoxically, we predict that an improvement in oversight is associated with more, rather than less, accounting manipulation. This follows because stronger boards not only directly deter manipulation, but also choose more conservative accounting systems. A higher level of conservatism, in turn, encourages manipulation, and this latter effect dominates the former. Although oversight and manipulation are positively related, improvements in oversight unambiguously lead to higher reporting quality and more efficient investment decisions.

43 Audit Committee – Independence in Combination with Frequency of Meeting – Reduction in Earnings Manipulation Effect – see discussion in this section 9.2.1 below of this chapter 9.
44 Audit Committee – Accounting Expertise – Earnings Manipulation Reduction Effect – see discussion in section 9.2.1.1.2 of this chapter 9.
45 Duality of CEO/Chair Positions – Probability of Earnings Manipulation – see discussion in section 9.2.1.1.3 of this chapter 9.
46 See discussion in section 2.6.5 of chapter 2.
result in better monitoring and “more unbiased financial statements”. Klein ascribes as reasons for this “the ability to withstand pressure from the firm to manipulate earnings” and reputational constraints.

Peasnell, Pope and Young also find support for the enhanced monitoring of independent directors in relation to upward earnings manipulation:

we find little evidence that the presence of an audit committee directly influences the level of earnings management (either income-increasing or income-decreasing). However, we do find evidence that the monitoring role of outside directors in relation to income-increasing earnings management is more pronounced in cases where an audit committee exists.

However, in a study further examined below, for Agrawal and Chadha, independence of the board and audit committee is not related to the probability of earnings manipulation.

Klein undertakes a study of whether independent directors on the audit committee reduce earnings manipulation. The composition of boards and audit committees for her sample were as follows:

- On average, 58.4% of board members and 79.6% of audit committee members are outsiders. While no firm has a completely independent board, 73.8% of the firms in the sample have boards in which the majority of directors are independent of management. In contrast, 43.4% of audit committees are comprised of outside directors only and 86.7% have a majority of independent directors.

While Klein finds that a reduction in earnings manipulation is associated to whether there is a majority of independent directors, there is no relation between earnings manipulation and 100% independence on the audit committee:

earnings manipulation is negatively related at the .05 level to whether the board’s audit committee has a majority of independent directors. This supports the view that audit committee independence is related to earnings management. However, contrary to the intentions of the new guidelines promulgated by the exchanges, there appears to be no meaningful relation between earnings management and having an audit committee comprised solely of independent auditors.

Thus, of note here for the thesis is that Klein considers that her results do not support the current US requirement under NYSE Final Rules section 303A.07(a) that independence from

47 Klein, above n 39, 3.
48 Ibid, 7 (footnotes omitted).


49 Peasnell, Pope and Young, “Board Monitoring and Earnings Management: Do Outside Directors Influence Abnormal Accruals?”, above n 40, 3-4.
51 Klein, above n 39, 22.
52 Ibid, 16-17 (footnote omitted)
53 Ibid, 22.
54 New York Stock Exchange, Final NYSE Corporate Governance Rules, approved by SEC 4 November 2003 (except s 303A.08) and 30 June 2003 (s 303A.08). The Rules (as amended from time to time) comprise section 303A.00 of the NYSE Listed Company Manual. See section 303A.00 Corporate Governance Standards
management exist for all audit committee members. The thesis can contribute some explanation of this result – that this may be due to the effect of the [AudIndInfo] (-) variable discussed in section 8.4.3. There it was hypothesised that, on account of a high degree of independence, there is a reduction in the information flow to the audit committee in relation to ‘firm-specific’ and ‘manager-specific’ information as well as information asymmetry of outside committee members.

Contrary to Klein, Marrakchi Chtourou, Bédard and Courteau, find that earnings misstatement reduces with 100% audit committee independence - but only when other factors are present:

Audit Committees with a clear mandate for the oversight and monitoring of financial reporting, with a higher proportion of outside members who are not managers in other firms, or with at least one financial expert are significantly less likely to have high levels of earnings management. While we find no direct significant support for the [Blue Ribbon Committee]’s recommendation that audit committees be composed entirely of independent directors, our results seem to suggest that completely independent audit committees that hold more than two meetings in the year are more likely to have low levels of earnings management. Hence, it seems that the audit committee is more efficient if all of its members are independent and it meets regularly.

Thus, other studies like Marrakchi Chtourou et al introduce, as intervening factors on the effects of independence, a combination of additional factors as affecting the probability of earnings manipulation. These include the time in review or number of audit committee meetings, the financial expertise of audit committee members and separation of the CEO/Chairperson roles. It is to these factors that the thesis now turns.

Agrawal and Chadha introduce an intervening factor that, for the authors, has much greater explanatory power than independence – the time factor or number of audit committee meetings. As noted above, for Agrawal and Chadha, independence of the board and audit committee is not related to the probability of earnings manipulation. The authors explain that, contrary to the notion that independence of the audit committee improves monitoring, the time dedicated to identifying relevant problems is more critical and that the relatively few meetings of an audit committee make it difficult “…for a small group of outsiders to detect fraud or accounting irregularities in a large, complex corporation in such a short time”.

Thus, for Agrawal and Chadha, the time factor or number of meetings reduces both accounting irregularities and fraud. In relation to the latter, Farber investigates the relationship between financial reporting fraud and Governance Variables. The author finds that Governance Variables linked to financial reporting fraud include:

(1) a low number or proportion of independent directors;

55 Klein, above n 39, 22.
56 See discussion in section 8.4.3 of chapter 8.
57 Ibid.
59 Ibid, 4.
60 Agrawal and Chadha, above n 50, 4.
61 Ibid, 5.
62 Ibid.
(2) a reduction in the number of meetings of the audit committee;

(3) lesser number of audit committee financial experts; and

(4) a greater proportion of CEO board chairpersons. 64

Returning to earnings manipulation, these findings are supported by those of Xie, Davidson and DaDalt who find a correlation (though not necessarily causation) between a reduction in earnings manipulation and:

(1) increases in the number of independent directors;

(2) increases in the proportion of audit committee members with financial expertise; and

(3) increases in the number of board and audit committee meetings. 65

Abbott, Parker and Peters are of a similar view though they place the frequency of audit committee meetings at a minimum of four per year to achieve a reduction in earnings misstatement 66 while finding no relationship between financial misstatement and a failure to comply with stipulations as to minimum size. 67 Similarly, for Anderson, Deli and Gillan, increases in the independence of the board and audit committee and in the frequency of board and audit committee meetings increase the degree of information relating to the reports as does division of the CEO and Chairperson functions. 68

The elements of independence, financial expertise and regularity of meetings would also accord with the findings of Bryan, Liu and Tiras. 69 Similarly, for the study by Marrakchi Chtourou et al noted above in relation to independence, earnings misstatement similarly reduces with increases in the number of outside directors and financial experts on the committee. 70 Again, in relation to the time spent in review, the authors find that earnings misstatement also reduces where a company has a "completely independent audit committee" holding more than two audit committee meetings per year. 71

Thus, it would appear that there is some support that the independence factor alone is of some explanatory power in minimising earnings manipulation but this is inconclusive. However, an increase in the independence factor appears from the studies to be critical in reducing earnings manipulation when combined with:

64 Ibid, 27.
70 S Marrakchi Chtourou, J Bédard and L Courteau, above n 58, 4.
71 Ibid (emphasis added).
• increases in the time spent in review (or the number of audit committee meetings) - [AudIndFreq] (+)72; and/or

• increases in the financial expertise of the relevant directors or committee - [AudAccEarn] (+)73.

This is in contrast this with the combination of the CEO/Chairperson roles which, for the studies noted above by Farber and, separately, Anderson, Deli and Gillan, appears to increase the likelihood that earnings management will occur. This is represented by the [DualEarn] (-)74 variable below.

[AudIndFreq]5 (+) Variable Relational Effect Path

Thus, the thesis assigns to the [AudIndFreq] variable a positive (+) directional marker to describe a reduction in the probability of earnings manipulation. The zone of effect of the [AudIndFreq] (+) variable is hypothesised to be identical to the [AudIndMon]76 (+) and, in turn, the [BrdIndMon] (+)77 variables. Again, there is a similarity in the starting point for the relational effect paths. In the case of [AudIndMon] (+) and [BrdIndMon] (+) variables – and reflecting the argued independence effect on monitoring and the quality of decision-making - the relational effect path is hypothesised to start at the reflexive relationship between the Monitoring & Audit Factor No. 5 and the Decision-making Factor No. 7.

This starting point for [AudIndMon] (+) and [BrdIndMon] (+) also applies to [AudIndFreq] (+) as the frequency of meeting is hypothesised to affect the themes encapsulated in both the Monitoring & Audit Factor No. 5 and the Decision-making Factor No. 7. As explained earlier in the thesis:

the Decision-Making Factor No. 7 is closely aligned (or interrelated) to the Monitoring & Audit Factor No. 5. In other words, these themes should normatively inform and shape each other. Thus, in real world terms, as the monitoring process within the corporation identifies that some action is required, so then is the decision-making process engaged. In turn, decision-making action should again normatively engage the monitoring and evaluation/assessment functions in a continuous cycle.78

So a company which holds more regular audit committee meetings is predicted to enhance its internal and external monitoring and audit quality. As a result, it is predicted to be more likely to detect and reduce earnings manipulation. In addition, like the case of [TransTimeMon] (+), the thesis predicts an improvement in the quality and reliability of information which flows to the board and, therefore, the market. This, in turn, enhances the quality of external or market monitoring of the board with, it is predicted, improvements in internal monitoring. From this

72 Audit Committee - Independence in Combination with Frequency of Meeting - Reduction in Earnings Manipulation Effect – see discussion in this section 9.2.1 below of this chapter 9.
73 Audit Committee – Accounting Expertise – Earnings Manipulation Reduction Effect – see discussion in section 9.2.1.1.2 of this chapter 9.
74 Duality of CEO/Chair Positions – Probability of Earnings Manipulation – see discussion in section 9.2.1.1.3 of this chapter 9.
75 Audit Committee – Independence in Combination with Frequency of Meeting – Reduction in Earnings Manipulation Effect.
76 Audit Committee - Independence - Monitoring Effect – see discussion in section 8.4.3 of chapter 8.
77 Board Independent Director: Executive Director Proportion – Monitoring Effect – see discussion in sections 7.3.2.1.1-2 of chapter 7.
78 See discussion in section 2.6.7 of chapter 2.
should flow enhanced quality of decision-making at the board, CEO and management levels which in turn engages the monitoring cycle.

Again, there is no case of double counting the [AudIndMon] (+) and [BrdIndMon] (+) variables. While the independence component drivers of [AudIndMon] (+) and [BrdIndMon] (+) are retained as the above studies would urge, an additional driver on account of the frequency or number of meetings is added. Thus, this relational effect path is hypothesised to have a stronger effect than the [AudIndMon] (+) and [BrdIndMon] (+) relational effect paths in isolation. So, assuming a constant proportion of independent directors on the board and audit committee, a company which increases the frequency of audit committee meetings is predicted to improve the quality of internal and external monitoring and audit and, in turn, the quality of board, CEO and management decision-making. This equates to a Coverage/Rating of +7/87.50 rprox for the [AudIndFreq] (+) variable in the Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

9.2.1.1 Board and Audit Committee Expertise

9.2.1.1.1 Accounting Financial Expertise Relevant But Possible Disincentive Effect

As discussed in chapter 8, accounting expertise on the audit committee appears more likely than other types of financial expertise to reduce the likelihood of earnings manipulation. However, the presence of financial experts may lead to some detrimental ‘free rider’ effects on the monitoring function required on the part of other audit committee directors.

Agrawal and Chadha also examine financial expertise of the audit committee. Again, contrary explanations occur. The authors explain that US requirements such as NYSE Final Rules s 303A.07(a), assume that “[M]embers with no experience in accounting or finance are less likely to be able to detect problems in financial reporting”. However, the authors warn that, (again) the time dedicated to identifying accounting problems as well as a possible disincentive effect on non-financial committee members could have counter-productive effects as “the presence of a member with financial expertise can lead other members to become less vigilant”. The authors find, however, that the probability of earnings manipulation is reduced in “companies whose boards or audit committees include an independent director with financial expertise”.83

In some studies, the nature of the financial expertise is the focus. For Carcello, Hollingsworth, Klein and Neal, the presence of accounting (but not other experience) financial expertise reduces earnings manipulation as does the independence of the financial expert.85

---

80 NYSE Final Rules, above n 54. See Commentary to section 303A.07, Audit Committee Additional Requirements, Rule (a).
81 Ibid. 4 (emphasis added).
82 Ibid.
83 Ibid. 4 (emphasis added).
85 Ibid.
Importantly, and reinforcing a theme highlighted in chapter 7, the authors conclude that a beneficial combination of Governance Variables can substitute for financial expertise. This study was among others later reviewed by Cunningham who draws the same conclusion in relation to accounting expertise for audit committees which must be disclosed (or, if not present, explained) consequent on reforms contained in SOX:

> [g]estures in SOX signal a sharp, yet still inchoate, conception of expertise on audit committees to promote superior financial reporting. Empirical evidence suggests that this works—directors with accounting expertise on audit committees are associated with more faithful financial reporting.

Thus, the implication of this is that accounting expertise (Monitoring & Audit Factor No. 5) is required to effectively tackle the significant width and complexity of modern company accounting requirements and thus to improve the quality and integrity of the reporting function (Reporting Factor No. 1). In turn, this enhances market monitoring of the company which enhances the company’s own internal monitoring and, consequently, decision-making (Decision-making Factor No. 7).

9.2.1.1.2 [AudAccEarn] (+) and [AudFree] (-) Variables Relational Effect Paths


In light of the above studies, the [AudAccEarn] variable is ascribed a positive (+) directional marker to reflect a reduction effect on the probability of earnings manipulation. The relational effect path of [AudAccEarn] (+) is hypothesised to be identical to that of [AudExpAcc] (+) (which is itself identical to [AudCom] (+)) but with the reduction effect targeted at the probability of earnings manipulation rather than firm value and/or operating performance. The starting point of all three variables, however, remains the same – the Monitoring & Audit Factor No. 5 (Internal and External/Audit Monitoring Quality). Thus, for example, if a company increased the accounting expertise on its audit committee, the thesis predicts that there will be an enhancement in the quality of monitoring emanating from the audit committee and, consequently, a reduction in the likelihood of earnings manipulation. As seen in the [AudExpAcc] (+) variable and the [AudCom] (+) variable, the Monitoring & Audit Factor No. 5 has a reflexive (dual direction) interrelationship with the Reporting Factor No. 1 and the Decision-making Factor No. 7. Thus, the thesis predicts an improvement in the transparency, timing and integrity of financial and other reports and an improvement in the quality of board,
CEO and management decision-making consequent on an increase in the accounting expertise of the audit committee.

In the case of the [AudExpAcc] (+) variable, the relational effect path was hypothesised to apply by isolating the interrelationships of only the accounting expertise factor and not the independence factor. The same reasoning applies in the case of [AudAccEarn] (+) giving rise again to an identical relational effect path. On this ‘accounting only’ view, the zone of effect of [AudAccEarn] (+) would extend to all Governance Factors except the Stakeholders Factor No. 6 and the Responsibility Factor No. 8. Importantly, like the [AudCom] (+) and [AudExpAcc] (+) variables, the single direction effect of the Compliance Factor No. 2 (Corporate Governance and Legal Compliance) is predicted to remain operative and strong on [AudAccEarn] (+) because of the significant guidance in Governance Codes relating to the functions of the audit committee. This equates to a Coverage/Rating of +6/75.00 rprox in the Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.


The [AudFree] (-) variable seeks to represent the possible ‘free rider’ effect identified by Agrawal and Chadha above and thus carries a negative (-) directional marker signifying an increase in the probability of earnings manipulation. Thus, the [AudFree] (-) variable’s relational effect path is hypothesised to be identical to the relational effect path for [AudAccEarn] (+) but with a negative (-) directional marker. This equates to a Coverage/Rating of -6/75.00 rprox in the Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

9.2.1.1.3 [DualEarn] (-)

Variable Relational Effect Path

The review of the above studies suggests that the probability of earnings manipulation is increased by combination of the dual roles of CEO and Chairperson. Therefore, the [DualEarn] variable is ascribed a negative (-) directional marker in this thesis. The relational effect path for [DualEarn] (-) is hypothesised to extend to all eight Governance Factors except the Compliance Factor No 2 in the same manner as the [DualTrade] (+/-) variable which, in turn, traced the pathway for [BrdIndMon] (+) and [BrdSkills] (+). The thesis stated in subsections 8.6.1 – 8.6.2 that the ‘crux’ of the [DualTrade] (+/-) variable was – like the [BrdIndMon] (+) variable - the effect of independence (or lack thereof) on the reflexive relationship between the Monitoring & Audit Factor No. 5 and the Decision-making Factor No. 7. This reasoning similarly applies in the case of [DualEarn] (-) which equates to a Coverage/Rating of -7/87.50 rprox for this variable in the Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

---

96 See discussion in section 8.4.4 of chapter 8.
97 See Global Governance Table 6.2.2 in section 6.2.2 of chapter 6.
98 See discussion in section 9.2.1.1.1 of this chapter 9.
99 Duality of CEO/Chair Positions – Probability of Earnings Manipulation.
100 Duality of CEO/Chair Positions – Monitoring and Decision-Quality ‘Trade-off’ – see discussion in sections 8.6.1 – 8.6.2 of chapter 8.
101 See discussion in section 7.3.2.1.1-2 of chapter 7.
102 See discussion in section 7.3.1.2.1 of chapter 7.
9.2.1.2 Summary of Board and Audit Committee Independence, Time, Expertise and Duality Factors

Thus, in summarising the preceding two sections, this analysis indicates that no firm conclusions can be made about the independence factor alone. However, the strong implication from the studies is that increases in the following factors, in combination with independence, may well reduce the likelihood of earnings manipulation:

- financial (particularly accounting) expertise of the audit committee - \([\text{AudAccEarn}]^{+}103\);
- time spent in review or number/regularity of audit committee meetings – \([\text{AudIndFreq}]^{+}104\); and
- separation of the CEO and Chairperson functions – \([\text{DualEarn}]^{-}105\).

Of course, these variables are not absolutes. For example, in the case of audit committee independence, the examination has noted above that the current US regime imposes an independence requirement on all audit committee members. But Klein on the one hand and Marrakchi Chtourou et al on the other disagree as to the effectiveness of a 100% independent audit committee.\(^{106}\) Here, the thesis agrees with Klein that the audit committee should not entirely consist of independent directors. For the relational approach, this is on account of the hypothesised effects of the \([\text{AudIndInfo}]^{-}\) variable above.\(^{107}\) There, it was noted that the relational effect path of the \([\text{AudIndInfo}]^{-}\) variable is hypothesised to equate to a Coverage/Rating of -4/50.00 \(r_{prox}\) in the Relational Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1. This is identical to the \([\text{BrdIndInfo}]^{-}108\) variable in section 7.3.2.1.3.

There is a reduction of the information flow to the audit committee in relation to ‘firm-specific’ and ‘manager-specific’ information as well as information asymmetry of outside audit committee members.\(^{109}\)

In relation to the third factor – the time spent in review or regularity of meetings – while the general import of this factor is recognised, the consideration raised by Agrawal and Chadha above\(^{110}\) in connection with the size and complexity of corporate operations and the consequent difficulty in identifying ‘accounting irregularities’ is a strong caveat. In other words, there is great difficulty in delineating a specific benchmark (e.g., in relation to the minimum number of meetings) for this factor. The time spent in review or frequency of audit committee meetings will, it is hypothesised, in turn depend on a number of factors in addition to the sheer size or complexity factor – for example, the financial expertise of the audit committee members. Here, the role of the external audit is also critical.

\(^{103}\) Audit Committee – Accounting Expertise – Earnings Manipulation Reduction Effect – see discussion in section 9.2.1.1.2 of this chapter 9.

\(^{104}\) Audit Committee – Independence in Combination with Frequency of Meeting – Reduction in Earnings Manipulation Effect – see discussion in section 9.2.1 of this chapter 9.

\(^{105}\) Duality of CEO/Chair Positions – Probability of Earnings Manipulation – see discussion in section 9.2.1.1.3 of this chapter 9.

\(^{106}\) Klein, above n 39, 25 and Marrakchi Chtourou, Bédard and Courteau, above n 58, 4. See discussion in section 9.2.1 of this chapter 9.

\(^{107}\) See discussion in section 8.4.3 of chapter 8.

\(^{108}\) Board Independent: Executive Director Proportion – Information Flow and Decision Quality Trade-off.

\(^{109}\) See discussion in section 7.3.2.1.3 of chapter 7.

\(^{110}\) See discussion in section 9.2.1 of this chapter 9.
In this section, the thesis identifies suggestions that the likelihood of earnings manipulation is reduced by reductions in board and audit committee size. In addition, there appears some consistency between these findings and those presented earlier relating to board effectiveness.111

Although outside the US, UK and Australia, in relation to board size and propensity for earnings management, Ching, Firth and Rui review Hong Kong companies and find that earnings manipulation is greater as board size increases.112 The authors state that “[t]he results are consistent with Jensen’s (1993) view that smaller boards provide more of a controlling function than do larger boards”.113 As noted above, for Anderson, Deli and Gillan, increases in the independence of the board and audit committee and in the frequency of board and audit committee meetings increase the degree of information relating to the reports (as does division of the CEO and Chairperson functions).114 However, for the authors, the level of this degree is not increased by increasing the size of the board but is increased by a reduction in audit committee size.115

Although both pointing in favour of smaller rather than larger boards and audit committees, a concluded view cannot be formed in relation to this factor given the sample size. This is not surprising given the thesis’ view in relation to the governance effects of board size generally.116 There, the thesis was unable to predict any consistent or conclusive result in relation to the relationship between board size and firm operating performance and/or firm value beyond the intuitive appeal of arguments concerning a perceived negative relationship between board size (above a particular point) and board effectiveness. Both studies presented here point in the same direction (a reduction in size) with the result that there is probably more indicative weight attaching to this finding (and the thesis puts it no higher than this).

Thus, for the reasons set out in subsections 8.2.2 – 8.2.2.2 of chapter 8, the relational effect path for the [BrdCmEarn] variable is given a dual-direction marker (+/-) and has a zone of effect identical to the [BrdCmSize] (+/-) variable.117 Here, as there, the issue goes (first, it is submitted) to Jensen’s effectiveness of the coordination, communication and decision-making of the board, thus giving rise to a starting point of the Decision-making Factor No. 7. And this effectiveness issue is hypothesised to be identical for the [BrdCmEarn] (+/-) variable in relation to board and committee size and the likelihood of earnings manipulation. For example, in the case of the audit committee, increases in the size of this committee beyond the ‘optimal’ size are predicted to reduce the effectiveness of its coordination, communication and decision-making functions. Like the [BrdCmSize] (+/-) variable, the optimal size will depend on the following intervening factors:

- compatibility of insider and outside shareholder interests;

---

111 See discussion in sections 8.2.1 – 8.2.2 of chapter 8.
115 Ibid.
116 See discussion in section 8.2.1 – 8.2.2 of chapter 8.
117 Board and Committee Size – see discussion in section 8.2.2.2 of chapter 8.
• practicability of ‘external verification’ or monitoring;
• size of the firm;
• national/statutory Governance Code or regime requirements; and
• level of firm ‘diversification’/complexity and debt.¹¹⁸

So both [BrdCmSize] (+/-) and [BrdCmEarn] (+/-) have a direction of effect which may be either positive or negative (+/-) depending upon the point for the ‘optimal’ number of directors for that particular firm. Thus, [BrdCmEarn] (+/-) affects all Governance Factors except the Stakeholders Factor No. 6 and the Responsibility Factor No. 8. Therefore, [BrdCmEarn] (+/-) has a Coverage/Rating of +/-6/75.00 rprox in the Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

9.2.3 Review of Auditors, Non-Audit Services and Earnings Management

Chapter 5’s examination of the Enron corporate collapse relating to the independence of auditors generally and, more specifically, the provision of non-audit services¹¹⁹, suggests that these services may undermine the independence of auditors and increase the likelihood of earnings manipulation. Here, the thesis presents conflicting studies as to whether such a relation exists.

In chapter 5’s studies of the Enron corporate collapse (Autopsies of the Enron and Hastie Corporate Collapses Key Field No. 2) which involved critical audit and auditor failure, a detailed study was undertaken in relation to both the following factors identified by commentators in the audit failure:

• independence¹²⁰; and
• non-audit services.¹²¹

The principal Governance Variables related to the external or independent audit from chapter 5 are examined below:

• [ExtAudEarn] (+): External/Independent Audit Function: +7/87.50 rprox in section 9.2.3.3; and

• [NonAuditS] (-): Non-Audit Services of External Auditor: -7/87.50 rprox in sections 9.2.3.2-3.

¹¹⁸ See discussion in section 8.2.2.2 of chapter 8.
¹²⁰ See discussion in sections 5.2.4.1 – 5.2.4.2 of chapter 5.
¹²¹ Ibid.
9.2.3.1. Review of Independence, Reputational Constraints and Auditor 'Attachment' from The Enron Corporate Collapse

As noted in Chapter 5, for Coffee, independent auditors constitute, at least in theory, ‘gatekeepers’ who are also intended to reduce agency costs. Risk of legal liability and damage to reputation should act as motivations for the auditor in performing its role. Barton identified a large number of client defections from Andersen as the fallout from the Enron audit failure. The thesis then examined the relationship between auditor reputation and firm value. Callen and Morel found some loss in firm value because of the Andersen failure but these losses were less than expected.

Coffee, in describing the possible causes of earnings manipulation, notes that one reason for ‘audit failures’ may be “inherent limitations on the auditor’s role or capacity”. In such circumstances:

generally accepted accounting principles empower corporate management to engage in earnings management by allocating them discretionary authority that the auditors cannot in effect reverse or challenge.

The implication here is that discretionary accounting principles which are not in the nature of mandatory rules for the treatment of accounting issues contribute to earnings manipulation.

Gillan and Martin observed that the Andersen audit – where the firm undertook both the internal and external audit function - in effect required Andersen to review its own work with the consequent loss of independence. Barret was of the opinion that auditor ‘attachment’ – the pressure to give a clean audit opinion to retain existing business and foster new business – was already a problem for auditors. He found that the Andersen ‘integrated’ audit strengthened the ‘attachment’ that Andersen already had with its client. Barrett considered that the ‘revolving door’ practice whereby Enron hired many Andersen former employees contributed to a ‘familiarity’ between auditor and client with consequent uncritical acceptance of management assertions.


123 Ibid.


126 Coffee, above n 122, 5.


128 See discussion in section 5.2.4.2 of chapter 5.


131 Ibid.

132 Ibid, 161-162.
Familiarity between auditor and client has been dealt with in Australia by the CLERP 9 reforms to the Corporations Act 2001.\textsuperscript{133} Du Plessis \textit{et al} describe the impetus for the CLERP 9 reforms as the collapses of Enron and WorldCom in the US and HIH Insurance Ltd in Australia\textsuperscript{134} and undertake a detailed review of the CLERP 9 provisions relating to accounting and audit governance including the preceding Ramsay Report.\textsuperscript{135} The CLERP 9 provisions include:

- a general requirement for auditor independence – if a conflict of interest occurs and the auditor is aware that it exists, the auditor must take reasonable steps to ensure any conflict of interest ceases: s. 324CA\textsuperscript{136};

- for this purpose, a conflict of interest situation means circumstances where the auditor is not capable of exercising objective and impartial judgement in relation to the conduct of the audit or where a reasonable person, with full knowledge of the relevant facts and circumstances would conclude the same – s. 324CD\textsuperscript{137};

- a prohibition period of two years before an auditor can become an officer of the audit client if that person was a lead auditor or review auditor for the audit – s. 324CJ\textsuperscript{138};

- a rotation period – if a person plays a significant role in the audit of a listed company for 5 successive financial years, the individual is not permitted to play a significant role in the audit for a later financial year unless the individual has not played a significant role in the audit for at least two successive financial years – s. 324DA\textsuperscript{139}; and

- in relation to non-audit services – the director’s report for a listed company must include the details of amounts paid or payable for non-audit services, a statement whether the directors are satisfied that the provision of non-audit services by the auditor is compatible with the general standard of independence for auditors imposed by the Corporations Act and a statement of the directors’ reasons for being satisfied that the non-audit services did not compromise the auditor independence requirements – s. 300(11B)\textsuperscript{140}.

Given the last of these reforms, how do commentators treat non-audit services and the independence of the auditor?

\textsuperscript{136} Corporations Act 2001, above n 133, s. 324CA.
\textsuperscript{137} Ibid, s. 324CD.
\textsuperscript{138} Ibid, s. 324CJ.
\textsuperscript{139} Ibid, s. 324DA.
\textsuperscript{140} Ibid, s. 300(11B).
9.2.3.2 Non-Audit Services

Again, a detailed examination in relation to non-audit services ‘sanctioning’ was undertaken in relation to the Enron corporate collapse.\(^{141}\) Coffee, for one, found that the threat of removing non-audit services from the auditor eroded the firm’s reputational constraints.\(^{142}\) The author also suggested that equity-based compensation for executives increased pressure on auditors to ‘acquiesce in earnings management’.\(^{143}\) Additional observations are now made here in relation to this factor.

In the case of non-audit services provided by accounting firms to their clients, Larcker and Richardson express the governance issue in terms a decrease in independence owing to “the risk of foregoing lucrative non-audit services”.\(^{144}\) The authors found that provision of non-audit services is linked to accruals/earnings management for approximately 20% of sample firms.\(^{145}\) In respect of these sample firms, the authors identify their critical features to include:

- higher insider holdings;
- smaller board of directors (and audit committee); and
- lower percentage of independent board (and audit committee) members.\(^ {146}\)

Two of these factors – smaller boards and audit committees – pose a dilemma. These factors appear to be at odds with the findings noted above\(^{147}\) that, while no concluded view can be reached, smaller boards and audit committees may reduce earnings manipulation. In the absence of further empirical evidence, it is possible that the other two features identified by Larcker and Richardson – higher inside equity ownership and lower board independence – may well have a more pronounced effect the smaller the relevant board or committee.

In a 2008 study in relation to non-audit services (‘NAS’), Brown, Falaschetti and Orlando found that a negative relationship existed between non-audit services and earnings quality but that its effect was reduced by the effect of the market and, possibly, mandatory disclosure rules:

[we find stronger evidence that auditors’ dependence on non-audit fees compromises earnings quality, but market discipline (perhaps enhanced by disclosure mandates) left little room for the SOX proscription on NAS to improve financial market performance. This evidence comes from evaluating how financial markets respond to news about auditors’ fee dependence – i.e., a reduced form relationship.]

\(^{141}\) See discussion in section 5.2.4.2 of chapter 5.
\(^{143}\) Ibid, 18-19.
\(^{145}\) Ibid, 25.
\(^{146}\) Ibid (format altered and bullet points added).


\(^{147}\) See discussion in section 9.2.2 of this chapter 9.
that proximately depends on whether this news informs markets about the potential for earnings management.148

Other studies find no such relationship as that identified by Larcker and Richardson or Brown et al. For Ruddock, Taylor and Taylor, increases in non-audit services do not ‘on average’ cause auditors to accept less conservative accounting.149 Agrawal and Chadha, too, found that non-audit services were not related to the probability of earnings manipulation.150 Thus, the results for the non-audit services factor are inconclusive in terms of earnings management. Despite this, detailed changes in relation to the provision of non-audit services were introduced by SOX151 and consequent exchange listing rules such as the NYSE Final Rules.152

9.2.3.3 [ExtAudEarn]153 (+) and [NonAuditS]154 (-) Variables Relational Effect Paths

The [ExtAudEarn] (+) variable is a ‘strong form’ independence variable. The term ‘strong form’ seeks to express an independence status that is hypothesised to have a stronger monitoring effect than the independence factor present in the board and audit committee functions. The independence element on the board and audit committee comes from outside directors. But the independence element in [ExtAudEarn] (+) comes from a number of considerations. First is on account of the external auditor’s familiarity with the financial operations and records of the company. Second is the mandatory status of the external audit in governance statutes like the Corporations Act.155 Third is the significant guidance in relation to the external audit in Governance Codes.156 Indeed, the independent/external audit was found to be a core feature of global and national listed Governance Codes combined.157 Finally, the reputational constraints on the external auditor are hypothesised to have a significant effect.158 Thus, the relational effect path of the [ExtAudEarn] (+) variable has a positive (+) directional marker that hypothesises a reduction in earnings management consequent on the external audit function.

Thus, the independence element in the [ExtAudEarn] (+) variable is hypothesised to have a stronger monitoring ‘improvement’ or ‘enhancement’ effect on the Monitoring & Audit Factor No. 5 (Internal and External/Audit Monitoring Quality) than [BrdIndMon] (+)159 and

---

150 Agrawal and Chadha, above n 50, 4.
151 See SOX Summary Table in Appendix C2, US Governance Code Table 6.4.2 in chapter 6 and NYSE Summary Table in Appendix C4. See discussion in sections 6.4.1 – 6.4.2.2 of chapter 6.
152 Ibid.
153 External/Independent Audit Function.
154 Non-Audit Services of External Auditor
156 See Global Governance Table 6.2.2, item 5.ii in section 6.2.2.2 of chapter 6. See also discussion in section 6.2.3.1 of chapter 6.
157 See discussion in section 6.8.1, item 5.ii of chapter 6.
158 See discussion in section 5.2.4.2 of chapter 5.
159 Board Independent Director: Executive Director Proportion – Monitoring Effect – see discussion in section 7.3.2.1.1-2 of chapter 7.
By contrast, the independence ingredient in these variables is outside-director-based which is hypothesised to be more open to management influence and less familiar with the company’s financial affairs than the external auditor. For example, in the case of outside directors, the thesis has hypothesised that there is a reduction in the flow of ‘firm-specific’ and ‘manager-specific’ information to the board and that outside directors have inferior information compared to inside directors.161

On this basis – and putting aside the strength of the effect - the zone of effect of the ExtAudEarn (+)162 variable is hypothesised to extend to all Governance Factors except the overriding nature of Compliance Factor No. 2 (as explained in section 2.6.2). Similarly to the BrdSkills (+) and BrdIndMon (+) variables, compliance with corporate governance and legal requirements on the company – which remain constant by the force of ‘hard’, ‘soft’ or ‘hybrid’ law163 - is hypothesised not to be affected by the ExtAudEarn (+) variable. This gives rise to a Coverage/Rating of +7/87.50 rprox in the Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

While not conclusive, to the extent that the above studies suggest that the independence of the external auditor is reduced in the direction of the inside management by the provision of non-audit services (even if tempered by ‘market discipline’ and ‘disclosure mandates’), the direction of the relational effect path of the NonAuditS variable will be negative (-) suggesting an increase in the probability of earnings management. Here, the predicted reduction in the independence ingredient leads to the hypothesis that the zone of effect of the NonAuditS (-) variable extends to all Governance Factors except the Compliance Factor No. 2 in the same manner – but opposite direction - as the ExtAudEarn (+) variable above. ExtAudEarn (+) was, in turn, modelled on the BrdIndMon (+) variable and the BrdSkills (+) variable. This equates to a Coverage/Rating for the NonAuditS (-) variable of -7/87.50 rprox in the Coverage Table 3.3.1 and Relational Proximity Table 3.3.2.1

9.2.4 Summary and Conclusion of Empirical Studies Key Field No. 4 in Chapter 10

Chapter 9 has examined the third set of studies in relation to the thesis’ over-arching purpose of the long-term efficiency and sustainability of the for-profit corporation. Instead of measures of firm operating performance and firm value, chapter 9 has used as a proxy the probability of earnings manipulation or management. The chapter has presented relational effect paths for Governance Variables including the monitoring effect of the transparency and timing of reporting and the consequent reduction effect on the flow of information. Other Governance Variables examined include board and audit committee independence, time and financial expertise, duality in the CEO/Chairperson roles and board and audit committee size effects on earnings management. The chapter reprised and expanded upon aspects of the Enron corporate collapse analysed in chapter 5 to examine the earnings management effects of

160 Audit Committee – Independence – Monitoring Effect – see discussion in sections 8.4.1 – 8.4.3 of chapter 8.
161 See discussion in section 7.3.2.1.3 of chapter 7.
162 External/Independent Audit Function – see discussion in this section 9.2.3.3 of this chapter 9.
163 See discussion in section 6.1.3.1 of chapter 6.
164 External/Independent Audit Function – see discussion in this section 9.2.3.3 of this chapter 9.
165 Board Independent Director: Executive Director Proportion – Monitoring Effect - see discussion in sections 7.3.2.1.1-2 of chapter 7.
166 Board – Director Skills ‘Mix’ – see discussion in section 7.3.1.2.1 of chapter 7.
auditor independence, reputational constraints and auditor ‘attachment’ as well as the effects of non-audit services.

A summary of the empirical studies and Governance Variables examined in this chapter 9 are contained in Appendix D2, Recurring Themes and Tensions in Empirical Studies Key Field No. 4 (Part 3).

The following chapter 10 examines the fourth and final part of the Empirical Studies Key Field No. 4. Again, the thesis reviews Governance Variables first introduced in chapter 5’s ‘autopsies’ of the Enron and Hastie corporate collapses. In particular, the chapter will examine the effects of firm-specific ‘good’ governance variables relating to executive, CEO and director compensation. Among these variables will be to examine the effects of director and management equity holdings, the level of director, CEO and executive compensation and the granting of short-term options to directors and executives.
CHAPTER 10
EMPIRICAL STUDIES KEY FIELD NO. 4 (PART 4):
‘GOOD’ CORPORATE GOVERNANCE AND DIRECTOR, CEO AND MANAGEMENT
COMPENSATION

10.1 Overview of Governance Approaches and Purpose of Chapter 10

The design, structure (including performance, incentives and shareholder ‘say-on-pay’1) and
development of director, CEO and management compensation was highlighted in the era of the
GFC and continues today. The examination of the consequent effect on agency costs and firm
governance of the compensation variable has been undertaken by commentators including,
notably, Professor Bebchuk2 and Professor Hill.3

1 For a discussion of the US and Australian initiatives of advisory shareholder ‘say-on-pay’ legislation and its effect
on firm value, see section 10.2.3.1 of this chapter 10.
2 See, for example, Lucian Ayre Bebchuk and Jesse M. Fried, “Executive Compensation as an Agency Problem”
Ayre Bebchuk, Jesse M Fried and David I Walker, “Managerial Power and Rent Extraction in the Design of
Executive Compensation” (2002) 69 University of Chicago Law Review 751-84, available at SSRN:
http://ssrn.com/abstract=316590; Lucian Ayre Bebchuk and Jesse M Fried, “Pay without Performance: Overview
Lucian Ayre Bebchuk and Jesse M Fried, “Executive Compensation at Fannie Mae: A Case Study of Perverse
Berkeley Public Law Research Paper No. 653125; Harvard Law and Economics Discussion Paper No. 505,
available at SSRN: http://ssrn.com/abstract=653125; Lucian Ayre Bebchuk, Yaniv Grinstein and Urs C Peyer,
487; UC Berkeley Public Law Research Paper No. 583861; Lucian Ayre Bebchuk and Yaniv Grinstein, “Firm Expansion and CEO Pay”,
http://ssrn.com/abstract=839245; Lucian Ayre Bebchuk, Martin Cremer and Urs C Peyer, “Pay Distribution in the
Top Executive Team”, Harvard Law and Economics Discussion Paper No. 574, (February 2007), available at SSRN:
http://ssrn.com/abstract=96430; Lucian A Bebchuk, Yaniv Grinstein and Urs C Peyer, “Lucky CEOs and
3 See, for example, Jennifer G Hill, “Regulating Executive Remuneration: International Developments in the Post-
Scandal Era” (2006) 3 European Company Law 64; Vanderbilt Law and Economics Research Paper No. 06-06,
Vanderbilt Law and Economics Research Paper No. 06-15, Sydney Law School Research Paper No. 06/10;
Trends in the Regulation of Executive Remuneration”, Directors In Troubled Times, pp. 100-123, R P Austin and A
Y Bilski, eds, Ross Parsons Centre of Commercial, Corporate and Taxation Law, 2009; Sydney Law School

For references by other commentators, see the references in Appendix E1, Additional References on Director,
CEO and Management Compensation.
In this thesis, chapter 10 highlights areas or studies of particular relevance to director, CEO and executive compensation and incentives in the context of the Enron corporate collapse in chapter 5. In chapter 5, the compensation and incentives variables were examined by a review of aspects of the undermining of director independence\(^4\) and the risk management\(^5\) function by equity holdings and share options and the use of ‘off-balance sheet’ entities to mask debt and executive payments.\(^6\) Attention will also refocus on the effect of CEO, executive and director compensation and incentives on the practice of earnings management\(^7\) by Enron including the effects of short-term share options.\(^8\)

10.1.1 The Governance Issue - The Director/CEO Compensation Levels Variable: [DirCEO$] (+/-)

The governance issue relating to director compensation is summarised by the International Organization of Securities Commissions (‘IOSCO’) in the following terms:

\[
\text{[The actual level of compensation may be relevant to assure, on the one hand, that qualified candidates are attracted to the job, but also, on the other, to make sure that an excessive level of remuneration is not impairing board members’ objectivity, e.g. by making them captive to the interests of those who play a significant role in the nomination (or re-nomination) of board members or determination of remuneration packages.} \]

The argument is, of course, also extended to CEO and executive compensation. Indeed Dent, in stating that the reality of corporate governance lies in ‘CEO domination’ rather than any other model, considers that the ‘overwhelming’ evidence is that “most boards are passive, dominated by CEOs who exert their power in their own interests”.\(^10\) Again, Dent gives reasons including the CEO’s role in recommending directors for board vacancies, the view that (purported) ‘outside’ directors who are themselves CEOs ‘defer’ to one another as a reciprocal practice and loyalty by outside directors to the person who nominated them.\(^11\) Among the costs of this domination, for Dent, is excessive management compensation\(^12\), ‘lavish’ executive perquisites and ‘design flaws’ in executive pay:

\[\text{See discussion in section 5.2.2.1.1 of chapter 5.}\]
\[\text{See discussion in section 5.2.2.1.2 of chapter 5.}\]
\[\text{See discussion in sections 5.2.3.1 of chapter 5.}\]
\[\text{See discussion in section 5.2.3.2 of chapter 5.}\]
\[\text{See discussion in section 5.2.3.2.1 of chapter 5.}\]


\[\text{Ibid.}\]
Often compensation is not tied to performance. Plans that are performance-based are rarely indexed, so executives reap windfalls if their industry or the market generally just hit good times. In both size and design executive pay schemes stink of control by management, not by independent directors bent on optimizing firm performance.\textsuperscript{13}

More recently in 2010, Frydman and Jenter examine CEO compensation and find the evidence consistent with two explanations—managerial power\textsuperscript{14} and competitive forces\textsuperscript{15}—but that neither provides a full explanation for the growth in CEO pay levels.\textsuperscript{16} Despite Dent’s views, Larcker and Tayan include among their “Seven Myths of Corporate Governance” that US “CEOs are systematically overpaid” and that “There is No “Pay for Performance” in CEO Compensation”.\textsuperscript{17}

\textbf{10.1.2 Approaches to Governance of Compensation}

How, then, is the governance aspect of compensation approached? Hill and Yablon investigate the governance consequences of “positional conflict” and performance-based remuneration\textsuperscript{18} and give an overview of three approaches to the issue:

\begin{quote}
The first of these is self-constraint (with judicial enforcement) via fiduciary duties.
\end{quote}

\begin{quote}
The second technique involves eliminating or controlling conflicts of interest through corporate governance techniques, such as the use of independent directors, remuneration committees and greater control by shareholders…
\end{quote}

\begin{quote}
The final way of dealing with the problem has been to accept the existence of managerial self-interest, but to try to align that self-interest with the interests of shareholders.\textsuperscript{19}
\end{quote}

\textsuperscript{13} Dent, above n 10, 15 of 72 (footnotes omitted).
\textsuperscript{15} Ibid, 20-22.
\textsuperscript{16} Ibid, 22.

Kaplan considers the evidence for three perceptions of executive compensation and corporate governance being “…(1) CEOs are overpaid and their pay keeps increasing; (2) CEOs are not paid for performance; and (3) boards are not doing their jobs as monitors” in Steven N Kaplan, “Executive Compensation and Corporate Governance in the U.S.: Perceptions, Facts and Challenges”, Chicago Booth Research Paper No. 12-42; Fama-Miller Working Paper, (August 22, 2012), available at SSRN: http://ssrn.com/abstract=2134208.


Hill and Yablon point to the NYSE Final Rules\textsuperscript{20} as an example of the second method.\textsuperscript{21} The Rules require the board to be comprised of a ‘majority’ of independent directors to “increase the quality of board oversight and lessen the possibility of damaging conflicts of interest”.\textsuperscript{22} In addition, in the case of board subcommittees, the Rules prescribe for listed companies a ‘compensation committee’\textsuperscript{23} on which only independent directors may sit. A review of corporate Governance Codes in table-form, including these features, was presented in chapter 6. For the third ‘alignment’ method, Hill and Yablon point to performance-based and option-based compensation for management.\textsuperscript{24}

Chapters 6\textsuperscript{25} and 7\textsuperscript{26} identified director independence as a ‘core’ or ‘central’ Governance Variable which is considered vital to the board’s function of the monitoring of the CEO and management. The enhancement of (or reduction in) the monitoring of the CEO and management will be demonstrated to be an important end or intervening effect of the variables examined in this chapter. Thus, the principal Governance Variables identified in Table 2.4 relating to director independence, the level of director/CEO compensation and equity and option holdings are:

- $[\text{AudIndMon}]$ (+) - Audit Committee - Independence – Monitoring Effect, + 7/87.50 $rprox;^27$
- $[\text{DirCEO}]$ (+/-) - Director/CEO Compensation Levels, +/- 7/87.50 $rprox;^28$
- $[\text{AudShortOpts}]$ (-) - Audit Committee – Short Term Options Granted to Outside Directors – Reduction in Monitoring Effect, - 7/87.50 $rprox;^29$
- $[\text{BrdIndMon}]$ (+) - Board Independent Director: Executive Director Proportion – Monitoring Effect, + 7/87.50 $rprox;^30$

\textsuperscript{19} Ibid, 13 (formatting altered). An examination of Hill and Yablon’s first approach, directors’ fiduciary duties, is beyond the scope of this thesis as explained in section 1.6.3 of chapter 1.
\textsuperscript{21} Hill and Yablon, above n 18, 14.
\textsuperscript{23} NYSE Final Rules, above n 20, s. 303A.05(a) Compensation Committee.
• **[EqOptIncent]** (+) - Equity/Option Plans and Holdings of Directors/Executives – “Incentive/Alignment” Effect (excludes short-term options), + 7/87.50 rprox 31

• **[EqOptEntrch]** (-) - Equity/Option Plans and Holdings of Directors/Executives – “Entrenchment” Effect (excludes short-term options), - 7/87.50 rprox 32

• **[ShortTOpts]** (-) - Short-Term Option Holdings/Plans of Directors and Executives, - 7/87.50 rprox 33

In chapter 5, many commentators pointed to the undermining of director independence as central to the Enron collapse. Authors such as Branson identified ‘outrageously high’ directors’ fees and consulting contracts for directors 34 as undermining director independence and thus the monitoring of management. An alternative – and more scrutinised - variable argued to undermine independence was the equity holdings and share options of supposedly outside independent directors 35

10.1.3 **Alignment of Performance, Option Compensation and the Purpose of Chapter 10**

The purpose of this chapter 10, in focusing the risk of agency costs for outside shareholders, identifies and examines various governance effects which are perceived to flow from the ‘alignment’ method identified by Hill and Yablon 36 The application of the relevant principles in the context of the Enron corporate collapse was examined in chapter 5. Here, the corporate governance ramifications of director, CEO and executive compensation will be examined with respect to Governance Variables including:

- compensation effects on the level/quality of monitoring and firm value and operating performance;
- the possible connection between firm size and director/executive compensation; and
- compensation effects on governance through reputational constraints.

31 See discussion in section 10.2.4 of this chapter 10.
32 Ibid.
33 See discussion in section 10.2.5.1 of this chapter 10.
35 See discussion in section 5.2.2.1 – 5.2.2.1.1 of chapter 5.
36 Hill and Yablon, above n 18, 13.


The chapter will conclude with a summary of the recurring themes and tensions in the governance effects of director, CEO and management compensation.

10.2 Compensation, the Level/Quality of Monitoring and Firm Value and Operating Performance

In this section, the thesis examines the perceived governance effects in either direction of Hill and Yablon’s ‘alignment’ method of compensation. The level of director and CEO compensation levels is represented by the [DirCEO$] (+/-) variable.

Looking ahead in the case of the proportion of equity held by inside directors and/or management, little can be predicted in terms of benefit for outside shareholders on account of two counterbalancing effects of this variable. The positive ‘incentive alignment’ effect is reflected in the [EqOptIncent] (+) variable and the negative ‘entrenchment’ effect is represented by the [EqOptEntrch] (-) variable. In addition, the examination highlights a number of studies where granting options pursuant to management and/or director incentive schemes is found to increase the likelihood of earnings manipulation or ‘management’.

10.2.1 Proportion of Insider/Management Equity Ownership – ‘Incentive Alignment’ Effect Countered by ‘Entrenchment’ Effect

Commentator autopsies of the Enron corporate collapse led by Gillan and Martin pointed accusingly to deficiencies in the standard of monitoring of management as a result of both director share and option holdings and the Enron compensation policy itself. Gordon, too, identified the undermining of the director independence as a monitoring variable as a result of substantial share ownership, share options and excessive director compensation “since a director’s sharp questioning of senior management may led (sic) to subtle pressures against his/her renomination”.

In the study by Fuerst and Kang above, the authors also examined the degree of insider/management ownership of shares in an attempt to describe the effects of that ownership on the interests of outside shareholders. The authors rely on the work of Morck,
Shleifer, and Vishny to explain that, initially, such ownership assists to align the positions of insiders and outsiders, but that, after a certain point, increasing the size of management ownership may harm outsider interests:

there are two opposing effects of inside ownership – incentive alignment and entrenchment. Their reasoning suggests that managers have a natural tendency to indulge their preferences for non-value maximizing activities. When managers' ownership increases, their interests are better aligned with those of other shareholders, and thus, deviations from value maximization decline. However, larger management shareholdings also increase their bargaining power, which, in turn, cause management to pursue self-interest at the expense of other shareholders. For this reason, it is impossible to predict which force dominates at various levels of inside ownership.47

These two distinct effects find traction in the Enron context. There, Gordon also tells us that while share options may enhance the alignment of management and outside shareholder interests, 'they provide perverse managerial incentives'48 with the result that:

managers will be strongly tempted to produce the financial results the market “expects” through manipulation of financial results.49

In a 2007 study, Kumar and Sivaramakrishnan similarly find the degree of board independence to have an ‘ambiguous' effect50 on firm value where board equity ownership exists.51

10.2.2 Studies Finding Positive Relationship Between Compensation and Firm Value and/or Operating Performance for [DirCEO$]

In favour of the relationship, Daines, Nair and Kornhauser examine the relationship between CEO compensation and skill level as measured by firm performance – “in perpetuating good firm performance and in reversing or turning around poor firm performance”.52 The authors find important evidence linking CEO pay to firm performance, but this requires two preconditions –


49 Ibid.


51 Ibid.

that the compensation be performance-based and that block-holder monitoring exist. Hanlon, Rajgopal and Shevlin similarly find a significant positive correlation between the granting of share options to executives and future firm operating performance, a result the authors considered to be “consistent with the incentive alignment perspective”.

In a 2007 study by Bhagat and Bolton above, the shareholding of directors was one variable that “is significantly positively correlated with better contemporaneous and subsequent operating performance”. The director shareholding Governance Variable was also positively related to ‘disciplinary management turnover’ in times of poor performance.

Bhagat and, this time, Carey and Elson investigate the relationship between firm performance and outside director shareholdings. The authors found an association (not necessarily causative) between substantial director shareholdings and improved performance. Important for the thesis’ purposes in this section relating to the level of monitoring, the authors conclude that there is a ‘probable correlation’ between substantial director shareholdings and improvements in the oversight of management.

Finally, Perry investigates the relationship between the incentive compensation of independent directors, board monitoring of management and CEO turnover. The author finds that where independent directors are entitled to ‘incentive compensation’, monitoring of the board (measured by the probability of ‘CEO turnover’) increases as firm performance falls. The author, in concluding that equity-incentive plans align board and shareholder interests, observes that “the likelihood of a firm adopting a stock-based incentive plan for directors is positively related to the fraction of independent directors on the board and institutional ownership”. That Perry should conclude that monitoring quality was linked to independent director incentives is, of course, no surprise given the discussion in chapter 7. In this respect Fernandes, in a study further described in the next section, concludes that:

[These results suggest that to foster the board of directors’ effective monitoring role, special attention needs to be paid to the role, quality and integrity of their non-executive directors. In particular, their real independence should be guaranteed.]

---

53 Ibid, 27.
55 See discussion in section 7.3.1.2 of chapter 7.
57 Ibid, 6.
59 Ibid, 15.
60 Ibid, 16.
62 Ibid, 2 and 24.
63 Ibid, 24.
Thus, for Perry and Fernandes, the independence of directors is an important precondition in equity incentive compensation.

10.2.3 Studies Finding No or Negative Relationship Between Compensation and Firm Value and/or Operating Performance for [DirCEO$]

Despite the preceding observation, the perceived link between executive compensation and firm value and/or operating profit is rejected by the study by Fernandes. For Fernandes, who investigates the relationship between firm performance, independence of the board and executive compensation in Portugal65, the level of compensation is linked to firm size but not firm performance66 and increases in the proportion of non-executive directors increase compensation levels.67 While concerned with firm value rather than operating performance, Brick, Palia and Wang find no relationship between firm value and the level of CEO compensation.68

In a 2007 study above, however, Cremers, Bebchuk and Peyer find a negative relationship between ‘CEO centrality’ and firm value.69 The authors define ‘CEO centrality’ as the relative importance of the CEO in the corporation’s upper management. This is measured by the ‘CEO’s pay slice’ or ‘CPS’ being the percentage of the total compensation of the top 5 executives captured by the CEO:

\[ \text{our proxy for CEO centrality is the CEO's pay slice (CPS), which we define as the percentage of the aggregate compensation awarded to the firm's top five executives captured by the CEO. Because higher CPS will tend to reflect a greater relative importance of the CEO within the top executive team, CPS can serve as a proxy for the CEO's centrality within this team.70} \]

The authors give various explanations for the negative relationship between CEO centrality and firm value but, in ‘governance’ terms of the agency costs identified in chapter 4, they suggest the possibility that:

the identified pattern might be due to the correlation between low value and excess CPS; having a high excess CPS might reflect agency and governance problems that in turn bring about a reduction in firm value.71

The authors also describe other results which “might reflect governance problems” including those relating to acquisition decisions:

high-CPS firms tend to make worse acquisition decisions as judged by the market's reaction to acquisition announcements. If the acquiring firm has a high CPS level, the stock return accompanying the acquisition announcement is lower and more likely to be negative.72

---

65 Ibid.
66 Ibid, 2 and 17.
67 Ibid.
70 Ibid, 1.
71 Ibid, 2.
72 Ibid, 3.
Thus, high CPS appears to be harmful to the long-term efficiency and sustainability of the corporation in the case of acquisitions.

In another study\(^{73}\), also concerned with CPS, the authors find that CPS “has been increasing over the past decade” and that:

> [c]omparing to other governance arrangements, we find that CPS is higher when shareholder rights are weaker and the firm has more management entrenching provisions, especially when the firm does not have a large block-holder. CPS is also higher when the CEO also chairs the board. CPS decreases with the number of board seats held by other members of the top executive team.\(^{74}\)

Thus, for the authors, high CPS is also indicative of weaker shareholder protection, higher management entrenchment and CEO/Chairperson duality. Conversely, CPS falls with increases in ‘insiders’ on the Board.

### 10.2.3.1 Say-On-Pay Shareholder Voting

The ‘Say-on-Pay’ legislative initiative in the United States “does not limit executive compensation but requires a non-binding shareholder vote on it” and the Australian position, known as the ‘two-strikes approach’ is similar but with an important qualification.\(^{75}\) The Australian Say-On-Pay regime is also an advisory/non-binding shareholder vote on the company’s ‘remuneration report’. The directors’ report for listed companies must include the matters set out in section 300A of the Corporations Act 2001.\(^{76}\) The matters in subsection (1) of section 300A must be included in the directors’ report under the heading ‘remuneration report’: section 300A(1A). At a listed company’s Annual General Meeting (AGM), a resolution that the remuneration report be adopted must be put to the vote: section 250R(2). The vote on the resolution is advisory only and does not bind the directors or the company: section 250R(3).

The Corporations Act was amended by the Corporations Amendment (Improving Accountability on Director and Executive Remuneration Act 2011 (Cth) to provide for a voting procedure

---


\(^{74}\) Ibid, 2.


relating to the remuneration report. If an advisory shareholder vote on the remuneration report receives 25% of the vote against adoption of the report, then the notice of the AGM to members the following year must state this and state that a ‘spill resolution’ for the re-election of directors will be put at the AGM: section 249L(2). At this later AGM, if the vote on the adoption of the remuneration report again receives 25% of the vote against the adoption of the resolution, then section 250V will apply: section 250U. Under section 250V, a ‘spill resolution’ must be put at the later AGM that another meeting of members must be held within 90 days (the ‘spill meeting’) and that all the company’s directors cease to hold office immediately before the end of the spill meeting: section 250V(1). If the spill resolution is passed (i.e., by a simple majority), then the spill meeting must be held within 90 days: section 250W(2). If the company does not hold the spill meeting within 90 days, then each person who is a director at the end of the 90 days commits a strict liability offence: sections 250W(5) - (6).

There is some suggestion that the two-strikes procedure could be used by shareholders dissatisfied with performance or governance issues apart from remuneration matters. The first company to experience the two-strikes procedure in Australia was Penrice Soda Holdings Limited. It received two strikes against its remuneration report even though senior executives had not received compensation increases for over two years.77 The Company’s Chairman, David Trebeck, was quoted at the time as saying:

[i] have concluded that any vote against the remuneration report is analogous to a lightning rod to which all shareholder disaffection can be directed regardless of its nature, rather than reflecting concerns with excessive remuneration of the type for which the two-strikes policy was enacted.78

The Chairman instead alluded that the vote was directed towards the Company’s falling profitability, increasing debt and recent losses.79 At the same general meeting, the shareholders voted against the re-election of one of the non-executive directors, John Hirst.80 The Company announced a restructuring one day before the spill meeting in January 2013 which included an up-coming closure of one of the Company’s chemical facilities that would be replaced by importing cheaper soda ash for its operations.81 The Company’s largest shareholder, London City Equities (LCE), nominated three directors for the spill meeting.82 Despite this, other commentators have rejected that the two-strikes policy will act generally as the ‘lightning rod’ for shareholder dissatisfaction that the Chairman had suggested stating that “the average vote for incumbent directors facing re-election was 95 per cent”83:

78 Ibid.
79 Ibid.
82 Ibid.
This says more about the passivity of investors than their support for the incumbents, particularly those in underperforming companies. The average turnout at annual meetings might have doubled from 30 per cent in 2000 to 60 per cent in 2010, but that means 40 per cent of investors still aren’t casting votes.84

In the end, the Chairman and another non-executive director, Andrew Fletcher, were re-elected each receiving about 78 per cent of the vote.85 The three LCE-nominated candidates failed to be elected, each receiving approximately 25 per cent of the vote on the (separate) resolutions for their election.86

**Is Say-On-Pay Voting An Effective Governance Tool?**

Cai and Walkling identify the opposing camps on the effectiveness of Say-On-Pay voting:

> proponents argue that the bill will increase shareholder democracy and align owner-manager interests. Opponents argue it will usurp power that is best left to the management and boards of specific firms.87

Indeed, the thesis describes below that the governance outcome for Say-On-Pay regimes may vary depending on factors such as:

- The level of CEO compensation;
- The degree of entrenchment of the management; and
- The form of the Say-On-Pay regime relating to whether the vote is advisory, unconditionally binding or only conditionally binding.

In their primary experiment, Cai and Walkling found that there was improvement in firm value for firms with abnormally high CEO compensation:

> stocks of firms with the highest abnormal CEO pay and low pay-for-performance sensitivity react in a significant, positive manner to the Say-on-Pay Bill. Mandatory Say-on-Pay legislation seems to create value for these firms.88

Thus, on this view, the effective sphere of operation of Say-On-Pay regimes is limited to firms with a compensation regime which is already displaying governance problems as described in the following paragraph.

However, Cai and Walkling divide the results according to the level of firm governance with no effect expected on highly entrenched managements:

> we find that the positive market reaction is stronger for firms with weak, but not the weakest governance. This result suggests that while the advisory shareholder vote proposed by the Say-on-Pay

---

84 Ibid.
86 Ibid.
87 Cai and Walkling, above n 75, 36.
88 Ibid.
Bill may benefit firms with overpaid CEO, it is up to the board of directors to make these changes. The legislation is unlikely to affect deeply entrenched managers.\textsuperscript{89} 

This view would again exclude from the effective sphere of operation Say-On-Pay regimes where they are needed most. 

Larcker, Ormazabal and Taylor examined market reaction to regulation initiatives relating to executive pay (including ‘Say-on-Pay’) and found an “insignificant reaction”.\textsuperscript{90} However, the authors then found: 

a negative relation between abnormal returns on the days of these events and CEO compensation. The higher the CEO’s compensation relative to industry and size peers, the more negative the reaction. These results are consistent with a value-maximizing view of current pay practices even for firms with extreme levels of compensation. The results are consistent with critics’ arguments that capping or regulating executive pay will result in less efficient contracts and negatively affect shareholder wealth in these firms.\textsuperscript{91} 

As noted above, ‘Say-on-Pay’ in its US form comprises a ‘non-binding’ or ‘advisory’ vote by shareholders in relation to the company’s executive pay program.\textsuperscript{92} Citing the preceding study by Larcker, Ormazabal and Taylor, Larcker and (this time) Tayan conclude in a 2011 paper that: 

[there is no evidence that these provisions improve corporate outcomes. In fact, some research findings suggest that Dodd-Frank [the US Say-on-Pay Act] is more likely to destroy than enhance shareholder value.\textsuperscript{93}

\textsuperscript{89} Ibid. For an examination of the governance effects of US ‘Say-on-Pay, \textsuperscript{90} David F Larcker, Gaizka Ormazabal and Daniel J Taylor, “The Market Reaction to Corporate Governance Regulation”, \textit{Journal of Financial Economics} (JFE), Forthcoming; Rock Center for Corporate Governance at Stanford University Working Paper Series No. 82, (October 14, 2010), available at SSRN: http://ssrn.com/abstract=165033. \textsuperscript{4}. 

\textsuperscript{91} Ibid. 

\textsuperscript{92} Larcker and Tayan, above n 17, 3. 

\textsuperscript{93} Ibid, 4 (footnote omitted). 

In a later 2012 paper, Larcker, McCall, Ormazabal and Tayan list as their 10 ‘myths’ of Say-On-Pay: 

Myth #1: There Is Only One Approach To “Say On Pay” 

Myth #2: All Shareholders Want The Right To Vote On Executive Compensation 

Myth #3: “Say On Pay” Reduces Executive Compensation Levels Myth #3: “Say On Pay” Reduces Executive Compensation Levels 

Myth #4: Pay Plans Are A Failure If They Do Not Receive Very High Support 

Myth #5: “Say On Pay” Improves Pay For Performance 

Myth #6: Plain-Vanilla Equity Awards Are Not Performance-Based 

Myth #7: Discretionary Bonuses Should Never Be Allowed 

Myth #8: Shareholders Should Reject Nonstandard Benefits 

Myth #9: Boards Should Adjust Pay Plans To Satisfy Dissatisfied Shareholders 

Myth #10: Proxy Advisory Firm Recommendations For “Say On Pay” Are Correct
Indeed, Bainbridge echoes the words of Roberta Romano to label the 2010 Dodd-Frank US Say-on-Pay provisions as ‘quack corporate governance’ in a highly critical review.94


For an examination of the governance effects of US ‘Say-on-Pay’ (SOP) advisory shareholder voting under the Dodd-Frank Act in 2011 and 2012, see Marinilka Barros Kimbro and Danielle Xu, “Shareholders Have a Say on Executive Compensation: Evidence from Say-on-Pay in the United States”, (April 1, 2013), available at SSRN: http://ssrn.com/abstract=2209936. The authors summarise their findings (at 37):

[O]ur results provide evidence in support SOP and shareholder voting rights in general. In particular we find that shareholders effectively identify firms with excessive and abnormal levels of CEO pay. Our results also confirm previous predictions from shareholder proposal studies and finds that SOP approval (reject) votes are associated with firms that have: higher (lower) ROA [Return On Assets], higher (lower) returns, lower (higher) institutional ownership and lower (higher) CEO total compensation. However, we also find that approval (reject) votes are associated with firms that have: lower (higher) volatility, lower (higher) abnormal compensation and lower (higher) abnormal accruals. Additionally, we also find that Boards react to the level of SOP rejection votes in by changing both CEO pay as well as the level of abnormal compensation in 2012. The results provide some evidence to infer that the effect of the percentage of institutional investors is less in 2012 than in 2011.

The authors conclude with a number of variables affecting SOP votes (at 38):

shareholder SOP votes are sensitive not only to excessive compensation, but also SOP votes are sensitive to firm risk, abnormal CEO compensation, accounting quality and financial performance. Second, we find that Boards react to the non-binding SOP rejection votes by subsequently reducing the level of abnormal or excessive compensation. Third, our results present evidence to suggest that shareholder voting rights - even when non-binding - could be an effective mechanism of corporate governance that addresses the problem of incomplete contracts and management rent extraction.


[In particular, we find that poorly performing companies with high levels of “excess” executive pay, low total shareholder return, and negative voting recommendations from the third party voting advisor Institutional Shareholder Services (ISS) experienced greater shareholder “against” votes than at other firms. ISS and other third party voting advisors appeared to have played a significant role in mobilizing shareholder opposition—and often a management response—at these firms.

Although say-on-pay votes are non-binding and corporate boards need not take action even if the proposed pay package fails to garner majority support, most companies receiving negative ISS recommendations or experiencing low levels of say-on-pay support undertook additional communication with shareholders or made changes to their pay practices, reflecting a change in their interactions with shareholders. During 2012, the second year of say-on-pay under Dodd-Frank, we find similar patterns, with companies responding proactively when the company comes onto shareholders’ radar screens because of an unfavorable ISS recommendation or an earlier poor, or failed, say-on-pay vote in 2011.


While the above relates to US-style ‘advisory’ or ‘non-binding’ Say-on-Pay shareholder voting, other studies have sought to model different Say-on-Pay regimes. Göx, Imhof and Kunz distinguish between three scenarios. First is the advisory/non-binding shareholder vote. The second form is unconditionally binding “where shareholders can reject the CEO’s bonus regardless of the project’s performance.” The third form is conditional “where shareholders vote on the bonus proposal only in case of poor performance while having no say on the bonus in case of project success.”

The authors observe in relation to reducing compensation that:

> [o]ur study shows that advisory shareholder voting rights are ineffective in curbing executive compensation. In addition, they even bear the potential to stimulate excessive pay demands in poorly governed firms. Conversely, unconditionally binding voting rights are an [sic.] effective instruments to curb executive pay. However, they also distort CEO investment incentives which results in reduced firm profits.

Thus, the authors find that advisory voting does not reduce executive compensation levels. By contrast, unconditionally binding shareholder voting does reduce such remuneration - but with a negative effect on firm profit. Göx, Imhof and Kunz found in relation to conditionally binding voting that:

> [t]hese negative consequences can be avoided by conditionally binding voting rights. The latter regime effectively curbs executive pay in case of poor performance. Moreover, it does not undermine investment incentives if expected CEO rents in case of good performance remain sufficiently large. In our experiment, this condition is met because the maximum bonus in case of project failure is rather small as compared to the maximum bonus in case of project success.

Thus, for the authors, conditionally binding voting – dependent on performance or project success - both reduces executive compensation in times of poor performance and avoids distorting CEO investment incentives.

### 10.2.3.2 Independence and the Level of CEO Compensation

It was observed above that, for Fernandes, increases in the proportion of non-executive directors increase executive compensation levels in Portugal. What is the state of this relationship in Anglo-American corporate governance?

---


96 Ibid, 21.

97 Ibid.

98 Ibid.

99 Ibid, 22.

100 Ibid. In this case, a ‘rent’ is an amount of remuneration in excess of the level of pay that would be fixed for the CEO by independent directors under the assumptions of perfect knowledge, complete contracts and equal bargaining power and with constant variables affecting that pay including a constant level of firm size, value, complexity, debt/leverage and performance.

101 See discussion in section 10.2.3 of this chapter 10.
The link between CEO compensation levels and independence of the Board was examined recently by Guthrie, Sokolowsky and Wan. Examining an earlier 2009 study by Chhaochharia and Grinstein relating to compliance with majority board independence requirements, the authors observe that:

[Chhaochharia and Grinstein] find that CEO pay decreases by 17% more in noncompliant firms than in compliant firms, which they interpret as the causal effect of improvements in board independence. Their findings are consistent with the managerial power hypothesis, namely that non-independent directors allow CEOs to extract rents in the form of higher pay.

Guthrie et al argue that Chhaochharia and Grinstein’s results are not applicable to publicly-traded firms in general on account of two ‘outliers’ in the sample of CEO compensation which ‘unduly impact’ the results. Guthrie et al conclude that:

[a]fter excluding the two outlier firms...our results indicate that (i) board independence does not affect the level of CEO pay; (ii) compensation committee independence causes CEO pay to increase; and (iii) the increase in CEO pay occurs only in the presence of blockholder directors or high institutional ownership concentration, both of which are considered to be monitoring substitutes. We draw similar conclusions based on median regressions and the change in pay for non-CEO executives.

Thus, for the authors, independence on the compensation committee increases CEO pay but not independence on the board itself. Further, this result appears to require the precondition of strong monitors – such as block-holders. In section 10.2.2 above, evidence linking CEO pay to firm performance required two preconditions, one of which was also such block-holder monitoring (the other was performance-based compensation). Whether Apple and Fossil should have been excluded from the original sample by Chhaochharia and Grinstein has spawned some debate between the competing authors. And Guthrie et al have suggested alternative explanations for their 2010 findings:

[O]ne plausible explanation for the increase in pay in noncompliant firms is that non-independent directors – perhaps due to more powerful incentives or superior information – have more bargaining power than independent directors, and thus monitor more effectively. It is also consistent with directors shifting their attention away from reining in CEO pay levels and toward other board responsibilities, especially in previously noncompliant firms.

In other words, for the first explanation, executive or inside directors with better information monitor the CEO more closely which reduces the level of CEO pay. By contrast, independent directors with inferior information and less effective monitoring judge the CEO less harshly than their inside counterparts leading to CEO pay increases.


103 Ibid, 2.

104 Ibid, 3. These ‘outliers’ were said to be Steve Jobs of Apple and Kosta Kartsotis of Fossil. See 8-12.


10.2.4 **Summary of Studies and Relational Effect Paths for [DirCEO$] (+/-), [EqOptIncent] (+)\(^{108}\) and [EqOptEntrch] (-)\(^{109}\)**

Thus, the overall impression of the studies examined is that only very guarded conclusions can be drawn here. First, a number of studies find no relationship between director and CEO/executive pay levels (represented by the [DirCEO$] (+/-) variable) and firm value and/or operating performance. If a causative relation exists between the CEO/executive pay levels variable and firm value, then, according to the 2007 study by Cremers, Bebchuk and Peyer described in section 10.2.3, it may well be negative. A significant number of studies examined found a positive relationship between director and CEO/executive pay levels and firm value and/or operating performance. However, this positive relationship may be heavily qualified by at least three pre-conditions.

First, putting a number of studies together, the relationship between director and CEO/executive pay levels and firm value and/or operating performance may well rely on the existence of independent directors and some sort of incentive-based payment, whether by way of performance-based payments, equity or options. In addition, one of the studies also requires the simultaneous operation of ‘block-holder monitoring’, a condition which may well be difficult to expect in a widely-dispersed shareholding company as explained in chapter 8.\(^{110}\) Nonetheless, this may be achievable where a sufficiently ‘active’ institutional or other large shareholder exists.

Not surprisingly, perhaps all that can be plausibly said at this time is that the dividing line between the ‘incentive alignment’ and ‘entrenchment’ effects identified by Fuerst and Kang will be a matter of degree always depending on the individual characteristics of the relevant firm, its ownership structure and the behaviour of its manager-owners themselves. In such cases, the question of the strength of the national shareholder protection/governance regime becomes relevant, in this case operating in the reverse direction than previously discussed\(^{111}\) and compensating for perceived gaps in the firm-specific governance measures. In these circumstances of divided studies, the thesis will assess the ‘incentive alignment’ effect and, conversely, the ‘entrenchment’ effect of director equity and option holdings (excluding short-term options) separately.

It follows then that the relational effect path of Governance Factors\(^{112}\) for [EqOptIncent] (+)\(^{113}\) is positive (+) with the starting point of the Alignment Factor No. 3 (Alignment of Management

---

\(^{108}\) Equity/Option Plans and Holdings of Directors/Executives – Incentive/Alignment’ Effect (excludes short-term options).


\(^{110}\) See discussion in sections 8.5 – 8.5.2 of chapter 8.

\(^{111}\) See discussion in section 7.3.1.3.1 of chapter 7.

\(^{112}\) See section 1.7.1 of chapter 1 for the eight Governance Factors which are discussed in sections 2.6.1 – 2.6.8 of chapter 2:

- **No. 1 Reporting Factor** - Transparency, Timing and Integrity of Financial and Other Reports;
- **No. 2 Compliance Factor** - Corporate Governance and Legal Compliance;
- **No. 3 Alignment Factor** - Alignment of Management and Shareholder Interests;
- **No. 4 Compensation Factor** - Board, CEO and Management Compensation and Incentives;
- **No. 5 Monitoring & Audit Factor** - Internal and External/Audit Monitoring Quality;
- **No. 6 Stakeholders Factor** - Identification, Participation and Protection of Stakeholder Interests;
and Shareholder Interests\textsuperscript{114}). Therefore, the relational effect path is the same as that of the Shareholder-Primacy Model ‘Umbrella’ (or ‘guiding principle’) in Figure 2.6.3A of chapter 2\textsuperscript{115} with the exception of the exclusion of the overriding requirements of the Compliance Factor 2 (Corporate Governance and Legal Compliance\textsuperscript{116}):

\textit{Figure 10.2.4: [EqOptIncent] (+) Relational Effect Path}

Here, the Alignment Factor No. 3 is the ‘umbrella’ or ‘guiding principle’ over all other Governance Factors except the Compliance Factor No. 2 which is excluded as discussed below. Therefore, there is a direct one directional link between the Alignment Factor No. 3 and the Monitoring & Audit Factor No. 5 (Internal and External/Audit Monitoring Quality). Thus, for example, Governance Variables which lead to improvements in the alignment of shareholder and management interests are hypothesised to consequently enhance the quality of monitoring on behalf of shareholders.

The Alignment Factor No. 3 and the Monitoring & Audit Factor No. 5 have an alternative link in which each of these Governance Factors has a connecting and reflexive relationship through the Decision-making Factor No. 7 (Quality of Board, CEO and Management Decision-Making). This is depicted in Figure 2.7.2A’s Shareholder-Primacy Interrelationship Scheme. But the one-directional link from the Alignment Factor No. 3 to the Monitoring & Audit Factor No. 5 is the more direct.

As in the case of the [BrdSkills] (+)\textsuperscript{117} and [BrdIndMon] (+)\textsuperscript{118} variables, the zone of effect for [EqOptIncent] (+) excludes the overriding nature of the Compliance Factor No. 2. Again by

<table>
<thead>
<tr>
<th>No. 7</th>
<th>Decision-Making Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. 8</td>
<td>Responsibility Factor</td>
</tr>
</tbody>
</table>

\textsuperscript{113} Equity/Option Plans and Holdings of Directors/Executives – Incentive/Alignment Effect (excludes short-term options).
\textsuperscript{114} See discussion in section 2.6.3 of chapter 2.
\textsuperscript{115} See discussion in section 2.6.3 of chapter 6.
\textsuperscript{116} See discussion in section 2.6.2 of chapter 2.
\textsuperscript{117} Board – Director Skills ‘Mix’. See discussion in section 7.3.1.2.1 of chapter 7.
example - and similarly to those variables - the provisions of corporate law statutes and Governance Codes which govern share and option incentive schemes for the CEO/executives and directors cannot be altered by the equity or option decisions or actions of the company or board. Indeed, the Compliance Factor No. 2 performs in part a ‘gap-filling’ function for gaps in firm-level Governance Variables.\(^{119}\)

Thus, \([\text{EqOptIncent}] (+)\) is ascribed a Coverage/Rating of +7/87.50 \(rprox\) in the Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

\([\text{EqOptEntrch}] (-)\) Relational Effect Path - Equity/Option Plans and Holdings of Directors/Executives – ‘Entrenchment’ Effect (excludes short term options)

Conversely, at the level of director and CEO/executive ownership where the ‘entrenchment’ effect is operative (i.e., in conjunction with but dominating the ‘alignment’ effect), the relational effect path of the \([\text{EqOptEntrch}] (-)\) variable is negative following the same relational effect path as its positive counterpart. Thus, there is still a direct one directional link between the Alignment Factor No. 3 (Alignment of Management and Shareholder Interests) and the Monitoring & Audit Factor No. 5 (Internal and External/Audit Monitoring Quality). But, for example, and conversely to the \([\text{EqOptIncent}] (+)\) variable, this Governance Variable is hypothesised to lead to reductions in the alignment of shareholder and management interests and to consequently reduce the quality of monitoring on behalf of shareholders.

This gives rise to a Coverage/Rating of -7/87.50 \(rprox\) for the \([\text{EqOptEntrch}] (-)\) variable in the Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

\([\text{DirCEOS}] (+/-)\) Relational Effect Path - Director/CEO Compensation Levels

Finally, the thesis has examined conflicting studies for the operation of the level of director and CEO compensation (\([\text{DirCEOS}] (+/-)\)) and firm value and operating performance.

The operation of this Governance Variable will depend on the ‘incentive alignment’ and ‘entrenchment’ effects identified by Fuerst and Kang.\(^{121}\) Thus, the behaviour of the \([\text{DirCEOS}] (+/-)\) variable may be positive or negative depending on the behaviour and strength of the \([\text{EqOptIncent}] (+)\) and \([\text{EqOptEntrch}] (-)\) variables (and which dominates over the other) acting in opposition to each other at any time.

This gives rise to a ‘dual direction’ marker for the \([\text{DirCEOS}] (+/-)\) variable with an identical relational effect path to both \([\text{EqOptIncent}] (+)\) and \([\text{EqOptEntrch}] (-)\). This gives rise to a Coverage/Rating of +7/87.50 \(rprox\) for the \([\text{DirCEOS}] (+/-)\) variable in the Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

---

\(^{118}\) Board Independent Director: Executive Director Proportion – Monitoring Effect. See discussion in sections 7.3.2.1.1 – 2 of chapter 7.

\(^{119}\) See discussion in section 7.3.1.3.1 of chapter 7.

\(^{120}\) Equity/Option Plans and Holdings of Directors/Executives – ‘Entrenchment’ Effect (excludes short-term options).

\(^{121}\) See discussion in section 10.2.1 of this chapter 10.
10.2.4.1 The Nature and Operation of the Compensation Committee – [CompCom] (+/-)

Here, the hypothesis is that the levels and structure of the [DirCEOS] (+/-), [EqOptIncent] (+) and [EqOptEntrch] (-) Governance Variables are themselves dependent on the operation and structure of the [CompCom] (+/-) variable. This is because the composition and levels of director, CEO and executive compensation flows (at least internally) from decision-making within the compensation committee. For example, in the 2010 study by Guthrie et al above, the authors found that increasing the independence of the compensation committee increases CEO pay (on the precondition of the presence of strong monitors).123

Therefore, the [CompCom] (+/-) variable has a dual direction marker (+/-) as the composition and levels of director, CEO and executive compensation – and therefore the balancing point between Fuerst and Kang’s ‘alignment’ and ‘entrenchment’ effects of that compensation - will be affected positively or negatively by the operation of this variable.

This gives rise to a ‘dual direction’ marker for the [CompCom] (+/-) variable with an identical relational effect path to [EqOptIncent] (+), [EqOptEntrch] (-) and (from the previous section) [DirCEOS] (+/-). This gives rise to a Coverage/Rating of +/- 7/87.50 rprox for the [CompCom] (+/-) variable in the Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

10.2.5 Short-Term Options and the Risk of Earnings Manipulation

The principal Governance Variables identified in Table 2.4 relating equity and option holdings are:

- [AudShortOpts] (-) - Audit Committee – Short Term Options Granted to Outside Directors – Reduction in Monitoring Effect, - 7/87.50 rprox124

- [EqOptIncent] (+) - Equity/Option Plans and Holdings of Directors/Executives – Incentive/‘Alignment’ Effect (excludes short-term options), + 7/87.50 rprox125

- [EqOptEntrch] (-) - Equity/Option Plans and Holdings of Directors/Executives – ‘Entrenchment’ Effect (excludes short-term options), - 7/87.50 rprox126 and

- [ShortTOpts] (-) - Short-Term Option Holdings/Plans of Directors and Executives, - 7/87.50 rprox.127

In the Enron context128, commentators pointed to the short term focus of share options as a factor contributing to significant levels of earnings manipulation. Recalling that discussion, Bratton observed that options lead managers to pursue ‘high risk strategies’:

122 Compensation Committee - Presence, Operation and Frequency.
123 See discussion in section 10.2.3.2 of this chapter 10.
124 See discussion in section 10.2.5.1 of this chapter 10.
125 See discussion in section 10.2.4 of this chapter 10.
126 See discussion in section 10.2.4 of this chapter 10.
127 See discussion in section 10.2.5.1 of this chapter 10.
128 See discussion in sections 5.2.3.2.1 – 2 of chapter 5.
Option holding dulls the actor’s sensitivity to degrees of distress on the downside, and at the same time gives the actor an incentive to generate chances for upside gains of high magnitude. Thus directed, a group of managers certainly would be more disposed to high risk strategies.  

And other similar views abound. Gordon suggests that the granting of short-term options may have increased fraudulent practices and risk-taking by executives to increase the share price and Gillian and Martin similarly emphasise the short-term option problem.

Confirming the Enron collapse analysis, for Marrakchi Chtourou, Bédard and Courteau, the risk of earnings misstatement increases with short-term options granted to outside audit committee directors thus inhibiting the function of such directors to monitor financial statement integrity. Similarly, for Tehranian, Cornett, Marcus and Saunders, option incentive plans increase earnings manipulation (but not performance).

Indeed, the risks posed by the granting of options, particularly short-term ones, are recognised by the International Organization of Securities Commissions (‘IOSCO’) in its Final Report, Board Independence of Listed Companies:

> [s]ome forms of compensation (e.g. stock options), if not properly designed, may shorten the planning horizon of board members and weaken their incentive to monitor rigorously potential managerial bias in favour of short term gains, earnings management or, in extreme cases, outright fraud.

Thus, the IOSCO view of short-term options is consistent with those of the commentators presented here.

An analysis of the practice of “backdating” options is beyond the scope of this thesis but received wide consideration from the commentators referred to in Appendix E2, References on the Practice of “Backdating” Options.

### 10.2.5.1 [AudShortOpts] (-) and [ShortTOpts] (-) Relational Effect Paths

The crux of the [AudShortOpts] and [ShortTOpts] variables in the studies above and the IOSCO Report is an increased risk of earnings misstatement due to short term options granted to independent directors on the audit committee or the board itself which, it is argued, reduces the quality of the internal monitoring function. Thus both variables are ascribed a negative (-) directional marker.

---

130 See discussion in section 5.2.3.2.1 of chapter 5.
131 Gordon, above n 45, 15-16.
132 See discussion in section 5.2.3.2.1 of chapter 5.
134 Ibid, 27.
137 IOSCO Report, above n 9, 26.
138 Audit Committee – Short Term Options Granted to Outside Directors – Reduction in Monitoring Effect.
139 Short-Term Option Holdings/Plans of Directors and Executives.
The thesis has described the ‘incentive alignment’ effect and ‘entrenchment’ effects identified by Fuerst and Kang in relation to the issue of short-term options to directors. For the reasons set out in section 10.2.1, the relational effect paths for \([\text{AudShortOpts}]\) (-) and \([\text{ShortTOpts}]\) (-) are identical to that of both \([\text{EqOptInc}]\) (+) and \([\text{EqOptEntrch}]\) (-) with the starting point of the Alignment Factor No. 3 (Alignment of Management and Shareholder Interests). Therefore, the relational effect paths for \([\text{AudShortOpts}]\) (-) and \([\text{ShortTOpts}]\) (-) are the same as that of the \([\text{EqOptInc}]\) (+) variable in Figure 10.2.4 above. There, the Alignment Factor No. 3 (Alignment of Management and Shareholder Interests) is the ‘umbrella’ or ‘guiding principle’ over the other Governance Factors with the exception of the overriding nature of Compliance Factor No. 2 (Corporate Governance and Legal Compliance). Again, Compliance Factor No. 2 is excluded from the relational effect path because it remains constant and is not affected by the option-granting decisions or actions of the company or board. Thus, the Compliance Factor No. 2 performs in part a ‘gap-filling’ function for gaps in firm-level Governance Variables.

This gives rise to a Coverage/Rating of - 7/87.50 in the Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1 for both \([\text{AudShortOpts}]\) (-) and \([\text{ShortTOpts}]\) (-).

### 10.2.6 Possible Connection Between Director and CEO Compensation Level

Several studies in sections 10.2.1 – 10.2.3 above sought to determine whether any causative relationship exists between the level of director compensation (in the form of equity and/or options) and the quality of director monitoring of management. While some support was found for this proposition in the studies – and this is reflected in the \([\text{EqOptInc}]\) (+) relational effect path in subsection 10.2.4 - it was not by any means universal. However, some greater support can be found for the proposition that director and CEO compensation levels are linked as follows in this section 10.2.6.

**Is Director Compensation Linked to the Difficulty of Monitoring the Firm and therefore CEO Compensation?**

In this respect, Brick, Palmon and Wald, after noting that supervision of management is a key function of the board, hypothesize “that director compensation is related to the difficulty of monitoring the firm” and therefore also related to CEO compensation. Thus, the authors find a positive relationship between director and CEO compensations. Seeking to determine whether this relationship is due to ‘unobserved firm complexity’ as opposed to ‘cronyism’, the

---

140 See discussion in section 10.2.1 of this chapter 10.
141 Equity/Option Plans and Holdings of Directors/Executives -- Incentive/Alignment Effect (excludes short-term options).
142 See discussion in section 7.3.1.3.1 of chapter 7.
145 Ibid.
authors find a negative relationship between firm performance and excess director compensation\textsuperscript{146} leading them to adopt the latter explanation.\textsuperscript{147}

For Evans and Evans, the shareholdings of non-executive directors operate as a ‘restraint’ on CEO compensation levels.\textsuperscript{148} In addition, and consistent with the findings of Brick et al, Evans and Evans find that increases in non-executive director compensation are linked to increases in the CEO compensation level.\textsuperscript{149}

10.3 Possible Connection between Firm Size and Director/Executive Compensation

There is also some suggestion that the level of compensation (in one study by Lee, for outside directors and, in the other by Fernandes, for executives) is linked to firm size. The study by Fernandes further suggests a positive link between executive pay and the proportion of non-executive directors on the board.

As noted earlier in chapter 8, one of the factors affecting the size of the board is likely to be firm size.\textsuperscript{150} As Lee explains:

\begin{quote}
[The larger size of firms] makes the earning of firms more sensitive to the board quality, so that the larger sized firms pay more to outside directors. Also, the big firms give more reputation values (generated by the performance of the firm) to board members. Conclusively, the large size makes board positions more attractive to the talented candidates for outside directors.\textsuperscript{151}
\end{quote}

Accordingly, there is support for the proposition that there is a positive relationship between firm size and outside director compensation levels.

Support for this possible ‘firm size: compensation’ relationship is also found by Fernandes, who investigates the relationship between firm performance, independence of the board and executive compensation in Portugal.\textsuperscript{152} For Fernandes, the level of compensation is linked to firm size but not firm performance\textsuperscript{153} and increases in the proportion of non-executive directors increase compensation levels.\textsuperscript{154}

Michaud and Gai investigate in 2009 the relationship between firm performance and CEO compensation finding that firm size (determined by sales) is a determinant of CEO compensation and that firm performance does not affect CEO compensation.\textsuperscript{155} The authors explain that:

\begin{itemize}
\item \textsuperscript{146} Ibid, 3.
\item \textsuperscript{147} Ibid, 2-3.
\item \textsuperscript{149} Ibid.
\item \textsuperscript{150} See discussion in sections 8.2.1 - 8.2.2.2 of chapter 8.
\item \textsuperscript{152} Fernandes, above n 64.
\item \textsuperscript{153} Ibid, 2 and 17.
\item \textsuperscript{154} Ibid.
\end{itemize}
Thus, the authors explain the result by reference to the reason that, as firm size increases, the ‘pool of talent’ capable of managing the firm is reduced and that this smaller pool has greater power to increase its compensation claims.

More recently in 2011, Mehran, Morrison and Shapiro examine governance lessons learned from the GFC. The authors observe in relation to executive pay that:

> The level of executive pay in a nonfinancial firm is generally related to the size of the firm’s assets (market value of equity or book value), its asset complexity, and the industry structure and competition. Leverage has an insignificant effect on pay, and, on average, firms judiciously choose their leverage for its effects on their credit ratings and potential costs of distress.

Accordingly, for the authors, factors affecting executive pay in the GFC include firm size and complexity but not leverage.

10.4 Compensation, Governance and Reputational Constraints

10.4.1 Reputational Constraints on Compensation are Dependent on Disclosure and Transparency

In chapter 4, it was explained that important governance mechanisms in the agency theory component of the shareholder and stakeholder models of the firm are the market for corporate control and, complimenting this, reputational constraints on directors. There is some suggestion in one of the studies reviewed in this thesis that such constraints, acting on the board, also place downward pressure on managerial compensation.

In this respect, Singh investigates the role of executive compensation as an incentive and indicator of governance quality. The author explains that:

> The compensation decisions a firm’s board of directors [makes] sends a potentially strong signal about the independence of the board from management.

In this way, the author concludes that reputational constraints limit the level of executive remuneration, the operation of these constraints being dependent on the existence of well-

---


158 Ibd, 5 (footnote omitted).

159 See discussion in section 4.2.2 of chapter 4.


161 Ibd.
known Governance Variables – disclosure standards and transparent reporting.\textsuperscript{162} By contrast, for Singh, “gaps in the reporting requirements”\textsuperscript{163} may lead to rent-extraction by managers including “...less transparent forms of pay, such as perks”.\textsuperscript{164} Thus, for example, comprehensive disclosure requirements relating to executive remuneration in the form of cash, equity and options but with comparatively less disclosure requirements relating to perquisites will, based on the agency costs theory, encourage claims for the latter. This is because agency theory tells us that inside managers will exploit their information advantage (information asymmetry) over dispersed shareholders to increase their wealth.\textsuperscript{165}

Separate Governance Variables are ascribed to the ‘disclosure standards’ ([ReputDiscl] (+)\textsuperscript{166}) and ‘transparent reporting’ ([ReputRep] (+)\textsuperscript{167}) aspects of the reputational constraints identified by Singh. These concepts or facets – hypothesised to be acting downwards on the Compensation Factor No. 4 (Board, CEO and Management Compensation and Incentives) – operate in the same manner as the [TransTimeMon] (+)\textsuperscript{168} variable depicted in Figure 9.1.2.1A of chapter 9.

As noted in subsection 9.1.2.1, the [TransTimeMon] (+) variable’s relational effect path is hypothesised to begin with the Reporting Factor No. 1 (Transparency, Timing and Integrity of Financial and Other Reports) itself as the ‘driver’ of this zone of effect. A ‘chain’ of reflexive relationships then directly link the Reporting Factor No. 1, the Monitoring & Audit Factor No. 5 (Internal and External/Audit Monitoring Quality), the Decision-making Factor No. 7 (Quality of Board, CEO and Management Decision-making) and culminating in the Compensation Factor No. 4 (Board, CEO and Management Compensation and Incentives). Being reflexive, this chain exerts influence in the opposite direction as well. So, for example, this chain works in the reverse. The nature and level of a firm’s board, CEO and executive compensation (Compensation Factor No. 4) is hypothesised to affect the quality of the decision-making of those organs (Decision-making Factor No. 7). This then has consequential effect on the quality of monitoring (Monitoring & Audit Factor No. 5) and, thus, the quality of the reporting function (Reporting Factor No. 1).

Therefore, the [ReputDiscl] (+) and [ReputRep] (+) variables are each hypothesised to affect all Governance Factors. This equates to a Coverage/Rating of +8/100.00 rprox in the Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1 for both the [ReputDiscl] (+) and [ReputRep] (+) variables.

\textsuperscript{162} Ibid, 20.
\textsuperscript{163} Ibid.
\textsuperscript{164} Ibid.
\textsuperscript{165} Evans and Evans, above n 148, 3-4. See discussion in sections 4.2.3 – 4.2.3.1 of chapter 4.


\textsuperscript{166} Reputational Constraints – ‘Disclosure Standards’.
\textsuperscript{167} Reputational Constraints – ‘Transparent Reporting’.
\textsuperscript{168} Transparency and Timing of Reporting – Monitoring Effect.
10.5 **Concluding Remarks on the Recurring Themes and Tensions in Executive, CEO and Director Compensation**

Chapter 10 has examined the fourth and final part of the studies forming the Empirical Studies Key Field No. 4 by examining perceived links between executive, CEO and director compensation and measures of firm value, operating performance and the probability of earnings manipulation. Other perceived links included firm size and reputational constraints and links between the CEO and director compensation levels *inter se*. The different forms of compensation have included performance-based and/or equity-based compensation and options (including short-term options).

A summary of the empirical studies and Governance Variables examined in chapter 10 is contained in Appendix E3, *Recurring Themes and Tensions in Empirical Studies Key Field No. 4* (Part 4).

The following represents further contour lines on a map of the corporate governance landscape - a summary of the hypothesised effects on firm value, operating performance and the probability of earnings manipulation of firm-specific ‘good’ Governance Variables relating to executive, CEO and director compensation.

### 10.5.1 The Compensation ‘Trade-off’

The review in chapter 10 suggests that director and management equity ownership has a ‘trade-off’ effect on the corporation between - on the one hand - the ‘incentive alignment’ effect and - on the other - the ‘entrenchment’ effect observed by Fuerst and Kang.\(^{169}\)

Translating this to the Relational Proximity Table 3.3.2.1, \[EqOptIncent\] \((+)^{170}\) and \[EqOptEntrch\] \((-)^{171}\) each have a Coverage/Rating of 7/87.50 \(_{rprox}\) as described in section 10.2.4 – the former positive and the latter negative. This indicates the strong (and opposite) hypothetical effects of these two Governance Variables. The strength (or otherwise) of the national shareholder protection scheme is hypothesised to be relevant in finding the balancing point in this trade-off reflected in a Coverage/Rating of +8/100.00 \(_{rprox}\) for the positive effects of the \[NationGov\] \((+)^{172}\) variable.

### 10.5.2 Compensation and the Level/Quality of Monitoring

There was some support for a causative link between increases in the level of director compensation (\([\text{DirCEOS]} (+/-)^{173}\)) and an increase in the quality of monitoring of management. But this seems to require that:

---

\(^{169}\) See discussion in section 10.2.1 of this chapter 10.

\(^{170}\) Equity/Option Plans and Holdings of Directors/Executives – Incentive/Alignment’ Effect (excludes short-term options) – see discussion in section 10.2.4 of this chapter 10.

\(^{171}\) Equity/Option Plans and Holdings of Directors/Executives – ‘Entrenchment’ Effect (excludes short-term options) – see discussion in section 10.2.4 of this chapter 10.

\(^{172}\) National Governance/Shareholder Protection Regime – see discussion in section 7.3.1.3.3 of chapter 7.

\(^{173}\) Director/CEO Compensation Levels has a Coverage/Rating of +/- 7/87.50 \(_{rprox}\) – see discussion in section 10.2.4 of this chapter 10.
(i) the directors be independent (see previously the \textit{BrdIndMon} (+) variable which has a Coverage/Rating of +7/87.50 \textit{rprox})\textsuperscript{174};

(ii) the compensation be incentive-based (including the \textit{EqOptIncent} (+) and \textit{EqOptEntrch} (-) variables from the previous section); and/or

(iii) (alternatively or additionally) that those directors have ‘substantial’ equity holdings (again, \textit{EqOptIncent} (+) and \textit{EqOptEntrch} (-)).

Instead, there is more persuasive support in section 10.2.6 above for the proposition that director and CEO compensation levels are linked, although this may require the directors to be independent.

\textbf{10.5.3 Firm Operating Performance and Firm Value}

Again in relation to [\textit{DirCEOs}]\textsuperscript{178} (+/-), the effect of this variable is both positive (+) and negative (-) at a Coverage/Rating of +/- 7/87.50 indicating an inconclusive relationship on account of conflicting studies in sections 10.2.2 – 10.2.3. Some studies find no relationship between CEO/executive pay levels and firm performance and/or firm value. If a causative relation exists between CEO/executive pay levels and firm value, it may well be negative according to Cremers, Bebchuk and Peyer\textsuperscript{179}.

The review suggests that if a positive relationship is to be found between CEO/executive pay levels and firm operating performance, it is heavily qualified. This relies on, at the least:

(i) existence of an incentive-based payment i.e., performance-based payments (Daines, Nair and Kornhauser\textsuperscript{180}) or options (Hanlon, Rajgopal and Shevlin\textsuperscript{181}) – the \textit{EqOptIncent} (+)\textsuperscript{182} and \textit{EqOptEntrch} (-)\textsuperscript{183} variables; and

(ii) simultaneous operation of ‘block-holder’ monitoring (Daines, Nair and Kornhauser\textsuperscript{184}) - the \textit{BlockMon} (+)\textsuperscript{185} and \textit{BlockCosts} (-)\textsuperscript{186} variables.

\textsuperscript{174} Board Independent Director: Executive Director Proportion – Monitoring Effect.
\textsuperscript{175} See discussion in sections 7.3.2.1.1-2 of chapter 7.
\textsuperscript{176} Equity/Option Plans and Holdings of Directors/Executives – Incentive/Alignment’ Effect (excludes short-term options) – see discussion in section 10.2.4 of this chapter 10.
\textsuperscript{177} Equity/Option Plans and Holdings of Directors/Executives – ‘Entrenchment’ Effect (excludes short-term options) – see discussion in section 10.2.4 of this chapter 10.
\textsuperscript{178} Director/CEO Compensation Levels has a Coverage/Rating of +/- 7/87.50 \textit{rprox} – see discussion in section 10.2.4 of this chapter 10.
\textsuperscript{179} Cremers, Bebchuk and Peyer, above n 69. See discussion in section 10.2.3 of this chapter 10.
\textsuperscript{180} See discussion in section 10.2.2 of this chapter 10.
\textsuperscript{181} Ibid.
\textsuperscript{182} Equity/Option Plans and Holdings of Directors/Executives – Incentive/Alignment’ Effect (excludes short-term options) – see discussion in section 10.2.4 of this chapter 10.
\textsuperscript{183} Equity/Option Plans and Holdings of Directors/Executives – ‘Entrenchment’ Effect (excludes short-term options) – see discussion in section 10.2.4 of this chapter 10.
\textsuperscript{184} See discussion in section 10.2.2 of this chapter 10.
\textsuperscript{185} Block Shareholding – Monitoring Effect – see discussion in sections 8.5.1 - 2 of chapter 8.
\textsuperscript{186} Block Shareholding – Other Shareholder Agency Costs – see discussion in sections 8.5.1 - 2 of chapter 8.
The thesis concluded this examination by hypothesising that the behaviour of the $\text{DirCEO} (+/-)$ variable may be positive or negative depending on the behaviour and strength of the $\text{EqOptInc} (+)$ and $\text{EqOptEntr} (-)$ variables acting in opposition to each other at any time. This gives rise to a ‘dual direction’ marker for $\text{DirCEO} (+/-)$ with an identical relational effect path to both $\text{EqOptInc} (+)$ and $\text{EqOptEntr} (-)$. This equates to a Coverage/Rating of +/- 7/87.50 $rprox$ for the $\text{DirCEO} (+/-)$ variable in the Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

10.5.4 Short-Term Options and Earnings Manipulation

The thesis reviewed in sections 10.2.5 - 10.2.5.1 some cautionary findings that the risk of earnings misstatement increases with short-term options granted to outside audit committee directors (the $\text{AudShortOpt} (-)$ variable) thus inhibiting the function of such directors to monitor financial statement integrity (as suggested by Marrakchi Chtourou, Bédard and Courteau190).

There was further suggestion that option incentive plans ($\text{ShortTOpt} (-)$191) increase earnings manipulation but not performance (Tehranian, Cornett, Marcus and Saunders192). This caution finds a Coverage/Rating in the Coverage Table and Relational Proximity Table for both $\text{AudShortOpt} (-)$ and $\text{ShortTOpt} (-)$ of -7/87.50 $rprox$.193

These findings are also reflected in the findings of the commentator evaluations of the Enron corporate collapse in chapter 5. There, commentators examined the role of share options, particularly those with a short-term structure, and bonus payments linked to share-price performance. It was hypothesised that these forms of CEO, executive and director compensation:

(i) increase the likelihood of the adoption of high-risk taking or strategies by management (Bratton194);

(ii) increase the risk of ‘aggressive accounting manipulations’ to boost stock option values (Armour and McCahery195); and

(iii) increase the likelihood of fraud and risk-taking to increase the share price (Gordon196).

---

187 Equity/Option Plans and Holdings of Directors/Executives – Incentive/‘Alignment’ Effect (excludes short-term options) – see discussion in section 10.2.4 of this chapter 10.
188 Equity/Option Plans and Holdings of Directors/Executives – ‘Entrenchment’ Effect (excludes short-term options) – see discussion in section 10.2.4 of this chapter 10.
189 Audit Committee – Short Term Options Granted to Outside Directors – Reduction in Monitoring Effect – see discussion in section 10.2.5.1 of this chapter 10.
190 See discussion in section 10.2.5 of this chapter 10.
191 Short-Term Option Holdings/Plans of Directors and Executives – see discussion in section 10.2.5.1 of this chapter 10.
192 See discussion in section 10.2.5 of this chapter 10.
193 See discussion in section 10.2.5.1 of this chapter 10.
194 See discussion in section 5.2.3.2.1 of chapter 5.
196 See discussion in section 5.2.3.2.1 of chapter 5.
10.5.5 Firm Size, Independence and Director/Executive Compensation

There is some suggestion in section 10.3 that the level of compensation for outside directors (Lee) and/or executives (Fernandes) – the [DirCEOS] (+/-)\(^{197}\) variable - is linked to the intervening variable of firm size. Michaud and Gai, too, found that firm size (determined by sales) is a determinant of CEO compensation and that firm performance does not affect CEO compensation.\(^{198}\) The authors suggest that increases in firm size reduce the ‘pool of talent’ able to manage that firm causing an increase in the price for CEOs.\(^{199}\)

10.5.6 Compensation and Reputational Constraints

Singh suggests that reputational constraints limit the level of executive remuneration, the author adding that the operation of these constraints is dependent on the presence of ‘disclosure standards’ and ‘transparent reporting’.\(^{200}\) Following Singh, the thesis ascribes separate Governance Variables to these pre-conditions. The [ReputDisc] (+)\(^{201}\) variable represents the ‘disclosure standards’ pre-condition and is ascribed the highest positive Coverage/Rating of +8/100.00 rprox. The ‘transparent reporting’ condition is represented by [ReputRep] (+)\(^{202}\) and again is ascribed the highest positive Coverage/Rating of +8/100.00 rprox. These two Governance Variables – hypothesised to be acting downwards on compensation levels within the Compensation Factor No. 4 – operate in the same manner as the [TransTimeMon] (+)\(^{203}\) Governance Variable depicted in Figure 9.1.2.1A of chapter 9.

10.6 Conclusion of the Empirical Studies Key Field No. 4

The operation of the director/CEO compensation variables ([DirCEOS] +/-, [EqOptIncent] (+) and [EqOptEntrch] (-)) and the short-term option variables ([AudShortOpts] (-) and [ShortTOpts] (-)) in the context of the Enron corporate collapse was undertaken in detail in chapter 5 with the results supported by the analysis in this chapter 10. The analysis in this chapter 10 also concludes the analysis of the Empirical Studies Key Field No. 4 – empirical and other studies of the effectiveness of corporate Governance Variables (including the strength of the national shareholder protection regime).

Within chapters 7 – 10, the thesis has identified, analysed and justified a relational effect path for each of the thirty-nine Governance Variables first presented in Table 2.4. A summary of each relational effect path for these Governance Variables – including the number of Governance Factors affected and the direction of effect – was presented in the Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1.

In the following chapter 11, the thesis presents concluding observations and analysis relating to the relational proximity of the Governance Variables and observations on the structure,

\(^{197}\) Director/CEO Compensation Levels has a Coverage/Rating of +/- 7/87.50 rprox – see discussion in section 10.2.4 of this chapter 10.

\(^{198}\) Michaud and Gai, above n 155, 50.

\(^{199}\) Ibid. See discussion in section 10.3 of this chapter 10.

\(^{200}\) See discussion in section 10.4.1 of this chapter 10.

\(^{201}\) Reputational Constraints – ‘Disclosure Standards’ - see discussion in section 10.4.1 of this chapter 10.

\(^{202}\) Reputational Constraints – ‘Transparent Reporting’ – see discussion in section 10.4.1 of this chapter 10.

\(^{203}\) Transparency and Timing of Reporting – Monitoring Effect – see discussion in section 9.1.2.1 of chapter 9.
explanatory power and limitations of the relational approach. Chapter 11 concludes the thesis with suggested improvements and areas for further research.
CHAPTER 11
RELATIONAL APPROACH CONCLUSIONS

Estimating the future effects of (publicly known) governance provisions (or governance characteristics correlated with them) is far from a straightforward matter and requires not only knowing the public information about the provisions but also plugging it into an appropriate structural model of the firms and their environment.

Lucian A Bebchuk, Alma Cohen and Charles C Y Wang

11.1 Relational Approach Conclusions and Approach of Chapter 11

The thesis has proposed a way of understanding and addressing governance problems that flow from the separation of ownership from management in the public corporation – that managers will seek to maximise their own wealth at the expense of outside shareholders. These actions – shirking, empire-building, overcompensation and ‘perks’ – reduce the firm’s value and performance. Consequently, the firm’s long-term efficiency and sustainability/survival is eroded. To counter these agency problems, a raft of Governance Variables are employed by regulators and firms to punish or deter the misconduct of managers or to align their interests with outside shareholders. The thesis has explained that many of these Governance Variables are mandated or enforced on a ‘comply or explain’ basis by the multitude of Governance Codes in operation today. For example, in the case of Australia’s ASX 2007-10 Revised Principles, companies listed on the Australian Securities Exchange are, under ASX Listing Rules, required to disclose the extent of their compliance with the Revised Recommendations.

But this does not tell us the relative importance of each variable in avoiding or reducing agency costs and therefore enhancing firm value, profitability and, thus in the long-term, the sustainability of the corporation. The thesis has demonstrated that many empirical studies on the effectiveness of Governance Variables in enhancing (or reducing) firm sustainability – using firm value, operating performance and cost of capital as proxies – are problematic as inconclusive or conflicting. In addition, many of these studies concern a single or small number of Governance Variables. The introductory quote from Bebchuk, Cohen and Wang, too, provides some insight into difficulties posed for this process. Indeed, the authors remind us of the limitations of theoretical studies in this area:

[o]ur findings have implications for the use of event studies to establish the desirability and value of legal reforms in the corporate governance area. Because theoretical analysis can usually identify both positive and negative effects that such reforms could have and, in any event, cannot tell us much about the effects’ magnitude, the sign and magnitude of a given reform’s effect cannot be a priori precisely indentified on theoretical grounds, leading researchers to make extensive use of events studies. For

example, researchers have conducted event studies of the 2002 passage of SOX and the exchanges' independence requirements...\(^4\)

The thesis contributes to the field by offering a new theoretical understanding of the relative importance of Governance Variables through a comprehensive approach based on the results of empirical studies. The thesis adds to the field by providing an approach where the *internal interrelationships* between Governance Variables can be used to construct a system for determining and ranking the relative importance of those Variables. It provides a normative or benchmark approach for the operation of Governance Variables which uses the received literature and empirical studies as a springboard for the construction of a framework which is *internal* to the corporation itself. Thus, perceived shortcomings in the design, operation or interpretation of past empirical studies do not undermine the relational approach.

While the theoretical studies referred to by Bebchuk, Cohen and Wang are said to have shortcomings in determining the sign (i.e., the direction of effect) and the magnitude (i.e., strength of effect) of a given reform, the thesis adds to the field by demonstrating an approach for ascribing such a sign with greater certainty. The strength of the effect under the relational approach awaits empirical testing.

Nor is the relational approach affected by events which affect the value or performance of corporations or the value of their equities such as the Global Financial Crisis. By contrast, the relational approach can be used to compare the interrelationships between Governance Variables internal to the company in crisis and non-crisis periods to identify problems or breakdowns in relationships.

*Relational Governance Determines the ‘Efficient Zone’ for a Variable*

The aim of *relational corporate governance* is to increase understanding of the interactive balancing processes of insiders and outsiders of the for-profit corporation. The thesis evaluated and in turn predicted the behaviour of 39 individual Governance Variables. Hypotheses about their relative importance in affecting agency costs and the long-term efficiency and sustainability of the corporation have been developed.

For regulators, policy-makers, law-reformers and corporate actors and their advisors, each Governance Variable represents an individual area of inquiry in a governance review of the corporation. The structure or operation of Governance Variables within the corporation can then be assessed by comparison to the way they *should* behave according to the relational approach and its normative relative proximity values. In the relational approach, deficiencies in the structure or operation of particular Governance Variables within the corporation place the corporation outside the ‘efficient zone’ for that variable. As the efficient zone of a variable reflects the relative agency cost value ascribed to that variable in the *Relational Proximity Table*, a deficiency in the real-world structure or behaviour of such a variable has the efficiency- and sustainability-reducing effects reflected from that value.

In the physics of the behaviour of light, the angle of incidence equals the angle of reflection. In governance terms, the relational approach demonstrates that a real-world deficiency in the structure or operation of a Governance Variable within the corporation will reduce the efficiency and sustainability of the corporation by the relative value equivalent to the *relational proximity*

\(^{4}\) Bebchuk, Cohen and Wang, above n 1.
Rating of that variable taken from the Relational Proximity Table. As more deficiencies are detected in other variables, the relative risk of inefficiency and a reduction in the sustainability of the corporation magnifies by the aggregate relational proximity of those variables.

Specifically for regulators, policy-makers, law-reformers and corporate actors and their advisors, the relational approach can also thus be used to review and map the purpose, structure and operation of current variables in Governance Codes and schemes around the world and to assess reform proposals in the field.

11.2 Key Aims and Developments of the Thesis from Chapter 1

The approach of this chapter will be two-fold. First will be to present the elements of the relational approach which were developed in the thesis as a response to the key goals or aims from chapter 1.\(^5\) These were to:

1. Introduce a new definition of corporate governance;
2. Create a simulated corporate governance environment which represents the ‘real world’ sphere of corporate governance;
3. Identify, describe and map diagrammatically the interrelationships, themes and factors underpinning this environment;
4. Create a comparative table or scheme system upon which to compare across sectors and over time the Governance Variables utilised in the major US, UK, Australian and global Governance Codes and schemes; and
5. As an over-arching aim, to propose an approach or tool for regulators and policy-makers to predict and measure the relative importance of Governance Variables in reducing (or increasing) agency costs and enhancing (or reducing) the long-term efficiency and sustainability of the for-profit firm.

As part of this, the conclusion will review these key elements of the relational approach and how they can be used in future to advance the understanding of corporate governance.

Second will be to highlight those elements which have emerged from the analysis contained in the Key Fields of this thesis as particularly significant for the relational approach.

11.2.1 To introduce a new definition of corporate governance

This is the Three Relational Axes of Good Governance examined in chapter 2.\(^6\) The Three Relational Axes are:

---

\(^5\) See discussion in section 1.3.3 of chapter 1.
\(^6\) See discussion in sections 2.3.1 – 2.3.3 of chapter 2.
1. **Objectives Axis**

On one axis, the freedom of a company’s management to pursue (profit-maximising) objectives (value enhancement) at one end is balanced against the interests of the shareholders (owners) in monitoring management’s performance (performance assessment and reporting) and seeing that a company’s resources are not dissipated (value preservation).

2. **Behaviours Axis**

On another axis, “entrepreneurism” and “innovation” (risk-taking) are balanced against risk management, “control” and “accountability” (responsibility).

3. **Positional Conflict Axis**

Lastly, the interests of those ‘within’ the company such as the board, CEO and executives/management (internal stakeholders) are balanced against the interests of those ‘outside’ the company such as shareholders/investors, employees, lenders, suppliers, government legislators and regulators and social interests including the environment and the general public (external stakeholders).

This is the theoretical set of scales which weighs the objectives, behaviours and positional conflict of insiders such as the directors, CEO and management with traditional outsiders such as shareholders and other wider stakeholders. Reflecting the increasing influence of stakeholder theory - in the same way as Australia’s ASX 2007-10 Revised Principles\(^7\) - the Three Relational Axes represent the competing claims on the governance framework of the national corporate governance or shareholder protection regime and, in turn, the governance systems of individual companies.

Unlike the original Cadbury Report definition\(^8\), the Three Relational Axes reflect in more concrete terms the role of insiders in risk-taking and innovation but still maintain that Report’s emphasis on monitoring/supervision of management and reporting to shareholders. The Three Relational Axes, like the OECD Principles\(^9\), reflect the aim that the maximisation of the interests of stakeholders beyond the shareholders are important in the firm’s long-term sustainability. Why has this approach been taken?

The Three Relational Axes denote that the governance system of a company is not static. They are the continuing considerations which the directors must apply to decisions concerning the company’s resources. The company’s long-term efficiency and sustainability requires the continual weighing process of these Axes and the maximisation of these considerations. How is this achieved?

The recurring themes and tensions underpinning corporate governance discourse – the eight Governance Factors – are weighed in this set of scales. Using empirical studies as a springboard, the results of the weighing process were calculated and presented for the reader. These are the two Interrelationship Schemes in Figures 2.7.2A reflecting the shareholder primacy environment and 2.7.2B again – like the OECD - reflecting stakeholder theory. These

---

\(^{7}\) ASX 2007-10 Revised Principles, above n 2


Schemes act as maps to guide the decision-making processes of the directors to enhance the firm’s long-term efficiency and sustainability.

11.2.2 To create a simulated corporate governance environment which represents the ‘real world’ sphere of corporate governance

These are the four Key Fields introduced in chapter 1\textsuperscript{10} and comprising the largest components of the relational approach:

Key Field No. 1: Application of the Principal Theories of the Firm to the Relational Approach (chapter 4)

The thesis explained and demonstrated the application of the ‘nexus of contracts’, ‘agency’ (costs) theory, the ‘shareholder’ (primacy) model and its associated shareholder wealth-maximisation principle, the ‘stakeholder’ model and the ‘director primacy’ model to the relational approach. The Weighing Mechanism of the relational approach was shown to be a theoretical representation of nexus theory.

Key Field No. 2: ‘Autopsies’ of the Enron and Hastie Corporate Collapses (chapter 5)

Compromised of literature and studies relating to the Enron corporate collapse, the thesis catalogued and analysed relevant Governance Variable failings surrounding that collapse as a pre-GFC phenomenon. The Enron corporate collapse was demonstrated, by its comparison to the post-GFC collapse of the Hastie Group, to be still very relevant today in predicting areas of potentially fatal governance problems in real corporations. The thesis demonstrated that this collapse should thus continue to inform the construction, operation and development of Governance Codes across the world.

Key Field No. 3: Comparative Corporate Governance Codes (chapter 6)

This was the international (OECD, ICGN and CACG) and national (US, UK and Australian) corporate Governance Codes, statutes, schemes and directives of best practice listed in Table 6.1.4. The thesis demonstrated the sphere of operation of the major national Governance Codes including the OECD Principles, NYSE Final Rules\textsuperscript{11} and the ASX 2007-10 Revised Principles. Using the process of recurrence or commonality of Governance Variables, these

\begin{footnotes}
10 See discussion in section 1.7.1 of chapter 1
\end{footnotes}
Governance Codes gave rise to a ‘core’ set of Governance Variables which were used for the identification and articulation of the Three Relational Axes of Good Governance and the Governance Factors.

Key Field No. 4: Empirical Studies on the Effectiveness of Governance Variables (chapters 7 – 10)

This Key Field examined empirical studies of the effectiveness of Governance Variables in reducing (increasing) agency costs and enhancing (reducing) the long-term efficiency and survival/sustainability of the for-profit corporation. These aims were measured by proxies for shareholder wealth including the firm cost of capital, firm value/share price, firm operating performance and the likelihood of earnings manipulation. This Field included studies of the strength of the national shareholder protection regime which continue to show common-law-origin regimes as leading the others. Importantly, the thesis demonstrated that these empirical studies can be used as a springboard to determine the starting point(s) of the relational effect paths of the Governance Variables.

In this way, the thesis created a simulated corporate governance environment which represents the ‘real world’ sphere of corporate governance. This is represented by the four Key Fields and 39 Governance Variables to which the Fields give rise. As noted in section 1.4, the four Key Fields were selected on the basis of the number of works on the SSRN platform as a measure of impact. Thus, of immediate value for regulators, policy-makers, law-reformers and corporate actors and their advisers, the relational approach’s simulated environment is very topical and current - in effect the 39 most-often considered Governance Variables in governance discourse.

Like any simulated or ‘model’ environment, the components of the environment must obey the ‘laws of nature’ of that environment. Thus, all the theoretical components of the relational approach – and how they ‘fit’ with each other – were demonstrated in the Relational Corporate Governance Framework in Figure 2.8. As explained there, all the components of the relational approach are ultimately drawn from the four Key Fields that form the base of the pyramid-like structure of the Framework.

To maintain the explanatory and predictive power of the relational approach, it will be necessary to continuously track new studies in relation to each Key Field. And, while the size of this thesis has restricted the Key Fields to four in number, the thesis’ simulated environment may be expanded in future to more closely resemble the real world by adding Key Fields as they emerge. Possibilities flagged in chapter 1 include non-profit corporations and governance, non-English-origin shareholder protection regimes and corporate social responsibility principles.

11.2.3 To identify, describe and map diagrammatically the interrelationships, themes and factors underpinning this environment

This is the Weighing Mechanism of the relational approach. As noted above, this Mechanism is comprised of the Three Relational Axes of Good Governance, the eight Governance Factors
and the Interrelationship Schemes between these Factors in Figures 2.7.2A and 2.7.2B. These three components are combined to create a relational effect path for each Governance Variable. The starting point(s) of each relational effect path was demonstrated by the thesis to be the empirical studies of the effectiveness of Governance Variables in Key Field No. 4.

The thesis demonstrated that the Governance Factors are the eight most significant or principal recurring aims, themes and tensions underlying or arising from the collective ‘sphere’ of corporate governance discourse:

**Reporting Factor No. 1:** Transparency, Timing and Integrity of Financial and Other Reports

**Compliance Factor No. 2:** Corporate Governance and Legal Compliance

**Alignment Factor No. 3:** Alignment of Management and Shareholder Interests

**Compensation Factor No. 4:** Board, CEO and Management Compensation and Incentives

**Monitoring & Audit Factor No. 5:** Internal and External/Audit Monitoring Quality

**Stakeholders Factor No. 6:** Identification, Participation and Protection of Stakeholder Interests

**Decision-making Factor No. 7:** Quality of Board, CEO and Management Decision-making

**Responsibility Factor No. 8:** Delineation and Disclosure of Powers, Duties and Lines of Responsibility.

The Weighing Mechanism was depicted in Figure 4.2. The thesis demonstrated that the Weighing Mechanism is the theoretical representation of the voluntary ‘obligations’ comprising the nexus of contracts theory of the firm. The Weighing Mechanism undertakes a theoretical or hypothetical ‘weighing’ exercise to depict – descriptively and diagrammatically – the themes and considerations relevant to the competing or opposing interests of ‘insiders’ and ‘outsiders’ of the corporation. In short, the eight Governance Factors are ‘weighed’ in the Three Relational Axes of Good Governance which acts like a set of scales to weigh the often competing aims or objectives (Objectives Axis No. 1), behaviours (Behaviours Axis No. 2) and interests (Positional Conflict Axis No. 3) of ‘insiders’ and ‘outsiders’ of the corporation.

As noted above, the results of this weighing process are already calculated and presented for the reader – these are the two Interrelationship Schemes in Figures 2.7.2A (for the shareholder primacy model) and 2.7.2B (for the stakeholder model). These Schemes are the two diagrams of hypothesised or predicted interrelationships between the eight Governance Factors. Thus, in turn, the Interrelationship Schemes represent the hypothesised or predicted interrelationships between the four Key Fields and the 39 Governance Variables to which the Fields give rise.
11.2.4 To create a comparative table or scheme system upon which to compare across sectors and over time the Governance Variables utilised in the major US, UK, Australian and global Governance Codes and schemes

These are the thesis’ Governance Code Tables and Commonality Tables presented in chapter 6.

Like the Three Relational Axes, the Governance Code Tables again reflect the influence of the OECD Principles. The thesis demonstrated that a comprehensive Governance Code Table can be constructed from elements of each of the global, US, UK and Australian sectors. The Tables compared the Governance Variables utilised in the major global and Anglo-American Governance Codes in operation today - including the OECD Principles, the NYSE Final Rules, the FRC’s UK Corporate Governance Code 2010-12\(^{12}\) and the ASX 2007-10 Revised Principles. Such a Table can be applied to determine the scope and nature of any Governance Code including, in the future, non-common-law origin countries.

On account of it’s comprehensive listing of Governance Variables, the Governance Code Table will be a useful comparative tool for regulators, policy-makers and law reformers in the area. In this respect, the thesis has demonstrated that a Governance Code Table such as that presented in chapter 6 can be used to track the degree of harmonisation or convergence in Governance Codes including, again, those of non-common-law origin countries. In this way, refinements or additions to Governance Codes over time can be assessed.

Flowing from the convergence aspect of the Governance Code Tables are the Commonality Tables. The thesis presented a Commonality Table to list the recurring Governance Variables within a sector and across sectors. Thus, the thesis has produced a Commonality Table for the global sector (Table 6.2.3.1) and each of the sectors of the US (Table 6.4.2.1) and UK (Table 6.5.1.1).\(^{13}\)

Again to display the convergence aspect, the thesis presented a Commonality Table to compare the US, UK and Australian listed corporate Governance Codes – those Codes currently in operation and backed with an enforcement or disclosure regime stemming from the listing rules of the relevant stock or securities exchanges.\(^{14}\) Again, refinements and additions to Governance Codes can be tracked and assessed.

The thesis concluded the examination of the commonality of Governance Variables by presenting a ‘core’ set of Governance Variables from the global and national listed sectors combined. These were:

- Questions and voting in meetings (item 2.iv);
- Interested or conflicted director disclosure (items 3.v and 6.iv.e);
- Employee/management/director incentive and participation schemes (item 4.iv);

---


\(^{13}\) No Commonality Table is presented for the Australian sector as explained in section 6.6.1 of chapter 6.

\(^{14}\) See Commonality Table 6.7.1 and discussion in section 6.7.1 of chapter 6.
• Timely disclosure of material information including remuneration policies (item 5.i.b);
• Independent/external audit (item 5.ii);
• Board functions and independence - compliance with statutory and legal duties on organisation/directors (item 6.i);
• Principal board responsibilities - corporate governance compliance (items 6.iv.b);
• Principal board responsibilities - interested director or management conflicts or transactions (item 6.iv.e);
• Independence from management - non-executive/independent directors (item 6.v.a); and
• Independence from management - responsibilities of board sub-committees delineated and disclosed (item 6.v.b).

The thesis demonstrated through commonality the significance of these Governance Variables in for-profit Governance Code discourse and for the relational approach in the identification, design and articulation of the Three Relational Axes of Good Governance15 and the Governance Factors.16

11.2.5 As an over-arching aim, to propose an approach or tool for regulators and policy-makers to predict and measure the relative importance of Governance Variables in reducing (or increasing) agency costs and enhancing (or reducing) the long-term efficiency and sustainability of the for-profit firm

This is the relational approach itself. It was introduced in this thesis and defined in chapter 1 as the examination and evaluation of the interrelationships between individual governance structures, mechanisms, processes and protocols (i.e., Governance Variables) that seek to minimise or avoid (or, contrastingly, increase) agency costs between economic actors ‘inside’ and ‘outside’ the for-profit corporation. The thesis explained that the approach gives rise to the theoretical Weighing Mechanism of the relational approach - the Three Relational Axes of Good Governance, the eight Governance Factors and the two Interrelationship Schemes. The Interrelationship Schemes identify the number of Governance Factors affected by a Governance Variable and the direction of effect. The Schemes are used in conjunction with the empirical studies in chapters 7 - 10 to construct a relational effect path for that Governance Variable. These empirical studies provide the starting point for the relational effect path.

The rationale of relational corporate governance is that the interrelationships between Governance Variables and their effects (whether positive or negative) on such agency costs affect the long-term efficiency and survival/sustainability of the firm. If these interrelationships can be better understood, then the thesis hypothesises or predicts that the relative importance of Governance Variables inter se in reducing (or increasing) these agency costs and enhancing (or reducing) shareholder welfare (measured by proxies for shareholder wealth such as firm cost of capital, firm value/share price and firm operating performance) can be

15 See discussion in sections 2.3.1 – 2.3.3 of chapter 2.
16 See discussion in sections 2.6.1 – 2.6.8 of chapter 2.
determined or predicted with better confidence. The hypothesised or predicted effects on these agency cost and shareholder welfare measures, in turn, permits determinations and predictions to be made in relation to the long-term efficiency and survival/sustainability of the corporation.

The Coverage Table 3.3.1 is the first of two operational tables of the relational corporate governance approach presented in this thesis. The relational effect path of each Governance Variable describes a predicted or hypothesised interrelationship directly or indirectly between each Governance Variable and one or more of the eight Governance Factors (the recurring themes and tensions underlying corporate governance). The description of, and results displayed for, each relational effect path are summarised in this Coverage Table. The summarised results are known as that Governance Variable’s Coverage. This Coverage is the number of Governance Factors affected, and the direction of effect (positive or negative), by each Governance Variable. The maximum Coverage is +/- 8 units. The results of the Coverage of a Governance Variable are set out in the Coverage Table.

The Relational Proximity Table 3.3.2.1 is the ultimate operational table of the thesis and represents the results of the relational corporate governance approach. The Coverage measure is converted into the relational proximity Rating of that Governance Variable in the Relational Proximity Table. This Rating is a proportion expressed as a number on a scale from 0 to a maximum of +/- 100.00 units known as rprox. The Relational Proximity Table ‘groups’ Governance Variables in descending order of relative importance in reducing (or increasing) agency costs and enhancing (or reducing) the long-term efficiency and survival/sustainability of the firm.

Having presented the thesis’ conclusions for its key research questions, the thesis now turns to highlight elements of the Key Fields as particularly significant for the relational approach.

11.3 The Application of the Principal Theories of the Firm to the Relational Approach

For regulators, policy-makers and law-reformers, the thesis has demonstrated the relational approach to Governance Variables adds explanatory power to the principal theories of the firm, in particular agency theory, the shareholder primacy model and the director-primacy model of corporate governance. To reflect the critical role of information asymmetry in agency theory, the relational approach’s Governance Factors are designed to reduce (or at least reflect) this informational problem.

And this informational problem is demonstrated by the thesis’ analysis of the Enron collapse in Key Field No. 2 (for example, ‘phantom’ profits and off-balance sheet entities17) and the ‘core’ features of Governance Codes in Key Field No. 3 listed above from section 6.8.1. Not surprisingly, then, the Coverage Table 3.3.1 and Relational Proximity Table 3.3.2.1 accord the highest Governance Factor Coverage and relational proximity Ratings (and therefore highest relative importance in reducing agency costs) to Governance Variables similarly designed to reduce this informational problem.

The thesis also demonstrated that the market for corporate control is essential to nexus theory.18 To reflect this significance, Governance Variables which are components of the

---

17 See discussion in section 5.2.1.1 of chapter 5.
18 See discussion in section 4.2.2 of chapter 4.
market for corporate control have relatively higher Governance Factor Coverage and relational proximity Ratings. Indeed, no component of the market for corporate control has a lower Coverage/Rating (ignoring the direction) of 8/100.00 \( rprox \) which reflects the relational approach’s degree of alignment with the nexus of contracts theory. As noted above, the Weighing Mechanism of the relational approach is a theoretical representation of nexus theory.

As a practical example, the thesis demonstrated that staggered board elections and other anti-takeover mechanisms – by virtue of constituting a shareholder welfare-reducing term of the nexus of contracts – reduce firm value and, consequently, firm sustainability.\(^{19}\) Such mechanisms reduce the effectiveness of the market for corporate control as a market-efficiency sanction and are thus ascribed the maximum negative relational proximity of -8/100.00 \( rprox \).

11.4 Concluding Remarks for ‘Overall’ Governance and Board Factors I and II

11.4.1 ‘Overall’ or ‘Multi-Variable’ Governance

The relational approach in this thesis demonstrates the central or prominent operation of board and director-related variables in the governance mix as well as the external audit function. In this respect, the thesis concludes that the combinations or groupings of Governance Variables which affect firm value and/or firm performance are board and committee size, a high level of attendance at board meetings, director independence and the proportion of executive directors and the presence and operation (including frequency of meeting) of board committees - in particular the audit, nominating and compensation committees. The mix must also contain the equity (including option) compensation and/or holdings of directors and executives, the board skills ‘mix’, the external/independent audit function, annual review of the board and outside/external board advisors. The mix is completed by the annual election of all directors (instead of staggered board elections), the absence of other anti-takeover mechanisms, blockholding and activism variables and the outside board positions held by independent directors.

11.4.2 Board Factors I - ‘Independence’ and Proportion of Non-Executive/Independent Directors

In the case of the director independence variable, an elegant case is argued that some of the perceived benefits may include enhanced acquisition decisions and monitoring and a greater likelihood of dismissal of the CEO after poor performance.\(^{20}\) Despite the inconclusive support for this variable in empirical studies at this time, the thesis demonstrated that the real push for independence in corporate governance discourse stems from the Governance Codes in Key Field No. 3. There, the thesis concluded that the key features of global and national listed Governance Codes included “board functions and independence – compliance with statutory and legal duties on organisation/directors”, “independence from management – non-executive/independent directors” and “independence from management – responsibilities of board sub-committees delineated and disclosed.”\(^{21}\)

And the thesis demonstrated that these features flowed from corporate collapses of the time. The Enron corporate collapse highlighted the undermining of the director independence factor

---

\(^{19}\) See discussion in sections 8.3 – 8.3.1.1 of chapter 8.

\(^{20}\) See discussion in section 7.3.2.1.1 of chapter 7.

\(^{21}\) See the discussion in section 6.8.1 of chapter 6.
on the grounds of 'outrageously high' director and consulting contracts for directors as well as share and option holdings which caused problems in monitoring. Potential conflicts of interest also arose on the risk management committee on account of options paid to directors. The Enron collapse also highlighted loss of director independence through board member familiarity, deference to inside directors and the regular attendance of the Chairman and (separate) CEO at the executive, finance and audit committees.

In the case of the perceived positive link between the independence variable and firm operating performance and/or firm value, the thesis demonstrated that the results of empirical studies are conflicting with many of the studies examined finding no such relation. The thesis concluded, however, that intervening variables for director independence include the relative importance of the CEO, the size of the board and the level of equity holdings for the CEO, management and both 'inside' and independent directors.

11.4.3 Board Factors II - Board Size

In relation to the second slate of individual board factors examined by the thesis, the board size factor appears to be itself affected by a wide range of other intervening factors. The size of the board will be affected by national statutory or Governance Code requirements. In addition, the size of the board will be larger the wider the gap between insider and outsider interests, the more difficult the practicability of external monitoring, the larger the firm's operations or size and the greater the firm's diversity and/or complexity and debt level. However, no consistent or conclusive result could be confidently predicted in relation to the relationship between board size and firm operating performance and/or firm value.

11.4.4 Audit Sub-Committee – Presence, Independence and Expertise

The perceived link between audit sub-committee independence and firm value and/or operating performance remains, at this time, a matter of debate. Again, the thesis demonstrates the significance of this committee as flowing from Governance Codes in Key Field No. 3. The thesis there demonstrated "independence from management – responsibilities of board sub-

---

24 See discussion in section section 5.2.2.1.2 of chapter 5.
25 See discussion in section 5.2.2.2 of chapter 5.
26 Gillan and Martin, above n 23, 25.
28 See discussion in sections 7.3.2.1.5 – 7.3.2.1.7 of chapter 7.
29 See discussion in sections 8.2.1 and 8.2.2.2 of chapter 8.
30 See discussion in section 8.2.2.1 of chapter 8.
committees delineated and disclosed" as a key feature of international and national listed corporate Governance Codes.31

The thesis demonstrated that a positive link likely exists between audit committee financial expertise and firm value and/or operating performance on account of perceived improvements in the quality of monitoring. It is likely that accounting expertise will be most significant again on monitoring quality grounds given the complexity of modern company accounting and reporting requirements.32

11.4.5 Independence and Earnings Management

The thesis demonstrated that, alone, the independence factor is of inconclusive explanatory power in minimising earnings manipulation.33 However, an increase in the independence factor appears to be critical in reducing earnings manipulation when combined with increases in the time spent in review (or the number of audit committee meetings), increases in the financial expertise of the relevant directors/committee and separation of the CEO and Chairperson functions.34 The thesis confirmed the discussion in the previous section by demonstrating that accounting expertise is more likely than other types of financial expertise to reduce the likelihood of earnings manipulation. However, the presence of financial experts may lead to some ‘free rider’ negative effects on the quality of monitoring by other directors on the audit committee.35

11.4.6 Executive, CEO and Director Compensation

Chapter 10 examined the fourth and final part of the empirical studies Key Field No. 4 by examining perceived links between executive, CEO and director compensation and measures of firm value, operating performance and the probability of earnings manipulation.

Other perceived links included firm size and reputational constraints and links between the CEO and director compensation levels inter se. The different forms of compensation have included incentive-based equity compensation and options (including short-term options). The relatively recent phenomenon of shareholder ‘Say-on-Pay’ statutes was also examined for governance effects.

The significance and debate relating to optimal executive, CEO and director compensation will be on-going. This is demonstrated by the presence as ‘core’ features of Governance Codes of “employee/management/director incentive and participation schemes” and the “timely disclosure of material information including remuneration policies”.36

31 See discussion in section 6.8.1 of chapter 6.
32 See discussion in section 9.2.1.1.1 of chapter 9.
33 See discussion in section 9.2.1.2 of chapter 9.
34 Ibid.
35 See discussion in section 9.2.1.1.2 of chapter 9.
36 See discussion in section 6.8.1 of chapter 6.
11.4.6.1  Substantial Director Shareholdings and Independence

There was some support among empirical studies for a link between increases in the level of director shareholdings and firm operating performance. In this respect, some studies found that substantial director shareholdings were associated with increased operating performance\(^37\), ‘disciplinary management turnover’ in times of poor performance\(^38\) and improvements in the oversight of management. The independence element is also likely to be a significant requirement here. Where independent directors are entitled to ‘incentive compensation’, monitoring of the board (measured by the probability of ‘CEO turnover’) increases as firm performance falls.\(^39\)

11.4.6.2  CEO/Executive Compensation and Firm Operating Performance/Value

Some studies find no relationship between CEO/executive pay levels and firm performance and/or firm value.\(^40\) If a causative relation exists between CEO/executive pay levels and firm value, it may well be negative.\(^41\) The thesis demonstrates that, if a positive relationship is to be found between CEO/executive pay levels and firm operating performance, it is heavily qualified relying on, at the least, existence of an incentive-based payment (i.e., performance-based payments\(^42\) or options\(^43\)) and the simultaneous operation of ‘block-holder’ monitoring.\(^44\)

11.4.6.3  Short-Term Options and Earnings Manipulation

In chapter 10, cautionary findings were presented that the risk of earnings misstatement increases with short-term options granted to outside audit committee directors inhibiting the function of such directors to monitor financial statement integrity.\(^45\) In addition, option incentive plans may well increase earnings manipulation but not performance.\(^46\)

---

38 Ibid, 6.
44 Daines, Nair and Kornhauser, above n 42, 27. See discussion in sections 10.2.2 and 10.2.4 of chapter 10.
These findings are also reflected in the findings of the commentator evaluations of the Enron collapse in chapter 5. There, commentators examined the role of share options, particularly those with a short-term structure, and bonus payments linked to share-price performance. The thesis there demonstrated that these forms of CEO, executive and director compensation increase the likelihood of the adoption of high-risk taking or strategies by management, increase the risk of ‘aggressive accounting manipulations’ to boost stock option values and increase the likelihood of fraud and risk-taking to increase the share price.

11.5 Observations on the Explanatory Power of the Relational Approach and Future Research

In this penultimate section of the thesis, an improvement to the relational approach is suggested consequent on future large-scale empirical testing.

The ‘Mode’ of the Relational Approach

In chapter 2, the thesis demonstrated that, in the relational approach’s shareholder-primacy mode, the Alignment Factor No. 3 (Alignment of Board, CEO, Management and Shareholder Interests) acts as an ‘umbrella’ or ‘guiding’ principle over Governance Factors with the exception of the Compliance Factor No. 2 (Corporate Governance and Legal Compliance). This would include the Stakeholders Factor No. 6 - Identification, Participation and Protection of Stakeholder Interests. Where, however, the relational approach is in stakeholder mode as presented in Figure 2.7.2B, shareholder interests do not necessarily rank above those of other non-shareholder-stakeholders and so the Alignment Factor No. 3 will not dominate over the Stakeholders Factor No. 6.

An alternative approach to determine or set the mode of the relational approach would be to have, as the only ‘umbrella’ principle ranking above other Governance Factors, the Compliance Factor No. 2. Theoretically, this would represent the ‘neutral mode’ of the relational approach. Where the relational approach is to reflect, again theoretically, shareholder primacy mode, an additional weighting would be accorded to the Alignment Factor No. 3 in the Coverage Table and (consequently) the Relational Proximity Table.

The precise additional weighting to be accorded to the Alignment Factor No. 3 in such a case would be determined by further empirical investigation. In the case of stakeholder mode, both the Alignment Factor No. 3 and the Stakeholders Factor No. 6 would be accorded the relevant additional weighting (which may not necessarily be equivalent) in the Coverage Table and the Relational Proximity Table.

50 See discussion in section 2.7.1 and Shareholder Primacy Interrelationship Scheme Figure 2.7.2A of chapter 2.
51 See discussion in section 2.7.1 and Stakeholder Model Interrelationship Scheme Figure 2.7.2B of chapter 2.
**Multiple Relational Effect Paths**

Of course, a large number of interrelationships or interactions between Governance Variables – both direct and indirect – can be conceived and constructed from the Interrelationship Schemes. Again due to considerations of size, the thesis has presented a single relational effect path for each Governance Variable. This is hypothesised to be the most direct pathway or zone of effect of Governance Factors based on the starting point which was determined by the empirical studies in Key Field No. 4.

In future stages of the relational approach based on empirical testing, it will be possible to devise multiple relational effect paths for the same Governance Variable. This means not just the most direct pathway but others revealed in these empirical studies. These paths will not necessarily take in as many or the same Governance Factors. Additionally, the order in which the Governance Factors are affected may affect the strength of the effect. This will enhance the explanatory and predictive power of the relational approach as the relational proximity Rating of a Governance Variable will reflect the sum total of its multiple pathways.

**11.6 Concluding Remarks for the Thesis**

Much earlier than the GFC, corporate collapses such as those of Enron and WorldCom in the US and HIH Insurance in Australia, culminating in measures such as the US’s Sarbanes-Oxley Act of 2002 and the New York Stock Exchange Corporate Governance Rules of 2003, had already put governance practices under the microscope. Consequently, a large body of legal, economic and econometric literature has grown examining developments in corporate Governance Codes and their constituent individual Governance Variables.

The thesis has presented a new unifying theme to complement and enhance the explanatory power of the existing principal ‘law and economics’ theories and models of the firm. The relational corporate governance approach presented in this thesis is akin to a ‘governance version’ of the Human Genome Project. It has evaluated and mapped on a ‘first principles’ basis the nature, operation, effect and, consequently, the relative importance of 39 of the myriad of corporate Governance Variables which arise in international and national corporate governance best practice and discourse. In this thesis, the approach is primarily orientated to the Anglo-American model of corporate governance but with the capacity for – in the future - ultimate comparative relevance to ‘continental’ systems.

Relational corporate governance is the construction of various theoretical components and operational tables to weigh competing interests which (in their simplest form) primarily involve those ‘inside’ the corporation (directors, CEO and management) and those ‘outside’ (shareholders, employees, lenders and other external stakeholders such as regulators and social interests).

To make hypotheses in relation to the relative importance of individual Governance Variables in enhancing or reducing the long-term efficiency and sustainability of the corporation, the thesis has constructed a Weighing Mechanism comprised of three theoretical components. First, the Three Relational Axes of Good Governance act like a set of scales to theoretically ‘weigh’ the competing objectives, behaviours and positional conflict of those ‘inside’ the corporation and those ‘outside’. Second, the thesis identified a set of eight Governance Factors which are the eight most common or recurring themes in this approach’s ‘landscape’ or
representation of the real-world sphere of corporate governance. Thirdly, the thesis constructed two Interrelationship Schemes or diagrams of the hypothesised interrelationships between these Governance Factors. To do so, the thesis analysed four Key Fields of corporate governance research – the pre-eminent theories of the firm, Enron corporate collapse literature, international and national Governance Codes and empirical studies of the effectiveness of Governance Variables in affecting shareholder-wealth measures.

The Interrelationship Schemes identify the effects (positive, negative or both) of the Governance Variables on the ‘enhancement’ or ‘diminution’ of the themes represented in each Governance Factor. In many cases, the views of authors and commentators as to the effect of the Governance Variables on shareholder-wealth measures are conflicting or limited in scope to less than the full number of Governance Factors. In such cases, the thesis has reconciled or extended these studies using the Interrelationship Schemes to determine the hypothetical or normative effects of the Governance Variables on the relevant Governance Factors and to find the starting point of the relational effect paths.

The number and direction of the Governance Factors affected by a Governance Variable comprises the Coverage of that Governance Factor. This is in turn converted to a proportion known as that Governance Variable’s relational proximity Rating. This Rating reflects the relative importance of the individual Governance Variables in affecting (positively or negatively) agency costs and, separately, enhancing or reducing the long-term efficiency and sustainability of the Anglo-American for-profit corporation.

The thesis has demonstrated that the relational approach may be used as a tool to complement and enhance the explanatory power of the existing principal ‘law and economics’ theories and models of the firm, to map the effectiveness of corporate Governance Variables in use in corporate Governance Codes around the world and to assess reform proposals in the field. It is proposed that, in the future, the relational approach will be econometrically and computer modelled and empirically tested. Over time, the components comprised in the Relational Corporate Governance Framework - in particular, those at the base of its pyramid structure and referred to as Key Fields - may thus be expanded to approximate in more detail the sphere of corporate governance best practice and discourse.
APPENDIX A1:

GLOSSARY OF RELATIONAL CORPORATE GOVERNANCE APPROACH TERMS AND COMPONENTS

This Glossary is an introduction - intended for ongoing reference by the reader - to the principal theoretical and operational (in-practice) terms and components of the Relational Corporate Governance Approach. The theoretical components of the relational approach are introduced and constructed in chapters 1 – 2. The operational results are displayed in the Coverage Table 3.3.1 and the Relational Proximity Table 3.3.2.1 of chapter 3.

The approach is built from an artificial environment that simulates the real world sphere of corporate governance and is comprised of the four Key Fields:

No. 1 Application of Principal Theories of the Firm to the Relational Approach (chapter 4)

No. 2 Autopsies of the Enron and Hastie Corporate Collapses (chapter 5)

No.3 Comparative Corporate Governance Codes (chapter 6)

No. 4 Empirical Studies of the Effectiveness of Governance Variables (chapters 7 -10)

In this Glossary, terms appearing in **bold** type in the definition or explanation section are themselves defined elsewhere in this Glossary.
### Glossary of Relational Corporate Governance Approach Terms and Components

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition or Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Behaviours Axis No. 2</td>
<td>Behaviours Axis No. 2: “entrepreneurism” and “innovation” (risk-taking) are balanced against risk management, “control” and “accountability” (responsibility). See the Three Relational Axes of Good Governance and the Weighing Mechanism.</td>
</tr>
<tr>
<td>Commonality</td>
<td>The process of identifying the core or central features of a number of Governance Codes within a sector (global, US, UK and Australia) and across sectors by the recurrence of Governance Variables in those Codes. See sections 6.1.1-2 of chapter 6.</td>
</tr>
<tr>
<td>Commonality Table</td>
<td>The list of recurring Governance Variables within a sector (global, US, UK and Australia) and across sectors. See Tables 6.2.3.1 (global); 6.4.2.1 (US) and 6.5.1.1 (UK). There is no Commonality Table for the Australian sector – see section 6.6.1 of chapter 6.</td>
</tr>
<tr>
<td>Enron corporate collapse</td>
<td>See Key Field No. 2 (chapter 5).</td>
</tr>
<tr>
<td>Coverage of a Governance Variable</td>
<td>This is the first of two operational tables of the relational corporate governance approach presented in this thesis. The relational effect path of each Governance Variable describes what this thesis submits is a predicted or hypothesised interrelationship directly or indirectly between each Governance Variable and one or more of the eight Governance Factors (the recurring themes and tensions underlying corporate governance). The description of, and results displayed for, each relational effect path are summarised in this Coverage Table. The summarised results are known as that Governance Variable’s ‘Coverage’. This Coverage is the number of Governance Factors affected, and the direction of effect (positive or negative), by each Governance Variable. The results of the Coverage of a Governance Variable set out in the Coverage Table are then converted into a numerical rating (known as the relational proximity Rating or rprox of a Governance Variable) in the Relational Proximity Table 3.3.2.1.</td>
</tr>
<tr>
<td>Coverage Table 3.3.1</td>
<td>This is a comparative table or scheme used to compare across sectors and over time the Governance Variables utilised in the major International/cross-border and US, UK and Australian Governance Codes. A Governance Code Table for each of these sectors is contained in chapter 6.</td>
</tr>
<tr>
<td>Governance Codes</td>
<td>The international (OECD, ICGN and CACG) and national (US, UK and Australian) corporate governance codes, statutes, schemes and directives of best practice listed in Table 6.1.4 that mandate, prescribe or recommend (as the case may be) the adoption of Governance Variables by a corporation. See Key Field No. 3 in chapter 6. The ‘core’ or ‘central’ features of these Codes are described in section 6.8.1 of chapter 6.</td>
</tr>
<tr>
<td>Governance Code Table</td>
<td>These Factors are themes this thesis submits are the eight most significant or principal recurring aims, themes and tensions underlying or arising from the collective ‘sphere’ of the four Key Fields – (1) the application of the principal theories of the firm to the relational approach; (2) autopsies of the Enron and Hastie corporate collapses; (3) comparative corporate Governance Codes and (4) empirical studies of the effectiveness of Governance Variables. See section 1.7.1 of chapter 1 for the eight Governance Factors which are discussed in sections 2.6.1 – 2.6.8 of chapter 2:</td>
</tr>
</tbody>
</table>

| Coverage | The process of identifying the core or central features of a number of Governance Codes within a sector (global, US, UK and Australia) and across sectors by the recurrence of Governance Variables in those Codes. See sections 6.1.1-2 of chapter 6. |
No. 1 Reporting Factor and Other Reports; - Transparency, Timing and Integrity of Financial
No. 2 Compliance Factor - Corporate Governance and Legal Compliance:
No. 3 Alignment Factor - Alignment of Management and Shareholder
Interests;
No. 4 Compensation Factor - Board, CEO and Management Compensation and
Incentives;
No. 5 Monitoring & Audit Factor - Internal and External/Audit Monitoring Quality;
No. 6 Stakeholders Factor - Identification, Participation and Protection of
Stakeholder Interests;
No. 7 Decision-making Factor - Quality of Board, CEO and Management
Decision-making; and
No. 8 Responsibility Factor - Delineation and Disclosure of Powers, Duties and
Lines of Responsibility.

The eight Governance Factors form part of the Weighing Mechanism of the relational
approach. See section 2.1 of chapter 2 and section 4.2 of chapter 4.

Governance Variables

The governance and management structures, mechanisms, processes and protocols which
are employed by a corporation to punish or deter management misconduct, to align the
interests of corporate ‘insiders’ such as the directors, CEO and management with
‘outsiders’ such as widely-dispersed shareholders and to otherwise reduce agency costs
and other shareholder value-reducing managerial behaviour or actions. In the real-world
sphere of corporate governance, Governance Variables may be found in the multitude of
international and national Governance Codes operating in the world today.

The 39 Governance Variables examined in this thesis are set out in Table 2.4 of chapter
2. They are described in brief in Appendix A2, Glossary of Governance Variables.
Empirical and other studies relating to the effectiveness of these Variables are examined in
chapters 7 – 10.

Interrelationship Schemes

These are the two (2) diagrams of hypothesised or predicted interrelationships between the
eight Governance Factors. Thus, in turn, the Interrelationship Schemes represent the
hypothesised or predicted interrelationships between the four Key Fields and the 39
Governance Variables to which the Fields give rise. There are two Scheme diagrams.
The first represents the hypothesised or predicted interrelationships between the
Governance Factors (and thus the Governance Variables) under the rubric of the
‘shareholder’ (primacy) model of corporate governance and its associated shareholder
wealth-maximisation principle. See Shareholder Primacy Interrelationship Scheme in
Figure 2.7.2A.

The second Interrelationship Scheme represents these interrelationships under the
‘stakeholder’ model. See Stakeholder Model Interrelationship Scheme in Figure
2.7.2B.

The Interrelationship Schemes identify the number of Governance Factors affected by a
Governance Variable and the direction of effect. The Schemes are used in conjunction
with the empirical studies in chapters 7 - 10 to construct a relational effect path for that
Governance Variable.

Key Fields

Four ‘fields’ or ‘areas’ of inquiry or examination which this thesis submits are the four most
significant or principal in terms of the volume of studies (on the Social Science Research
Network or SSRN) and impact in the sphere of corporate governance best practice study
and discourse. See section 1.3.2.

The four Key Fields comprise:
No. 1: The application of the principal theories of the firm to the relational approach
(chapter 4);
No. 2: ‘Autopsies’ of the Enron and Hastie corporate collapses (chapter 5);
No. 3: Comparative corporate Governance Codes (chapter 6); and No. 4: Empirical studies of the effectiveness of Governance Variables (chapters 7-10).

The Key Fields form the base of the pyramid-like structure of the relational approach known as the Relational Corporate Governance Framework. See Figure 2.8. Thus, all theoretical and operational components of the relational approach are ultimately drawn from the four Key Fields.

Key Field No. 1
The application of the principal and currently pre-eminent theories and models of the firm to the relational approach. These comprise the ‘nexus of contracts’, ‘agency’ (costs) theory, the ‘shareholder’ (primacy) model and its associated shareholder wealth-maximisation principle, the ‘stakeholder’ model and the ‘director primacy’ model. See chapter 4.

Key Field No. 2
Autopsies of the Enron and Hastie Group corporate collapses. This is comprised of literature and studies relating to the Enron corporate collapse which seek to catalogue relevant Governance Variable failings surrounding that collapse. The Enron corporate collapse is compared to the collapse of the Hastie Group detailed in the Administrators’ Report under section 439A of the Corporations Act. See chapter 5.

Key Field No. 3
Comparative Corporate Governance Codes. The international (OECD, ICGN and CACG) and national (US, UK and Australian) corporate Governance Codes, statutes, schemes and directives of best practice listed in Table 6.1.4. See chapter 6.

Key Field No. 4
Empirical field studies of the effectiveness of Governance Variables in reducing (increasing) agency costs and enhancing (reducing) the long-term efficiency and survival/sustainability of the for-profit corporation. These aims are usually measured by proxies for shareholder wealth including the firm cost of capital, firm value/share price and firm operating performance. This Field includes studies of the strength of the national shareholder protection regime. This Field comprises the largest of the Key Fields and is examined in detail in chapters 7-10.

NYSE Summary Table
(Appendix C4)
This Table in Appendix C4 examines the ‘downstream’ effects of the US Sarbannes-Oxley Act of 2002 (‘SOX’). These are the themes and tensions underpinning the ‘core’ NYSE Final Rules variables (i.e., the core Governance Variables of US corporate governance that are contained in or taken from the NYSE Final Rules). The content of these Rules is presented in table form for the purpose of the construction of the Three Relational Axes of Good Governance in sections 2.3.1 – 2.3.3 and the Governance Factors in sections 2.6.1 – 2.6.8. See Appendix C4.

See also New York Stock Exchange, Final NYSE Corporate Governance Rules, approved by SEC 4 November 2003 (except s 303A.08) and 30 June 2003 (s 303A.08). The Rules (as amended from time to time) comprise section 303A.00 of the NYSE Listed Company Manual. See section 303A.00 Corporate Governance Standards (approved 25 November 2009), available at http://nysemanual.nyse.com/lcm/ (accessed 19 November 2012), (‘NYSE Final Rules’).

Objectives Axis No. 1
[Objectives Axis No. 1]: the freedom of a company’s management to pursue (profit-maximising) objectives (value enhancement) at one end is balanced against the interests of the shareholders (owners) in monitoring management’s performance (performance assessment and reporting) and seeing that a company’s resources are not dissipated (value preservation);

See the Three Relational Axes of Good Governance and the Weighing Mechanism.

Positional Conflict Axis No. 3
[Positional Conflict Axis No. 3]: the interests of those ‘within’ the company such as the board, CEO and management (internal stakeholders) are balanced against the interests of those ‘outside’ the company such as shareholders, employees, lenders, suppliers, government legislators and regulators and social interests including the environment and the general public (external stakeholders).
See the **Three Relational Axes of Good Governance** and the **Weighing Mechanism**.

| Relational Corporate Governance Approach | This is the approach introduced in this thesis and defined in chapter 1 as the examination and evaluation of the interrelationships between individual governance structures, mechanisms, processes and protocols (Governance Variables) that seek to minimise or avoid (or, contrastingly, increase) agency costs between economic actors ‘inside’ and ‘outside’ the for-profit corporation. This concept is further examined in chapter 4 as giving rise to the theoretical Weighing Mechanism of the relational approach - the **Three Relational Axes of Good Governance**, the eight Governance Factors and the two Interrelationship Schemes. The Interrelationship Schemes identify the number of Governance Factors affected by a Governance Variable and the direction of effect. The Schemes are used in conjunction with the empirical studies in chapters 7 - 10 to construct a relational effect path for that Governance Variable. The rationale of relational corporate governance is that the interrelationships between Governance Variables and their effects (whether positive or negative) on such agency costs affects the long-term efficiency and survival/sustainability of the firm. If these interrelationships can be better understood, then the thesis hypothesises or predicts that the relative importance of Governance Variables *inter se* in reducing (or increasing) these agency costs and enhancing (or reducing) shareholder welfare (measured by proxies for shareholder wealth such as firm cost of capital, firm value/share price and firm operating performance) can be determined or predicted with better confidence. The hypothesised or predicted effects on these agency cost and shareholder welfare measures, in turn, permits determinations and predictions to be made in relation to the long-term efficiency and survival/sustainability of the corporation. |
| Relational Corporate Governance Framework | This is the diagram in Figure 2.8 which brings together all the theoretical components of the Relational Corporate Governance Approach. |
| relational proximity Rating or $r_{prox}$ | Numerical rating scale from 0.00 to a maximum of +/- 100.00 units abbreviated as $r_{prox}$. This is displayed in the **Relational Proximity Table 3.3.2.1**. The relational proximity Rating or $r_{prox}$ is determined by converting the ‘Coverage’ of a Governance Variable from the Coverage Table 3.3.1. This Rating may be positive (+) or negative (-). A positive rating represents a hypothesis or prediction by the thesis that the relevant Governance Variable reduces agency costs and enhances the long-term efficiency and survival/sustainability of the firm as determined by proxies for shareholder welfare/wealth such as firm cost of capital, firm value/share price and firm operating performance. A negative rating represents the opposite effect on these measures. Thus, the relational proximity Rating represents the relative importance (also referred to as ‘centrality’) of that Governance Variable *(vis-à-vis other Governance Variables)* in reducing (or increasing) agency costs and enhancing (or reducing) the long-term efficiency and survival/sustainability of the firm. In the Relational Proximity Table 3.3.2.1, Governance Variables are depicted in groupings of identical hypothesised or predicted relative importance. |
| Relational Proximity Table 3.3.2.1 | This is the ultimate operational table of the thesis and represents the results of the relational corporate governance approach. The penultimate table, the Coverage Table 3.3.2.1, illustrates the identity and number of the eight Governance Factors (the recurring themes and tensions underlying corporate governance) affected or influenced by each Governance Variable and the direction (positive or negative) of that effect – this result is known as the ‘Coverage’ of that Governance Variable. This Coverage measure is then converted into the relational proximity Rating of that Governance Variable in the Relational Proximity Table. This Rating is a proportion expressed as a number on a scale from 0 to a maximum of +/- 100.00 units known as $r_{prox}$. The Relational Proximity Table ‘groups’ Governance... |
Variables in descending order of relative importance in reducing (or increasing) agency costs and enhancing (or reducing) the long-term efficiency and survival/sustainability of the firm.

relative importance of a Governance Variable

See relational proximity Rating or rprox.

Shareholder Primacy Interrelationship Scheme

See Interrelationship Schemes and Figure 2.7.2A of chapter 2.

SOX Summary Table (Appendix C2)

In the SOX Summary Table, the thesis highlights the themes and tensions underpinning the reforms contained in the US’ Sarbannes-Oxley Act of 2002. The content of these reforms is presented in table form for the purpose of the construction of the Three Relational Axes of Good Governance in sections 2.3.1 – 2.3.3 and the Governance Factors in sections 2.6.1 – 2.6.8. See Appendix C2.


Stakeholder Model Interrelationship Scheme

See Interrelationship Schemes and Figure 2.7.2B of chapter 2.

survival or sustainability of the firm

This concept is represented by ‘proxy’ or ‘substitute’ measures for (usually) shareholder welfare or wealth such as, most commonly, firm cost of capital, firm operating performance and firm value/share price (see chapters 7, 8 and 10). The concept is also measured by the likelihood of earnings manipulation or management (see chapter 9). If these proxy measures can be maintained, improved and optimised over the long-run time-frame then, all other things being equal, the corporation will continue as a ‘going concern’ or financially viable entity.

Three Relational Axes of Good Governance

This is the first of three components of the theoretical Weighing Mechanism of the relational approach. See sections 2.3.1 – 2.3.3.

The Three Relational Axes of Good Governance act like a ‘set of scales’ to theoretically weigh the aims/objectives (Objectives Axis No. 1), behaviours (Behaviours Axis No. 2) and interests (Positional Conflict Axis No. 3) of ‘insiders’ and ‘outsiders’ of the corporation and is defined as follows:

[Objectives Axis No. 1]: the freedom of a company’s management to pursue (profit-maximising) objectives (value enhancement) at one end is balanced against the interests of the shareholders (owners) in monitoring management’s performance (performance assessment and reporting) and seeing that a company’s resources are not dissipated (value preservation);

[Behaviours Axis No. 2]: “entrepreneurism” and “innovation” (risk-taking) are balanced against risk management, “control” and “accountability” (responsibility); and

[Positional Conflict Axis No. 3]: the interests of those ‘within’ the company such as the board, CEO and management (internal stakeholders) are balanced against the interests of those ‘outside’ the company such as shareholders, employees, lenders, suppliers, government legislators and regulators and social interests including the environment and the general public (external stakeholders).

The recurring themes and tensions underpinning corporate governance discourse and
The Weighing Mechanism of the relational approach is a theoretical component comprised of three parts - the **Three Relational Axes of Good Governance**, the eight **Governance Factors** and the two **Interrelationship Schemes**. It is depicted in Figure 4.2 and is the theoretical representation of the intersection of the voluntary ‘obligations’ comprising the nexus of contracts theory of the firm.

The Weighing Mechanism undertakes a theoretical or hypothetical ‘weighing’ exercise to depict – descriptively and diagrammatically – the themes and considerations relevant to the competing or opposing interests of ‘insiders’ and ‘outsiders’ of the corporation. In short, the eight Governance Factors are ‘weighed’ in the Three Relational Axes of Good Governance which acts like a set of scales to weigh the often competing aims or objectives (Objectives Axis No. 1), behaviours (Behaviours Axis No. 2) and interests (Positional Conflict Axis No. 3) of ‘insiders’ and ‘outsiders’ of the corporation. The results of this weighing process are already calculated and presented for the reader – these are the two Interrelationship Schemes in Figures 2.7.2A (for the Shareholder primacy model) and 2.7.2B (for the stakeholder model). These Schemes are the two diagrams of hypothesised or predicted interrelationships between the eight Governance Factors. Thus, in turn, the Interrelationship Schemes represent the hypothesised or predicted interrelationships between the four **Key Fields** and the 39 **Governance Variables** to which the Fields give rise. See sections 2.1 and 4.2.
APPENDIX A2:

GLOSSARY OF GOVERNANCE VARIABLES

Column 2 of this Glossary contains the names of the 39 corporate governance and management mechanisms, structures, processes and protocols examined by the thesis and known as **Governance Variables**. As is the practice in many ‘multi-variable’ studies, the Governance Variables are abbreviated in alphabetical order in Column 3. For ease of identification, the relevant abbreviations will appear in square parentheses “[    ]” throughout the thesis. This Appendix is tabbed for on-going reference by the reader.

The nature, operation and effect of the individual Governance Variables is examined in detail in **Key Field No. 4 – Empirical Studies of the Effectiveness of Governance Variables** in chapters 7 - 10. Column 5 contains the reference in the thesis to the discussion of the relevant **relational effect path** of that Governance Variable.

**Glossary of Governance Variables**

<table>
<thead>
<tr>
<th>No.</th>
<th>Governance Variable</th>
<th>Abbreviation (Alphabetical)</th>
<th>Description</th>
<th>Relational Effect Path</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Audit Committee – Accounting Expertise – Earnings Manipulation Reduction Effect</td>
<td>AudAccEarn (+)</td>
<td>The presence of one or more audit committee members with financial expertise of an <strong>accounting</strong> nature vis-à-vis other forms of financial expertise. This variable measures the predicted reduction or fall in earnings manipulation or management as a result of that accounting expertise.</td>
<td>9.2.1.1.2</td>
</tr>
<tr>
<td>2.</td>
<td>Audit Committee - Presence, Operation and Frequency</td>
<td>AudCom (+)</td>
<td>The basic matters pertaining to the audit committee of the board of directors. These include principally its (usually mandated) existence, basic structure, performance of its functions and responsibilities and number of meetings or time in review.</td>
<td>8.4.2</td>
</tr>
<tr>
<td>3.</td>
<td>Audit Committee - Financial Expertise (Accounting)</td>
<td>AudExpAcc (+)</td>
<td>The presence of one or more audit committee members with financial expertise of an <strong>accounting</strong> nature vis-à-vis other forms of financial expertise. This variable measures the predicted increase in firm value and operating performance as a result of that accounting expertise.</td>
<td>8.4.4</td>
</tr>
<tr>
<td>4.</td>
<td>Audit Committee - Non-Accounting Expertise - ‘Free Rider’ Effect</td>
<td>AudFree (-)</td>
<td>The presence of one or more audit committee members <strong>without</strong> accounting expertise. This variable tests whether such members ‘free-ride’ or become ‘less vigilant’1 because of reliance on other committee members - i.e., the suggestion that non-accounting members may lack the necessary expertise to understand complex accounting issues and may rely excessively on ‘accounting-expertise’ members to carry out the monitoring function of the committee without adding sufficient additional skills.</td>
<td>9.2.1.1.2</td>
</tr>
</tbody>
</table>

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>5.</td>
<td>Audit Committee – Independence in Combination with Frequency of Meeting – Reduction in Earnings Manipulation Effect</td>
<td><strong>AudIndFreq</strong> (+)</td>
</tr>
<tr>
<td>6.</td>
<td>Audit Committee - Independence - Information Flow and Decision Quality ‘Trade-off’</td>
<td><strong>AudIndInfo</strong> (-)</td>
</tr>
<tr>
<td>7.</td>
<td>Audit Committee - Independence – Monitoring Effect</td>
<td><strong>AudIndMon</strong> (+)</td>
</tr>
<tr>
<td>8.</td>
<td>Audit Committee – Short Term Options Granted to Outside Directors – Reduction in Monitoring Effect</td>
<td><strong>AudShortOpts</strong> (-)</td>
</tr>
<tr>
<td>9.</td>
<td>Block Shareholding – Other Shareholder Agency Costs</td>
<td><strong>BlockCosts</strong> (-)</td>
</tr>
<tr>
<td>10.</td>
<td>Block Shareholding – Monitoring Effect</td>
<td><strong>BlockMon</strong> (+)</td>
</tr>
<tr>
<td>11.</td>
<td>Board – Attendance Level (High)</td>
<td><strong>BrdAttend</strong> (+)</td>
</tr>
<tr>
<td>12.</td>
<td>Board and Committee (Non-Audit) Size – Earnings Manipulation Effect</td>
<td><strong>BrdCmEarn</strong> (+/-)</td>
</tr>
<tr>
<td></td>
<td>Description</td>
<td>Code</td>
</tr>
<tr>
<td>---</td>
<td>-----------------------------------------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>13.</td>
<td>Board and Committee Size</td>
<td>BrdCmSize (+/-)</td>
</tr>
<tr>
<td>14.</td>
<td>Board Independent Director: Executive Director Proportion – Information Flow and Decision Quality 'Trade-off'</td>
<td>BrdIndInfo (-)</td>
</tr>
<tr>
<td>15.</td>
<td>Board Independent Director: Executive Director Proportion – Monitoring Effect</td>
<td>BrdIndMon (+)</td>
</tr>
<tr>
<td>16.</td>
<td>Board – Annual Review</td>
<td>BrdReview (+)</td>
</tr>
<tr>
<td>17.</td>
<td>Board – Director Skills 'Mix'</td>
<td>BrdSkills (+)</td>
</tr>
<tr>
<td>18.</td>
<td>Compensation Committee - Presence, Operation and Frequency</td>
<td>CompCom (+/-)</td>
</tr>
<tr>
<td>19.</td>
<td>Director/CEO Compensation Levels</td>
<td>DirCEOS (+/-)</td>
</tr>
<tr>
<td>20.</td>
<td>Duality of CEO/Chair Positions – CEO Dismissal Probability</td>
<td>DualDismiss (-)</td>
</tr>
<tr>
<td>21.</td>
<td>Duality of CEO/Chair Positions – Probability of Earnings</td>
<td>DualEarn (-)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>Manipulation consequent on combining these roles.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>22.</td>
<td>Duality of CEO/Chair Positions – Effect on Strategic Decision-making</td>
<td>DualStrat (+)</td>
</tr>
<tr>
<td>23.</td>
<td>Duality of CEO/Chair Positions – Monitoring and Decision-Quality ‘Trade-off’</td>
<td>DualTrade (+/-)</td>
</tr>
<tr>
<td>24.</td>
<td>Equity/Option Plans and Holdings of Directors/Executives – Incentive/‘Alignment’ Effect (excludes short-term options)</td>
<td>EqOptIncent (+)</td>
</tr>
<tr>
<td>25.</td>
<td>Equity/Option Plans and Holdings of Directors/Executives – ‘Entrenchment’ Effect (excludes short-term options)</td>
<td>EqOptEntrch (-)</td>
</tr>
<tr>
<td>26.</td>
<td>External/Independent Audit Function</td>
<td>ExtAudEarn (+)</td>
</tr>
<tr>
<td>27.</td>
<td>National Governance/Shareholder Protection Regime</td>
<td>NationGov (+)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>No.</th>
<th>Variable Description</th>
<th>Notes</th>
<th>References</th>
</tr>
</thead>
<tbody>
<tr>
<td>28.</td>
<td>Nominating Committee - Presence, Operation and Frequency</td>
<td><strong>NomCom (+/-)</strong></td>
<td>The basic matters pertaining to the nominating committee of the board of directors. These include principally its existence, basic structure, performance of its functions and responsibilities and number of meetings.</td>
</tr>
<tr>
<td>29.</td>
<td>Nominating Committee – Independence Proportion</td>
<td><strong>NomInd (+)</strong></td>
<td>This variable tests for the effects of the number or proportion of members of the nominating committee who are outside or independent directors.</td>
</tr>
<tr>
<td>30.</td>
<td>Non-Audit Services of External Auditor</td>
<td><strong>NonAuditS (-)</strong></td>
<td>This variable tests whether the provision of non-audit services by the firm conducting the company's annual external audit reduces the independence of the auditor and the consequences (if any) for earnings manipulation or management and restatements.</td>
</tr>
<tr>
<td>31.</td>
<td>Other Anti-Takeover Mechanisms (excludes staggered board elections)</td>
<td><strong>OtherATMs (-)</strong></td>
<td>The effect of anti-takeover mechanisms (other than staggered board elections) on the (argued) disciplining and management replacement effects of the market for corporate control with the effect that management may become 'entrenched'. The consequences of such entrenchment may increase agency costs for 'outside' widely-dispersed shareholders due to the directors, CEO and/or executives engaging in management misconduct (such as 'shirking', empire-building, overcompensation and over-consumption of 'perks') and other value-reducing behaviours.</td>
</tr>
<tr>
<td>32.</td>
<td>Outside Board Positions of Independent Directors</td>
<td><strong>OutBrdPos (-)</strong></td>
<td>The number of board positions on other companies and organisations held by the independent or outside directors. This variable tests whether there is a reduction in the quality of monitoring of the CEO and management by such directors or whether such directors ‘shirk’ responsibilities such as serving on committees.</td>
</tr>
<tr>
<td>33.</td>
<td>Outside/External Board Advisers</td>
<td><strong>OutBrdAdv (+)</strong></td>
<td>Whether the board or its committees engage outside or independent advisers, experts or consultants to advise the board in relation to particular financial, operational, risk management and other matters requiring the relevant expertise and the effects of such a practice.</td>
</tr>
<tr>
<td>34.</td>
<td>Reputational Constraints – ‘Disclosure Standards’</td>
<td><strong>ReputDiscl (+)</strong></td>
<td>‘Reputational constraints’ are consequences of and signals to inside and outside markets for decision agents for individual directors, CEOs and managers relating to the performance of those ‘insider’ actors that assist or accompany the (argued) disciplining and replacement effects of the market for corporate control. Such reputational constraints are argued to act to restrict or dissuade directors, CEOs and managers from engaging in management misconduct and like value-reducing behaviours.</td>
</tr>
</tbody>
</table>

---

3 Ibid.
behaviours as well as constraining the level of executive compensation. The operation of such constraints is argued to be partly dependent on appropriate and adequate 'disclosure standards' existing in (and set by) the relevant statutory and regulatory regime.

| 35. | Reputational Constraints – 'Transparent Reporting' | ReputRep (+) | As for the preceding [ReputDiscl] variable, the operation of reputational constraints is argued to be partly dependent on circumstances and governance variables, affecting ‘transparent reporting’. |
| 36. | Staggered Board Elections | StagBrdElect (-) | The effect of staggered board elections (an anti-takeover mechanism) in which only a proportion of directors (i.e., less than the full board) is open to re-election at a particular annual meeting of shareholders. In particular, the effects of such elections on the (argued) disciplining and management replacement effects of the market for corporate control with the effect that management may become 'entrenched'. The consequences of such entrenchment may increase agency costs for 'outside' widely-dispersed shareholders due to the directors, CEO and/or executives engaging in management misconduct (such as 'shirking', empire-building, overcompensation and over-consumption of 'perks') and other value-reducing behaviours. |
| 37. | Short-Term Option Holdings/Plans of Directors and Executives | ShortTOpts (-) | This variable is related to the [EqOptIncent] and [EqOptEntrch] variables both of which exclude a consideration of short-term options. This variable relates to the level or amount of director, CEO and executive compensation in the form of short-term options. The variable tests the relationship (if any) between the nature and levels of this compensation and matters such as agency costs, the quality of decision-making, monitoring of the CEO and management and the manipulation or management of earnings. |
| 38. | Transparency and Timing of Reporting – Monitoring Effect | TransTimeMon (+) | This variable tests the principal aim of reporting – the reduction of agency costs associated with problems of 'information asymmetry' between insiders such as the directors, CEO and management and 'outside' widely-dispersed shareholders. In particular, the variable examines the effects of improvements in the transparency, integrity and timing of financial and other reports on enhancing the monitoring of the CEO and management. |
| 39. | Transparency and Timing of Reporting – Information Flow Reduction Effect | TransTimeRedn (-) | This variable examines the opposite effect of the preceding [TransTimeMon] variable. It tests whether, instead of or at the same time as any (argued) improvements in the monitoring of management consequent on improvements |

---

7 Ibid, 20.
8 Ibid.
9 Ashbaugh-Skaife, Collins and LaFond, above n 2.
in the transparency and timing of reporting, there may be an increase in agency costs for outside widely-dispersed shareholders due to (again argued) negative effects on the quality of information flow from management to the board with consequential reductions in the quality of decision-making and monitoring of the CEO and management.
APPENDIX B:

ADDITIONAL REFERENCES FOR CHAPTERS 1 - 5

B1: The Operation and Efficacy of Corporate Governance Variables in the 2008 Global Financial Crisis

B2: Accounts of the Enron and Other Corporate Collapses


For an examination of the ‘share-centred view’ and movement to (at 779) a framework of “corporate managers as explicitly political participants in an explicitly political conflict over public values and private money”, see Daniel J H
B3: References on the Separation of Ownership from Management


B4: Discussion of Models of the Firm and Corporate Governance Theories

APPENDIX C:

ADDITIONAL REFERENCES AND TABLES FOR CHAPTERS 6 – 10

C1: Harmonisation or Convergence of Global and National Corporate Governance


C2: Summary of Content and Themes from SOX Reforms

In the following SOX Summary Table, the thesis highlights the themes and tensions underpinning the reforms contained in the US’ Sarbanes-Oxley Act of 2002. The content of these reforms is presented in table form for the purpose of the construction of the Three Relational Axes of Good Governance in sections 2.3.1 – 2.3.3 and the Governance Factors in sections 2.6.1 – 2.6.8. As much as is practicable, the description of the content of the Governance Variables has been taken from SOX itself:

SOX Summary Table: Summary of SOX Content and Themes

<table>
<thead>
<tr>
<th>No</th>
<th>SOX Section</th>
<th>Content of Governance Variables</th>
<th>Underpinning Theme/Rationale for Identification/Articulation of Three Relational Axes of Good Governance and Governance Factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>SOX Audit Sub-Committee and Financial Experts</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| 1.1 | 301 | • Audit Committee ‘directly responsible’ for appointment, compensation and oversight of external auditor  
• Audit committee also responsible for disagreements between auditor and management in relation to financial reporting | • Delineate line of responsibility and accountability:  
o Accountability and responsibility  
o Objectives Axis 1(b) and Behaviours Axis 2(b)  
o Responsibility Factor No. 8  
o Decision-making Factor No. 7  
• Enhance quality of monitoring of board, CEO and management:  
o Monitoring & Audit Factor No. 5  
o Alignment Factor No. 3 |
| 1.2 | 301 | • External auditor to report directly to Audit Committee | • Delineate line of responsibility and accountability:  
o Accountability and responsibility |

12 See section 1.7.1 of chapter 1 for the eight Governance Factors which are discussed in sections 2.6.1 – 2.6.8 of chapter 2.
• Enhance auditor independence (by reducing risk of management interference) and therefore quality of monitoring of auditor:
  o Monitoring & Audit Factor No. 5
  o Alignment Factor No. 3
• Enhance transparency, timing and integrity of reporting and reduce information asymmetry and agency costs:
  o Objectives Axis 1(b) and Behaviours Axis 2(b)
  o Reporting Factors No. 1 and Compliance Factor No. 2
  o Alignment Factor No. 3

1.3 301
• All members of Audit Committee to be independent directors
• Enhance quality of monitoring of board, CEO and management by reducing potential for management influence/interference:
  o Objectives Axis 1(b) and Behaviours Axis 2(b)
  o Monitoring & Audit Factor No. 5
  o Alignment Factor No. 3
• Enhance quality of board, CEO and management decision-making:
  o Decision-making Factor No. 7
  o Responsibility Factor No. 8

1.4 301
Audit Committee to establish procedures for:
• the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and
• the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.
• Enhance quality of monitoring of board, CEO and management:
  o Monitoring & Audit Factor No. 5
  o Alignment Factor No. 3
• Enhance transparency, timing and integrity of reporting:
  o Objectives Axis 1(b) and Behaviours Axis 2(b)
  o Reporting Factor No. 1
  o Compliance Factor No. 2
• Delineate line of responsibility and accountability:
  o Accountability and responsibility
  o Objectives Axis 1(b) and Behaviours Axis 2(b)
  o Responsibility Factor No. 8
  o Decision-making Factor No. 7
• Enhance quality of board, CEO and management decision making:
  o Decision-making Factor No. 7

1.5 301
Audit Committee to have the authority to engage independent counsel and other advisers to carry out its duties.
• Enhance quality of monitoring of board, CEO and management:
  o Monitoring & Audit Factor No. 5
• Enhance quality of board, CEO and management decision making:
  o Decision-making Factor No. 7
  o Responsibility Factor No. 8
| 1.6 | 806 | Civil action (including damages) for protection of ‘whistleblowers’ who provide information relating to fraud |
|     |     | • Enhance quality of monitoring of board, CEO and management by reducing potential for management influence/interference:  
  |     |   o Objectives Axis 1(b) and Behaviours Axis 2(b)  
  |     |   o Monitoring & Audit Factor No. 5  
  |     |   o Alignment Factor No. 3  
|     |     | • Delineate line of responsibility and accountability:  
  |     |   o Accountability and responsibility  
  |     |   o Objectives Axis 1(b) and Behaviours Axis 2(b)  
  |     |   o Responsibility Factor No. 8  
  |     |   o Decision-making Factor No. 7  
|     |     | • Enhance quality of monitoring of board, CEO and management by reducing potential for management influence/interference:  
  |     |   o Objectives Axis 1(b) and Behaviours Axis 2(b)  
  |     |   o Monitoring & Audit Factor No. 5  
  |     |   o Alignment Factor No. 3  

| 1.7 | 407 | Disclosure of Audit Committee Financial Expert – Issuer must disclose that Audit Committee includes at least one financial expert or give reasons why this is not the case |
|     |     | • Enhance quality of monitoring of board and management  
  |     |   o Monitoring & Audit Factor No. 5  
  |     |   o Alignment Factor No. 3  
|     |     | • Strengthen board and Audit Committee skills ‘mix’ and therefore enhance quality of board, CEO and management decision-making:  
  |     |   o Decision-making Factor No. 7  
  |     |   o Responsibility Factor No. 8  
|     |     | • Enhance transparency, timing and integrity of reporting and reduce information asymmetry and agency costs:  
  |     |   o Objectives Axis 1(b) and Behaviours Axis 2(b)  
  |     |   o Reporting Factor No. 1 and Compliance Factor No. 2  
  |     |   o Alignment factor No. 3  
|     |     | • Delineate line of responsibility and accountability:  
  |     |   o Accountability and responsibility  
  |     |   o Objectives Axis 1(b) and Behaviours Axis 2(b)  
  |     |   o Responsibility Factor No. 8  
  |     |   o Decision-making Factor No. 7  

### 2 SOX Reporting I – Responsibility for Accuracy of Financial Reports

| 2.1 | 302 | Certification of Annual/Quarterly Reports by CEO and CFO that:  
  |     |   • No material untrue/misleading statements/omissions;  
  |     |   • Fairly presents in all material respects the financial condition and results of operations  
|     |     | • Enhance transparency, timing and integrity of reporting:  
  |     |   o Reporting Factor No. 1  
  |     |   o Compliance Factor No. 2  
|     |     | • Enhance alignment of insiders with ‘outside’ shareholder interests |
| **Issuer;** | • Responsibility for establishing and maintaining internal controls and report on effectiveness of internal controls;  
• Report any material deficiencies in internal controls to auditors  
• Report indicates any significant changes in internal controls, including any corrective actions with regard to significant deficiencies and material weaknesses | o Alignment Factor No. 3  
o Positional Conflict Axes 3(a) and 3(b)  
• Reduce information asymmetry and agency costs  
  o Reporting Factor No. 1 and Alignment Factor No. 3  
• Delineate line of responsibility and accountability  
  o Responsibility Factor No. 8  
  o Decision-making Factor No. 7  
• Enhance risk management and control:  
  o Monitoring & Audit Factor No. 5  
  o Alignment Factor No. 3  
• Enhance quality of monitoring of management by the board (and by management itself)  
  o Monitoring & Audit Factor No. 5  
  o Alignment Factor No. 3  
• Delineate line of responsibility and accountability:  
  o Accountability and responsibility  
  o Objectives Axis 1(b) and Behaviours Axis 2(b)  
  o Responsibility Factor No. 8  
  o Decision-making Factor No. 7 |
|---|---|---|
| **2.2 304 If the Issuer prepares an accounting restatement due to material non-compliance by the Issuer, then the CEO/CFO are to reimburse bonuses, incentive payments, equity-based compensation and any trading profits from sale of securities** | • Delineate line of responsibility and accountability  
  o Accountability and responsibility  
  o Objectives Axis 1(b) and Behaviours Axis 2(b)  
  o Responsibility Factor No. 8  
  o Decision-making Factor No. 7  
  o Compensation Factor No. 4  
• Reduce incentive to distort earnings and hinder transparency  
  o Reporting Factor No. 1  
  o Compliance Factor No. 2  
  o Alignment Factor No. 3  
• Enhance transparency, timing and integrity of reporting and therefore reduce information asymmetry and agency costs:  
  o Reporting Factor No. 1 and Alignment Factor No. 3  
  o Positional Conflict Axes 3(a) and 3(b)  
• Balancing of management ‘alignment’ strategy  
  o Alignment Factor No. 3  
  o Compensation Factor No. 4  
  o Positional Conflict Axes 3(a) and 3(b)  
• Enhance risk management and control:  
  o Monitoring & Audit Factor No. 5  
  o Alignment Factor No. 3  
• Enhance quality of monitoring of management by the board (and by management itself)  
  o Monitoring & Audit Factor No. 5 |
### 3 SOX Reporting II – Transparency and Timing

| 3.1 |  | • Financial reports to reflect all material correcting adjustments that are identified by accounting firm |
| 3.2 |  | • Disclosure of all material off-balance sheet transactions, arrangements, obligations (including contingent obligations) and other relationships |
| 3.3 |  | • Pro-forma financial information:  
| | | o not to contain material untrue/misleading statements or omissions and  
| | | o must be reconciled to reported financial condition and results of Issuer |
| 3.4 |  | • Prohibition of loans to directors and executive officers – Unlawful for Issuer directly or indirectly to extend, maintain, arrange or renew an extension of credit in the form of a personal loan to any director or executive officer  
| | | (Exceptions for ordinary course of consumer credit business of Issuer, credit generally made available by Issuer to the public or credit on market terms no more favourable to general public) |

|  |  | • Enhance transparency, timing and integrity of reporting:  
| | | o Reporting Factor No. 1  
| | | o Compliance Factor No. 2  
| | | o Alignment Factor No. 3 |
|  |  | • Reduce information asymmetry and agency costs:  
| | | o Reporting Factor No. 1  
| | | o Compliance Factor No. 2  
| | | o Alignment Factor No. 3  
| | | o Positional Conflict Axes 3(a) and 3(b) |
|  |  | • Enhance risk management and control:  
| | | o Monitoring Factor No. 5  
| | | o Alignment Factor No. 3 |
|  |  | • Reduce risk of earnings manipulation  
| | | o Reporting Factor No. 1  
| | | o Compliance Factor No. 2  
| | | o Alignment Factor No. 3 |
|  |  | • Enhance quality of monitoring of management:  
| | | o Monitoring & Audit Factor No. 5  
| | | o Alignment Factor No. 3 |
|  |  | • Enhance director independence and reduce conflicts of interest  
| | | o Compensation Factor No. 4  
| | | o Alignment Factor No. 3 |
|  |  | • Enhance quality of board, CEO and management decision making:  
| | | o Decision-making Factor No. 7  
| | | o Responsibility Factor No. 7 |
|  |  | • Enhance director independence and therefore the quality of monitoring of the board, CEO and management:  
| | | o Monitoring & Audit Factor No. 5  
| | | o Alignment Factor No. 3 |
|  |  | • Reduce information asymmetry and agency costs:  
| | | o Reporting Factor No. 1  
| | | o Compliance Factor No. 2  
| | | o Alignment Factor No. 3  
| | | o Positional Conflict Axes 3(a) and 3(b) |
|  |  | • Enhance transparency, timing and integrity of reporting:  
| | | o Reporting Factor No. 1  
| | | o Compliance Factor No. 2  
| | | o Alignment Factor No. 3 |
|  |  | • Enhance value preservation:  
| | | o Objectives Axis No. 1(b) |
|  |  | • Enhance control and accountability:  
| | | o Behaviours Axis 2(b) |
### 3.5 403

- **Disclosure of transactions by directors, officers and principal stockholders regarding equity:**
  - Directors, officeholders and principal stockholders who directly/indirectly own more than 10% of any class of equity to file:
    - A statement of the amount of all equity of which the filing person is the beneficial owner
    - Any changes in such ownership
- **Reduce information asymmetry and agency costs:**
  - Reporting Factor No. 1
  - Compliance Factor No. 2
  - Alignment Factor No. 3
  - Positional Conflict Axes Nos. 3(a) and 3(b)
- **Enhance transparency, timing and integrity of reporting:**
  - Reporting Factor No. 1
  - Compliance Factor No. 2
- **Alert outsiders to conceivable increase in agency costs consequent on ‘block-holdings’:**
  - Alignment Factor No. 3
  - Positional Conflict Axes Nos. 3(a) and 3(b)
- **Enhance alignment of inside and outside interests:**
  - Alignment Factor No. 3
  - Compensation Factor No. 4

### 3.6 408

- **Enhanced review of Issuer disclosures by SEC especially in relation to:**
  - Material restatements of financial results
  - Significant volatility in stock price
  - Issuers with the largest market capitalisation
  - Emerging companies with disparities in price to earnings ratios
  - Issuers whose operations significantly affect any material sector of the economy
- **Reduce information asymmetry and agency costs:**
  - Reporting Factor No. 1
  - Compliance Factor No. 2
  - Alignment Factor No. 3
- **Enhance transparency, timing and integrity of reporting:**
  - Reporting Factor No. 1
- **Enhance risk management and control:**
  - Behaviours Axis 2(b)
- **Enhance Performance assessment and reporting:**
  - Objectives Axis No. 1(b)
- **Reduce risk of earnings manipulation:**
  - Reporting Factor No. 1
  - Alignment Factor No. 3
- **Enhance (external) monitoring of management:**
  - Monitoring & Audit Factor No. 5
  - Alignment Factor No. 3

### 3.7 409

- **‘Rapid and current’ disclosure of material changes in financial condition or operations of the Issuer**
- **Reduce information asymmetry and agency costs:**
  - Reporting Factor No. 1
  - Compliance Factor No. 2
  - Alignment Factor No. 3
- **Enhance transparency, timing and integrity of reporting:**
  - Reporting Factor No. 1
- **Enhance risk management and control:**
  - Behaviours Axis 2(b)
- **Enhance Performance assessment and reporting:**
  - Objectives Axis No. 1(b)
- **Reduce risk of earnings manipulation:**
  - Reporting Factor No. 1
  - Alignment Factor No. 3
- **Enhance (external) monitoring of management:**
### 4 SOX Earnings Manipulation I - Internal Controls and Finance Code of Ethics

#### 4.1 404
- Management Assessment of Internal Controls - ‘Internal control report’ to be included in Issuer’s annual report including:
  - Responsibility of management for establishing/maintaining an adequate internal control structure and procedures for financial reporting
  - Management assessment of effectiveness of internal controls
- Reduce information asymmetry and agency costs:
  - Reporting Factor No. 1
  - Compliance Factor No. 2
  - Alignment Factor No. 3
- Enhance transparency, timing and integrity of reporting:
  - Reporting Factor No. 1
  - Compliance Factor No. 2
- Enhance risk management and control
  - Behaviours Axis 2(b)
- Enhance Performance assessment and reporting:
  - Objectives Axis No. 1(b)
- Reduce risk of earnings manipulation
  - Reporting Factor No. 1
  - Alignment Factor No. 3
- Enhance (external) monitoring of management:
  - Monitoring & Audit Factor No. 5
  - Alignment Factor No. 3
- Delineate line of responsibility and accountability
  - Responsibility Factor No. 8
  - Decision-making Factor No. 7
  - Objectives Axis 1(b) and Behaviours Axis 2(b)

#### 4.2 404
- External auditor to attest and report on the assessment of internal controls made by the management of the Issuer
- Reduce information asymmetry and agency costs:
  - Reporting Factor No. 1
  - Compliance Factor No. 2
  - Alignment Factor No. 3
- Enhance transparency, timing and integrity of reporting:
  - Reporting Factor No. 1
  - Compliance Factor No. 2
- Enhance risk management and control
  - Behaviours Axis 2(b)
- Enhance Performance assessment and reporting:
  - Objectives Axis No. 1(b)
- Reduce risk of earnings manipulation
  - Reporting Factor No. 1
  - Alignment Factor No. 3
- Enhance (external) monitoring of management:
  - Monitoring & Audit Factor No. 5
  - Alignment Factor No. 3
- Delineate line of responsibility and accountability
  - Decision-making Factor No. 7
  - Responsibility Factor No. 8
4.3 | 406 | Disclosure of whether the Issuer has adopted a code of ethics for senior financial officers applicable to principal financial officer or principal accounting officer.

- Reduce information asymmetry and agency costs:
  - Reporting Factor No. 1
  - Compliance Factor No. 2
  - Alignment Factor No. 3
- Enhance transparency, timing and Integrity of reporting:
  - Reporting Factor No. 1
  - Compliance Factor No. 2
- Enhance risk management and control
  - Behaviours Axis 2(b)
- Enhance Performance assessment and reporting:
  - Objectives Axis No. 1(b)
- Reduce risk of earnings manipulation
  - Reporting Factor No. 1
  - Alignment Factor No. 3
- Enhance (external) monitoring of management:
  - Monitoring & Audit Factor No. 5
  - Alignment Factor No. 3
- Delineate line of responsibility and accountability
  - Decision-making Factor No. 7
  - Responsibility Factor No. 8
  - Objectives Axis 1(b) and Behaviours Axis 2(b)

| 5 | SOX Earnings Manipulation II - Auditors and Non-Audit Services |
|---|---|---|
| 5.1 | 201 | Prohibition on external auditor for provision of non-audit services (as defined/listed) to issuer
  - Pre-approval of non-audit services including tax that is not defined/listed by Audit Committee of Issuer
- Enhance auditor independence (by avoiding conflicts) and therefore enhance (external) monitoring of management (‘gate-keeping’):
  - Monitoring & Audit Factor No. 5
  - Alignment Factor No. 3
- Reduce information asymmetry and agency costs:
  - Responsibility Factor No. 1
  - Alignment Factor No. 3
- Enhance transparency, timing and Integrity of reporting:
  - Reporting Factor No. 1
  - Compliance Factor No. 2
- Enhance risk management and control
  - Behaviours Axis 2(b)
- Enhance Performance assessment and reporting:
  - Objectives Axis No. 1(b)
- Reduce risk of earnings manipulation
  - Reporting Factor No. 1
  - Alignment Factor No. 3
- Enhance (external) monitoring of management:
  - Monitoring & Audit Factor No. 5
  - Alignment Factor No. 3

| 5.2 | 202 | All auditing services and non-audit services provided to the Issuer must be preapproved by the Audit Committee of the Issuer

| 5.3 | 203 | Rotation of audit/reviewing partners:
  - unlawful for external auditor to provide auditing services to an Issuer if the lead/coordinating audit partner or audit partner responsible for reviewing the audit, has performed audit services for that Issuer in each of the 5 previous fiscal years
- Enhance transparency, timing and Integrity of reporting:
  - Reporting Factor No. 1
  - Compliance Factor No. 2
- Enhance risk management and control
  - Behaviours Axis 2(b)
- Enhance Performance assessment and reporting:
  - Objectives Axis No. 1(b)
- Reduce risk of earnings manipulation
  - Reporting Factor No. 1
  - Alignment Factor No. 3
- Enhance (external) monitoring of management:
  - Monitoring & Audit Factor No. 5
  - Alignment Factor No. 3

| 5.4 | 204 | Auditor ‘timely’ report to audit committee:
  - External audit firm shall timely report to the Audit Committee of the Issuer:
| 5.4 | 204 | o All critical accounting policies and practices used  
o All alternative treatments of financial information within generally accepted accounting principles  
o ramifications of the use of such alternative disclosures and treatments practices  
o the external auditor's preferred treatment; and  
o other material written communications with management  |
| 5.5 | 206 | Conflicts of Interest:  
• Prohibition on auditor undertaking audit services if an employee in a senior management position was employed by the auditor and participated in any capacity in the audit of the Issuer during a 1-year period preceding the initiation of the audit  
• Delineate line of responsibility and accountability  
o Decision-making Factor No. 7  
o Responsibility Factor No. 8  
o Relational Axes 1(b) and 2(b) |
C3: Evaluations of the SOX Reforms


For a discussion of whether US governance reform measures such as SOX would have prevented the Enron collapse, see Stuart L Gillan and John D Martin, "Corporate Governance Post-Enron: Effective Reforms, or Closing the Stable Door?", (March 21, 2007), available at SSRN: http://ssrn.com/abstract=977585.
C4: Summary of Content and Themes from NYSE ‘Core’ Variables

In the SOX Summary Table in Appendix C2, the thesis drew together the underlying themes and tensions which arise in the case of the SOX reforms.

In this Appendix C4, the thesis examines the ‘downstream’ effects of SOX. These are the themes and tensions underpinning the ‘core’ NYSE Final Rules variables (i.e., the core Governance Variables of US corporate governance that are contained in or taken from the NYSE Final Rules13). The content of these Rules is presented in table form for the purpose of the construction of the Three Relational Axes of Good Governance in sections 2.3.1 – 2.3.3 and the Governance Factors in sections 2.6.1 – 2.6.8. As much as is practicable, the description of the content of the Governance Variables has been taken from section 303A of the Listed Company Manual14 itself.

NYSE Summary Table: NYSE ‘Core’ Variables and Themes

<table>
<thead>
<tr>
<th>No</th>
<th>NYSE Listed Company Manual Section</th>
<th>Content of Governance Structure/Mechanism/Processes (Governance Variables)</th>
<th>Underpinning Theme/Rationale for Identification/Articulation of Three Relational Axes of Good Governance and Governance Factors</th>
</tr>
</thead>
</table>
| 1  | Independence of the Board from Management | • Listed companies must have a ‘majority’ of independent directors  
  • Independence tests - including provisions to determine an independent director | Together, these provisions:  
• Enhance freedom from management influence and therefore enhance the quality of monitoring of the board, CEO and management:  
  o Monitoring & Audit Factor No. 5  
  o Objectives Axis 1(b) and Behaviours Axis 2(b)  
• Enhance alignment of insiders with ‘outside’ shareholder interests:  
  o Alignment Factor No. 3  
  o Positional Conflict Axes 3(a) and 3(b)  
• Reduce risk of ‘entrenchment’ of management:  
  o Alignment Factor No. 3  
  o Positional Conflict Axes 3(a) and 3(b) |
| 1.1 | 303A.01  
  303A.02 | | |
| 1.2 | 303A.03 | Executive Sessions:  
• Non-management directors to additionally meet at regularly scheduled sessions separate to management | |

14 Ibid.
For the Board:

- As only a ‘majority’ of independent directors is mandated, there is a possible improvement in the quality of monitoring of the board, CEO and management and the quality of board decision-making due to retention of ‘management’ or ‘inside’ knowledge on the Board:
  - Monitoring & Audit Factor No. 5
  - Decision-making Factor No. 7
  - Responsibility Factor No. 8
  - Objectives Axis 1(b) and Behaviours Axis 2(b)

- Possible deficiencies in the quality of monitoring of the board, CEO and management and decision-making due to:
  - Possible reduction in quality of information flow to the Board on account of presence of independent directors:
    - Monitoring & Audit Factor No. 5
    - Decision-making Factor No. 7
    - Responsibility Factor No. 8
    - Objectives Axis 1(b) and Behaviours Axis 2(b)
  - Lack of ‘management’ or ‘inside’ knowledge on the part of independent directors:
    - Monitoring & Audit Factor No. 5
    - Decision-making Factor No. 7
    - Responsibility Factor No. 8
    - Objectives Axis 1(b) and Behaviours Axis 2(b)

---

2 Board Subcommittees and Audit Subcommittee Independence and Financial Expertise

2.1 303A.04  Nominating/Corporate Governance Committee:
- Comprised only of independent directors
- Must have a written charter which addresses:
  - Committee’s purpose and responsibilities including:
    - identify individuals qualified to become board members
    - to select, or to recommend that the board select, the

Together, these provisions:
- Delineate line of responsibility and accountability:
  - Compliance Factor No. 2
  - Responsibility Factor No. 8
  - Decision-making Factor No. 7
  - Objectives Axis 1(b) and
director nominees for the next annual meeting of shareholders
- develop and recommend to the board a set of corporate governance guidelines and
- oversee the evaluation of the board and management; and
  - Annual performance evaluation of the Committee

<table>
<thead>
<tr>
<th>2.2</th>
<th>303A.05</th>
<th><strong>Compensation Committee</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Comprised only of independent directors</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Must have a written charter which addresses:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>o Committee’s purpose and responsibilities including:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>▪ review and approve corporate goals and objectives relevant to CEO compensation</td>
<td></td>
</tr>
<tr>
<td></td>
<td>▪ evaluate the CEO’s performance;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>▪ either as a committee or together with the other independent directors (as directed by the board), determine and approve the CEO’s compensation level based on this evaluation;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>▪ make recommendations to the board with respect to non-CEO executive officer compensation, incentive-compensation and equity-based plans that are subject</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Together, these provisions:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Delineate line of responsibility and accountability:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>o Compliance Factor No. 2</td>
<td></td>
</tr>
<tr>
<td></td>
<td>o Responsibility Factor No. 8</td>
<td></td>
</tr>
<tr>
<td></td>
<td>o Decision-making Factor No. 7</td>
<td></td>
</tr>
<tr>
<td></td>
<td>o Objectives Axis 1(b) and Behaviours Axis 2(b)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Enhance freedom from management influence and enhance the independence and quality of nominees thus enhancing the quality of board, CEO and management decision-making:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>o Alignment Factor No. 3</td>
<td></td>
</tr>
<tr>
<td></td>
<td>o Decision-making Factor No. 7</td>
<td></td>
</tr>
<tr>
<td></td>
<td>o Responsibility Factor No. 8</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Enhance quality of monitoring of board, CEO and management:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>o Monitoring &amp; Audit Factor No. 5</td>
<td></td>
</tr>
<tr>
<td></td>
<td>o Alignment Factor No. 3</td>
<td></td>
</tr>
<tr>
<td></td>
<td>o Objectives Axis 1(b) and Behaviours Axis 2(b)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Enhance alignment with ‘outside’ shareholder interests:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>o Alignment Factor No. 3</td>
<td></td>
</tr>
<tr>
<td></td>
<td>o Positional Conflict Axes 3(a) and 3(b)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Reduce risk of ‘entrenchment’:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>o Alignment Factor No. 3</td>
<td></td>
</tr>
<tr>
<td></td>
<td>o Positional conflict Axes 3(a) and 3(b)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Balance management ‘alignment’ strategy:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>o Alignment Factor No. 3</td>
<td></td>
</tr>
<tr>
<td></td>
<td>o Positional Conflict Axes 3(a) and 3(b)</td>
<td></td>
</tr>
</tbody>
</table>
|      | • Enhance quality of monitoring of board, CEO and management:
### Audit Committee:

Listed companies must have an Audit Committee that satisfies the requirements of Rule 10A-3 under the Securities Exchange Act.

**303A.06**

- Minimum of 3 directors
- All audit committee members must satisfy the requirements for independence set out in Section 303A.02
- Each member of the audit committee must be financially literate or must become financially literate within a reasonable period of time after his or her appointment to the audit committee
- At least 1 member has accounting or related financial management expertise

Together, these provisions:

- Enhance board skills 'mix' to enhance quality of board, CEO and management decision-making:
  - Decision-making Factor No. 7
  - Responsibility Factor No. 8

- Enhance quality of monitoring of management:
  - Monitoring & Audit Factor No. 5
  - Objectives Axis 1(b) and Behaviours Axis 2(b)

- Enhance auditor independence (by reducing risk of management interference):
  - Reporting Factor No. 1

---

**(a)** to board approval; and

- Annual performance evaluation of the Committee

---

- Monitoring & Audit Factor No. 5
- Alignment Factor No. 3
- Objectives Axis 1(b) and Behaviours Axis 2(b)

- Enhance alignment with 'outside' shareholder interests:
  - Alignment Factor No. 3
  - Positional Conflict Axes 3(a) and 3(b)

- Reduce risk of 'entrenchment':
  - Alignment Factor No. 3
  - Positional Conflict Axes 3(a) and 3(b)

- Balance management ‘alignment’ strategy:
  - Alignment Factor No. 3
  - Positional Conflict Axes 3(a) and 3(b)

- Determine the compensation of the CEO and non-CEO management, set goals and objectives for compensation, determine incentive-compensation and equity-compensation and evaluate performance of CEO and non-CEO management:
  - Alignment Factor No. 3
  - Compensation Factor No. 4
  - Monitoring & Audit Factor No. 5
  - Decision-making Factor No. 7
  - Responsibility Factor No. 8
  - Positional Conflict Axes 3(a) and 3(b)
### 303A.07 (b)

| Integritity of financial statements | o Alignment Factor No. 3  
| Compliance with legal and regulatory requirements | o Monitoring & Audit Factor No. 5  
| the independent auditor's qualifications and independence | o Reduce information asymmetry and agency costs:  
| the performance of the company's internal audit function and independent auditors | o Reporting Factors No. 1  
| • Annual performance evaluation of the Committee | o Compliance Factor No. 2  
| • Duties and responsibilities of the Audit Committee including: | o Alignment Factor No. 3  
| o at least annually, obtain and review a report by the independent auditor describing the firm's internal quality-control procedures and any material issues raised by the most recent internal quality-control review | o Positional Conflict Axes 3(a) and 3(b)  
| o meet to review and discuss the company's audited financial statements | • Enhance freedom from management influence:  
| o discuss the company's earnings press releases | o Alignment Factor No. 3  
| o discuss policies with respect to risk assessment and risk management | o Positional Conflict Axes 3(a) and 3(b)  
| o meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function) and with independent auditors | • Enhance quality of monitoring of management by improving quality of committee decision-making:  
| o review with the independent auditor any audit problems or difficulties and management's response | o Monitoring & Audit Factor No. 5  
| o set clear hiring policies for employees or former employees of the independent auditors | o Decision-making Factor No. 7  
| o report regularly to the board of directors | o Objectives Axis 1(b) and Behaviours Axis 2(b)  

### 303.07 (c)

Internal audit – company must have an internal audit function

| Possible deficiencies in the quality of the monitoring of management and decision-making due to: | • Possible reduction in quality of information flow to Committee on account of presence of independent directors:  
| o Lack of ‘management’ or ‘inside’ knowledge on the part of independent directors: | o Monitoring & Audit Factor No. 5  
| o Delineate line of responsibility and accountability: | o Decision-making Factor No. 7  
| o set clear hiring policies for employees or former employees of the independent auditors | o Objectives Axis 1(b) and Behaviours Axis 2(b)  
| o report regularly to the board of directors | • Enhance alignment with ‘outside’ shareholder interests:  
| o at least annually, obtain and review a report by the independent auditor describing the firm's internal quality-control procedures and any material issues raised by the most recent internal quality-control review | o Alignment Factor No. 3  
| o meet to review and discuss the company's audited financial statements | o Positional Conflict Axes 3(a) and 3(b)  
| o discuss the company's earnings press releases | • Reduce risk of ‘entrenchment’:  
| o discuss policies with respect to risk assessment and risk management | o Alignment Factor No. 3  
| o meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function) and with independent auditors | o Positional Conflict Axes 3(a) and 3(b)  
| o review with the independent auditor any audit problems or difficulties and management's response | • Delineate line of responsibility and accountability:  
| o set clear hiring policies for employees or former employees of the independent auditors | o Responsibility Factor No. 8  
<p>| o report regularly to the board of directors |</p>
<table>
<thead>
<tr>
<th>3</th>
<th>Shareholder Approval of Equity Compensation Plans</th>
</tr>
</thead>
</table>
| 3.1 | 303A.08 | Shareholders must be given the opportunity to vote on all equity-compensation plans and material revisions thereto (with limited exemptions).

Section 303A.08 states that “An "equity-compensation plan" is a plan or other arrangement that provides for the delivery of equity securities (either newly issued or treasury shares) of the listed company to any employee, director or other service provider as compensation for services.”

- Enhance alignment of insider and outside shareholder interests:
  - Alignment Factor No. 3
  - Positional Conflict Axes 3(a) and 3(b)
- Enhancement of components of board, CEO and management compensation and incentives:
  - Compensation Factor No. 4

<table>
<thead>
<tr>
<th>4</th>
<th>Corporate Governance Guidelines and Codes of Conduct and Ethics</th>
</tr>
</thead>
</table>
| 4.1 | 303A.09 | Listed companies must adopt and disclose corporate governance guidelines including:

- Director qualification standards including independence requirements, policies limiting the number of boards on which a director may sit, and director tenure, retirement and succession.
- Director responsibilities including basic duties and responsibilities with respect to attendance at board meetings and advance review of meeting materials.
- Director access to management and, as necessary and appropriate, independent advisors.
- Director compensation.
- Director orientation and continuing education.
- Management succession.
- Annual performance evaluation of the board.

Together, these provisions:

- Delineate line of responsibility and accountability:
  - Responsibility Factor No. 8
- Enhance quality of decision-making by board and directors:
  - Decision-making Factor No. 7
- Enhance quality of monitoring of management:
  - Monitoring & Audit Factor No. 5
- Reduce risk of ‘entrenchment’:
  - Alignment Factor No. 3
  - Positional Conflict Axes 3(a) and 3(b)
- Enhance freedom from management influence:
  - Alignment Factor No. 3
  - Positional Conflict Axes 3(a) and 3(b)
- Enhance (external) monitoring of management:
  - Monitoring & Audit Factor No. 5
- Enhance risk management and control and hence enhance quality of monitoring of board, CEO and management:
4.2 303A.10 including:
  • Conflicts of interest
  • Corporate opportunities
  • Confidentiality
  • Fair dealing
  • Protection and proper use of listed company assets
  • Compliance with laws, rules and regulations (including insider trading laws)
  • Encouraging the reporting of any illegal or unethical behaviour

4.3 303A.12 Certification Requirements:
  • Each listed company CEO must certify to the NYSE each year that he or she is not aware of any violation by the listed company of NYSE corporate governance listing standards, qualifying the certification to the extent necessary.
  • Each listed company CEO must promptly notify the NYSE in writing after any executive officer of the listed company becomes aware of any non-compliance with any applicable provisions of this Section 303A.

4.4 303A.13 Public Reprimand Letter:
  • The NYSE may issue a public reprimand letter to any listed company that violates a NYSE listing standard.

4.4 Monitoring & Audit Factor No. 5
  • Reduce information asymmetry and agency costs:
    o Reporting Factor No. 1
    o Alignment Factor No. 3
    o Positional Conflict Axes 3(a) and 3(b)
  • Enhance transparency and timing of reporting:
    o Reporting Factor No. 1
    o Objectives Axes 1(b) and Behaviours Axis 2(b)
  • Enhance director independence and reduce conflicts of interest:
    o Alignment Factor No. 3
    o Positional Conflict Axes 3(a) and 3(b)
  • Enhance value preservation:
    o Objectives Axis 1(b)
  • Enhance corporate governance and legal compliance:
    o Compliance Factor No. 2
APPENDIX D1:

RECURRING THEMES AND TENSIONS IN EMPIRICAL STUDIES KEY FIELD NO. 4
(PARTS 1 AND 2)

Summary Table D1: Benefits and Effects from the National Shareholder Protection
Regime and Board Factors I and II

In chapters 7 and 8, the relational approach traversed Parts 1 and 2 of four Parts containing
the Governance Variables which form part of the expanse of the Relational Corporate
Governance Approach.

Here, the relational approach has presented and reviewed in detail the first two of four chapters
containing law, economic and econometric literature from the US, UK, Europe and Australia.
The aim has been to identify and analyse core features or aspects, including recurring themes
and tensions, of the Governance Variables which operate in the for-profit sector. These flow
from, principally, the agency component of the shareholder and stakeholder models examined
in chapter 4.

What can be concluded from the empirical studies in chapters 7 and 8 in relation to the
relational approach’s over-arching purpose of the long-term efficiency and survival or
sustainability of the for-profit corporation?

Using as proxies for such efficiency and sustainability measures of firm operating performance
and value (as well as other governance outcomes), the following Table D1 represents the
contour lines on a map of the thesis’ Relational Corporate Governance Framework in Figure
2.8 - a summary of the perceived benefits or effects from the national shareholder protection
regime and relevant board factors I and II examined in chapters 7 and 8:
Summary Table D1: Benefits and Effects from the National Shareholder Protection Regime and Board Factors I and II

<table>
<thead>
<tr>
<th>Section</th>
<th>Governance Variable</th>
<th>Perceived/Claimed Benefit/Effect</th>
<th>Summary of Findings</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.3</td>
<td>Firm-Specific Effects of ‘Good’ Corporate Governance – Firm Value and Operating Performance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7.3.1</td>
<td>‘Overall’ Governance Structure and the Level and the Strength of the National Shareholder Protection Regime</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>7.3.1.1-2</th>
<th>‘Overall’ Governance Structure and Level</th>
<th>Increase in firm value and/or performance</th>
<th>Support for the proposition that combinations/groupings of the following Governance Variables affect firm value and/or firm performance:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Board and committee size – [BrdCmSize] (+)(^{15})</td>
<td>Increase in firm value and/or performance</td>
<td>• Board and committee size – [BrdCmSize] (+)(^{15})</td>
</tr>
<tr>
<td></td>
<td>A high level of attendance at board meetings – [BrdAttend] (+)(^{16})</td>
<td></td>
<td>• A high level of attendance at board meetings – [BrdAttend] (+)(^{16})</td>
</tr>
<tr>
<td></td>
<td>The presence and operation (including frequency of meeting) of board committees - in particular the:</td>
<td></td>
<td>• The presence and operation (including frequency of meeting) of board committees - in particular the:</td>
</tr>
<tr>
<td></td>
<td>o audit committee ([AudCom] (+)(^{22}))</td>
<td></td>
<td>o audit committee ([AudCom] (+)(^{22}))</td>
</tr>
<tr>
<td></td>
<td>o nominating committee ([NomCom] (+/-)(^{23}) and [NomInd] (+)(^{24})) and</td>
<td></td>
<td>o nominating committee ([NomCom] (+/-)(^{23}) and [NomInd] (+)(^{24})) and</td>
</tr>
<tr>
<td></td>
<td>o compensation committee ([CompCom] (+/-)(^{25}))</td>
<td></td>
<td>o compensation committee ([CompCom] (+/-)(^{25}))</td>
</tr>
<tr>
<td></td>
<td>The equity (including option) compensation</td>
<td></td>
<td>The equity (including option) compensation</td>
</tr>
</tbody>
</table>

\(^{15}\) Board and Committee Size – see discussion in section 8.2.2.2 of chapter 8.

\(^{16}\) Board – Attendance Level (High) – see discussion in section 7.3.2.1.2 of chapter 7.

\(^{17}\) Board Independent Director: Executive Director Proportion – Monitoring Effect – see discussion in sections 7.3.2.1.1-2 of chapter 7.

\(^{18}\) Board Independent Director: Executive Director Proportion – Information Flow and Decision Quality ‘Trade-Off’ – see discussion in section 7.3.2.1.3 of chapter 7.

\(^{19}\) Audit Committee - Independence - Monitoring Effect – see discussion in section 8.4.3 of chapter 8.

\(^{20}\) Audit Committee - Independence - Information Flow and Decision Quality ‘Trade-off’ – see discussion in section 8.4.3 of chapter 8.

\(^{21}\) Audit Committee – Independence in Combination with Frequency of Meeting – Reduction in Earnings Manipulation Effect – see discussion in section 9.2.1 of chapter 9.

\(^{22}\) Audit Committee – Presence, Operation and Frequency - see discussion in section 8.4.2 of chapter 8.

\(^{23}\) Nominating Committee – Presence, Operation and Frequency – see discussion in section 7.3.1.2.2 of chapter 7.

\(^{24}\) Nominating Committee – Independence Proportion – see discussion in section 7.3.1.2.2 of chapter 7.

\(^{25}\) Compensation Committee – Presence, Operation and Frequency – see discussion in section 10.2.4.1 of chapter 10.
7.3.1.2.1 Board Skills ‘Mix’ Variable - [BrdSkills] (+)  
Increase in firm value and/or performance  
- Hypothesised to affect all Governance Factors except Compliance Factor No. 2 (Corporate Governance and Legal Compliance)  
- Coverage/Rating of +7/87.50 rprox  
- Structure and operation of the [BrdSkills] (+) variable is itself dependent on the operation and structure of the [NomCom] (+/-) variable as the composition – and therefore skills mix – of the board flows from the nominating committee

7.3.1.2.2 Nominating Committee – Presence, Operation and Frequency - [NomCom] (+/-)  
Increase in firm value and/or performance  
- [NomCom] (+/-) variable has a dual direction marker (+/-) as the board’s skill mix will be affected positively or negatively by the operation of this variable.

26 Director/CEO Compensation Levels – see discussion in section 10.2.4 of chapter 10.  
27 Equity/Option Plans and Holdings of Directors/Executives – Incentive/Alignment’ Effect (excludes short-term options) – see discussion in section 10.2.4 of chapter 10.  
28 Equity/Option Plans and Holdings of Directors/Executives – ‘Entrenchment’ Effect (excludes short-term options) – see discussion in section 10.2.4 of chapter 10.  
29 Short-Term Option Holdings/Plans of Directors and Executives – see discussion in section 10.2.5.1 of chapter 10.  
30 Board – Director Skills ‘Mix’ – see discussion in section 7.3.1.2.1 of chapter 7.  
31 External/Independent Audit Function – see discussion in section 9.2.3.3 of chapter 9.  
32 Board – Annual Review – see discussion in section 7.3.2.1.2 of chapter 7.  
33 Outside/External Board Advisors – see discussion in section 7.3.2.1.2 of chapter 7.  
34 Staggered Board Elections – see discussion in section 8.3.1.1 of chapter 8.  
35 Other Anti-Takeover Mechanisms (excludes staggered board elections) – see discussion in section 8.3.1.1 of chapter 8.  
36 Block Shareholding - Monitoring Effect – see discussion in section 8.5.1-2 of chapter 8.  
37 Block Shareholding – Other Shareholder Agency Costs – see discussion in section 8.5.1-2 of chapter 8.  
38 Outside Board Positions of Independent Directors – see discussion in section 8.2.3.1 of chapter 8.  
39 Board – Director Skills ‘Mix’ – see discussion in section 7.3.1.2.1 of chapter 7.  
40 Nominating Committee – Presence, Operation and Frequency – see discussion in section 7.3.1.2.2 of chapter 7.
| 7.3.1.2.2 | Nominating Committee – Independence Proportion – [NomInd] (+)\(^{41}\) | Increase in firm value and/or performance | • Hypothesis that increases in the independence proportion of the nominating committee ([NomInd] (+)) will have a positive effect on the monitoring and decision-making – and therefore board skills – attributes of directors nominated by that committee  
• Thus, like [NomCom] (+/-), as the operation of the [NomInd] (+) variable directly precipitates the operation of the [BrdSkills] (+) variable, [NomInd] (+) has an identical relational effect path in the positive direction  
• Coverage/Rating of +7/87.50 rprox |
|---|---|---|---|
| 7.3.1.3 – 7.3.1.3.3 | National Shareholder Protection Regime – [NationGov] (+)\(^{42}\) | Increase in firm value and/or performance | Support for view that:  
• There is a positive relationship between firm performance and the level of shareholder protection provided by the national governance regime (Bruno and Claussens, 2007)\(^{45}\), (Ng, Gul and Mensah, 2007)\(^{44}\) and (Klapper and Love, 2002)\(^{46}\)  
• Thus, increases in the level of national regime protection (to a specific point) improves firm performance  
• After this point, ‘excessive regulation can harm valuation’ by reducing managerial initiative and generating lower returns (Bruno and Claussens, 2007)\(^{46}\)  
• Firm-specific Governance Variables can ‘fill gaps’ in national regulatory regime – ‘substitution effect’ (Bruno and Claussens, 2007)\(^{47}\)  
• Common law regimes give highest level of protection (LaPorta, Lopez-de-Silances, Shleifer and Vishny, 1996, 1999 and 2008)\(^{48}\) and (Gugler, Mueller and Yurtoglu, 2003)\(^{49}\)  
• Compliance Factor No. 2 (Corporate Governance and Legal Compliance) is an overriding requirement of all Governance Factors and provides the content of the national shareholder protection regime.  
• Thus, the thesis hypothesises that the relational effect path for the [NationGov] (+) variable affects all Governance Factors in a manner identical to Figure 2.6.2 (Compliance Factor No. 2 Interrelationships);  
• [NationGov] (+) has a Coverage/Rating of +8/100.00 rprox. |

\(^{41}\) Nominating Committee – Independence Proportion – see discussion in section 7.3.1.2.2 of this chapter 7.  
\(^{42}\) National Shareholder Protection Regime – see discussion in section 7.3.1.3.3 of chapter 7.
### 7.3.2 Board Factors I – ‘Independence’, the Proportion of Non-Executive/Independent Directors and Equity Ownership

#### 7.3.2.1 - 7.3.2.1.1

<table>
<thead>
<tr>
<th>Director Independence</th>
<th>Improved monitoring of management which reduces agency costs with a consequent increase in firm value and/or performance</th>
</tr>
</thead>
</table>

**Intervening Variable for Independence**

- **Improvements in the quality of monitoring are not certain**
- **Perceived positive effects of independence on monitoring of management:**
  - More independent boards make better acquisition decisions, are more likely to choose an outsider as CEO, are more likely to resist a takeover bid, and are more likely to fire the CEO following poor performance. (Black and Kim, 2007)\(^{54}\)
- **Independence may enhance monitoring quality and sensitivity of CEO turnover:**
  - CEO turnover is more sensitive to performance when the board is more independent (Weisbach and Hermalin, 2000)\(^{55}\)
- **Intervening variable for independence - CEO turnover may be reduced by relative importance of CEO** (Cremers, Bebchuk and Peyer, revised 2008)\(^{56}\)
  - The probability of CEO turnover is lower if CEO centrality is higher controlling for the CEO’s length of service and performance.\(^{57}\)
- **Some studies suggest a beneficial or positive (+) effect of greater independence among board members on the quality of board monitoring:**
  - [BrdIndMon] (+) variable with Coverage/Rating of +7/87.50

---

46 Bruno and Claessens, above n 43, 4-5.
47 Ibid.
48 See the references in n 101 of section 7.3.1.3.1 of chapter 7.
50 Board Independent Director: Executive Director Proportion – Monitoring Effect – see discussion in section 7.3.2.1.2 of chapter 7.
## 7.3.2.1.3 Board Independent: Executive Director Proportion – Information Flow and Decision Quality ‘Trade-off’ - [BrdIndInfo] (-)

| Board – Annual Review - [BrdReview] (+) | ○ [BrdReview] (+) is a ‘strong-form’ of [BrdIndMon] (+) with a Coverage/Rating of +7/87.50 rprox |
| Board – Attendance Level (High) - [BrdAttend] (+) | ○ [BrdAttend] (+) is again a ‘strong-form’ of [BrdIndMon] (+) with a Coverage/Rating of +7/87.50 rprox |
| Outside/External Board Advisors - [OutBrdAdv] (+) | ○ [OutBrdAdv] (+) is again a ‘strong-form’ of [BrdIndMon] (+) with a Coverage/Rating of +7/87.50 rprox |

- Reduction in Information-Flow to the board
- Improvements in monitoring are difficult to ensure due to a perceived negative effect in terms of information flow to the board with consequent negative (-) effects on the quality of board decision-making:
  - ○ [BrdIndInfo] (-) variable with a Coverage/Rating of -4/50.00 rprox

- Increase in firm value and/or performance
- Conflicting results with many studies finding no relation between firm value/performance and the degree of independence
- Fewer studies identify a positive relationship between firm performance and/or value and the independence proportion

- Intervening factors for independence
  - ○ Performance and value increased by (Fuerst and Kang)\(^58\):
    - The degree of equity holdings of CEO, executives and inside directors
    - Increased equity holdings

---

\(^{51}\) Board – Annual Review - see discussion in section 7.3.2.1.2 of chapter 7.

\(^{52}\) Board – Attendance Level (High) - see discussion in section 7.3.2.1.2 of this chapter 7.

\(^{53}\) Outside/External Board Advisors - see discussion in section 7.3.2.1.2 of this chapter 7.


\(^{57}\) Ibid, 3.


| 7.3.2.1.6 | Size of the firm (Grinstein and Chhaochharia, 2007) | • The direction (positive or negative) of the effect of director ownership on firm performance is suggested in one study to be dependent on the costs of acquiring information for outside directors to remedy asymmetric information problems (Duchin, Matsusaka and Ozbas): o Positive (or negative) effect on firm performance was dependent on the low (or high) cost of acquiring information relating to the firm. |

| 8.2 | Board Factors II – Board Size and Outside Board Positions |
| 8.2.1 | Determinants of Optimum Board Size | Factors affecting board size | Increases in board size determined by increases in: |
| 8.2.2 | Board Size \([\text{BrdCmSize}] (+/-)\) | Firm value and/or performance |
| 8.2.2.2 | - | • The gap between ‘insider’ and ‘outside’ shareholder interests – a better alignment of incentives of insiders with outside shareholders result in smaller boards (Raheja, 2005) |
| | - | • The practicability of ‘external verification’ of firm activities (Raheja, 2005) |
| | - | • Size of the firm (Lehn, Patro and Zhao, 2003) and (Coles, Daniel and Naveen, 2005) |
| | - | • National/statutory regime requirements such as SOX and NYSE Final Rules have increased board size and proportion of independent directors (Linck, Netter and Yang, 2007) and |
| | - | • Level of firm ‘diversification’ and ‘leverage’ – “firms that are diversified, large, and have high debt have 2 more board members, who are outsiders.” (Coles, Daniel and Naveen, 2005) |
| | - | • Conflicting results - No consistent/conclusive results for this variable |
| | - | • Increases in board size (past an ‘optimal’ point of 7-8 members) possibly reduce board |

---

61 Board and Committee Size – see discussion in section 8.2.2.2 of chapter 8.
62 Outside Board Positions of Independent Directors – see discussion in section 8.2.3.1 of chapter 8.
64 Ibid.
68 Coles, Daniel and Naveen, above n 59, 3.
### 8.2.3 - 8.2.3.1

| Increases in ‘outside’ board positions of independent directors –  
[OutBrdPos] (-) | Reduction in quality of monitoring |
|---|---|
| • Possible reduction in quality of board monitoring “where the majority of outside directors hold three or more directorships...”  
(Fich and Shivdasani, 2004) |  |
| • [OutBrdPos] (-) has a Coverage/Rating of -6/75.00 rprox |

### 8.3 Anti-Takeover Mechanisms and Market for Corporate Control – ‘Whole’ Board and ‘Staggered’ Board Elections

| Anti-takeover Mechanisms (ATMs) (excludes staggered board elections) -  
[OtherATMs] (-) | Reduction in firm value |
|---|---|
| • Possible reduction in firm value but inconclusive due to number of studies  
• Argued that ATMs result in reduction in effectiveness of the market for corporate control by shielding management who acquire investments at an over-value thus reducing firm value (Masulis, Wang and Xie, 2006) |  |
| • [OtherATMs] (-) has a Coverage/Rating of -6/75.00 rprox |
| |  |

---

64 Other Anti-Takeover Mechanisms (excludes staggered board elections) – see discussion in section 8.3.1.1 of chapter 8.
65 Staggered Board Elections – see discussion in section 8.3.1.1 of chapter 8.
68 Ibid, 2 (format altered). An explanation of the operation of each of these mechanisms is set out at 7-13.
8.3.1.1 ‘Staggered’ Board Elections - [StagBrdElect] (-)²²

<table>
<thead>
<tr>
<th>Reduction in firm value</th>
</tr>
</thead>
<tbody>
<tr>
<td>• The above studies lead the thesis to hypothesise that the relational effect path for [OtherATMs] is negative (-) reflecting this corresponding diminution in firm value.</td>
</tr>
<tr>
<td>• The thesis hypothesises that the most direct or proximate relational effect path for [OtherATMs] (-) is identical to that for [NationGov] (+) but in the negative direction:</td>
</tr>
<tr>
<td>o Coverage/Rating of -8/100.00 rprox.</td>
</tr>
<tr>
<td>• Study by Bebchuk and Cohen leads the thesis to hypothesise that the relational effect path for [StagBrdElect] (-) is negative (-) reflecting this corresponding diminution in firm value²²;</td>
</tr>
<tr>
<td>• Firm value is enhanced by annual elections for the whole board (Aggarwal, Erel, Stulz and Williamson, 2006)²²;</td>
</tr>
<tr>
<td>• The thesis hypothesises that the most direct or proximate relational effect path for [StagBrdElect] (-) is identical to that for [NationGov] (+) but in the negative direction:</td>
</tr>
<tr>
<td>o Coverage/Rating of -8/100.00 rprox.</td>
</tr>
<tr>
<td>• No conclusive view, but the implication is that ‘staggered’ board elections have a negative effect on firm value by interfering with or reducing the effectiveness of the market for corporate control.</td>
</tr>
</tbody>
</table>

8.4 Audit Sub-Committee – Presence, Independence and Expertise

<table>
<thead>
<tr>
<th>Structural Determinants</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Presence, independence and financial expertise may be mandated by corporate governance legislation and Governance Codes, for example,</td>
</tr>
<tr>
<td>o SOX</td>
</tr>
<tr>
<td>o NYSE Final Rules</td>
</tr>
</tbody>
</table>

²²⁸ Audit Committee - Presence, Operation and Frequency – see discussion in section 8.4.2 of chapter 8.
²⁹ Audit Committee – Independence – Monitoring Effect – see discussion in section 8.4.3 of chapter 8.
³⁰ Audit Committee – Information Flow and Decision Quality ‘Trade-Off’ – see discussion in section 8.4.3 of chapter 8.
³¹ Audit Committee – Financial Expertise (Accounting) – see discussion in section 8.4.4 of chapter 8.
8.4.1-2  Audit Committee - Presence, Operation and Frequency  
Increase in the monitoring quality of the Audit Committee and consequent increase in firm value and operating performance

8.4.2  Audit Committee - Presence, Operation and Frequency  
[AudCom] (+)  

8.4.3  Audit Committee – Independence – Monitoring Effect – [AudIndMon] (+)  

- ASX 2007-10 Revised Principles
- Determinants of an increase in number and financial expertise of outside directors (Beasley and Salterio, 2001)  
  - Increase in percentage of outsiders on the board;
  - Division of the CEO and Chairperson functions; and
  - Increases in the size of the board.

- Inconclusive with conflicting studies.
- Argued that increases in the independence of the audit committee and the number of meetings enhances the committee’s quality of monitoring (Black and Kim, 2007)  
  - (Aggarwal, Erel, Stulz and Williamson)  
  - (Ashbaugh-Skaife, Collins and LaFond)  
  - (Smith)  
- Argued no significant link between firm value and presence of audit Committee for UK firms (Weir, Laing and McKnight)  
- Further empirical investigation is required to confirm a significant causal relationship.

- Subject to the preceding, Coverage/Rating of +6/75.00 rprox

- The relational effect path of the [AudIndMon] (+) variable is, for the reasons set out in subsection 7.3.2.1.1-2, hypothesised to be identical to the [BrdIndMon] (+) zone of effect:

---


84 Aggarwal, Erel, Stulz and Williamson, above n 70, 4-5.


88 Board Independent Director: Executive Director Proportion – Monitoring Effect – see discussion in section 7.3.2.1.1-2 of chapter 7.

89 Board Independent Director: Executive Director Proportion – Information Flow and Decision Quality ‘Trade-off – see discussion in section 7.3.2.1.3 of chapter 7.

| 8.4.3 | Audit Committee – Information Flow and Decision Quality ‘Trade-Off’ - [AudIndInfo] (-) | Increase in monitoring quality of committee and consequent increase in firm value and operating performance |
| 8.4.4 | Financial expertise of audit committee | |
| 8.4.4 | Audit Committee – financial Expertise (Accounting) – [AudExpAcc] (+) | |

- The relational effect path of the [AudIndInfo] (-) variable is hypothesised to be identical to the [BrdIndInfo] (-) variable in section 7.3.2.1.3:
  - Coverage/Rating of +7/87.50
- All the studies presented suggest positive link between Audit Committee financial expertise and firm value and/or operating performance
- However, likely that accounting expertise will be most significant rather than other types of financial expertise (DeFond, Hann and Hu, 2004)
  - Coverage/Rating for Audit Committee – Financial Expertise (Accounting) – [AudExpAcc] (+) is +6/75.00

| 8.5 | ‘Block’ and Institutional Shareholdings |
| 8.5.1 | Presence of ‘block’ (>5%) shareholdings | Improved monitoring of management and consequent increase in firm performance |
| 8.5.2 | Block Shareholding - Monitoring Effect – [BlockMon] (+) | |

- Governance effects of the existence of (independent) blockholders can be both positive in terms of enhancing the monitoring of management (with consequent improvement in firm value) and negative in terms of the distribution of benefits (Fuerst and Kang);
- Stock returns during the GFC were worse for companies with high institutional shareholder ownership (Erkens, Hung and Matos);
- Firm performance is reduced by large (greater than 5%) shareholdings by independent or non-management shareholders (Fuerst and Kang);
- Agency risk and the cost of equity capital were found to increase with the number of large blockholders (Ashbaugh-Skaife, Collins and LaFond);
- Summary - current evidence points away from enhanced monitoring and firm value and more towards such shareholdings increasing agency costs for small outside shareholders.

- [BlockMon] (+):
  - Coverage/Rating +6/75.00

---

91 Block Shareholding - Monitoring Effect – see discussion in section 8.5.1-2 of chapter 8.
92 Block Shareholding – Other Shareholder Agency Costs - see discussion in section 8.5.1-2 of chapter 8.
93 Fuerst and Kang, above n 51, 7.
## 8.5.2 Block Shareholding – Other Shareholder Agency Costs - [BlockCosts] (-)\(^92\)

- \([\text{BlockCosts}] (-)\) is identical to \([\text{BlockMon}] (+)\) but in the negative direction:
  - Coverage/Rating -6/75.00 rprox

## 8.6 Division in CEO/Chairperson Roles

<table>
<thead>
<tr>
<th>8.6.1</th>
<th>Separation of CEO and Chairperson functions</th>
<th>Increase firm value Increase in firm operating performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>8.6.2</td>
<td>Dual CEO/Chairperson Roles</td>
<td>Quality of board decision-making and monitoring</td>
</tr>
<tr>
<td>8.6.3</td>
<td>Duality of CEO/Chair Positions – Monitoring and Decision-Quality 'Trade-off' - [DualTrade] (+/-)(^97)</td>
<td>Dismissal of CEO who is Chairperson</td>
</tr>
<tr>
<td>8.6.3</td>
<td>Duality of CEO/Chair Positions – CEO Dismissal Probability - [DualDismiss] (-)(^98)</td>
<td>Participation of directors in strategic decision-making</td>
</tr>
</tbody>
</table>

- No significant link between firm value and dividing these roles (Weir, Laing and McKnight)\(^103\)
- 2007 study suggests that dividing these roles may increase firm operating performance (Bhagat and Bolton)\(^101\)
- There is a possible ‘trade-off’ between improvements in the quality of board decision-making due to ‘inside’ knowledge and possible deficiencies in the quality of the monitoring of management because of difficulty in controlling inside directors (Weir, Laing and McKnight)\(^102\):
  - \([\text{DualTrade}] (+/-)\) has the same relational effect path as \([\text{BrdSkills}](+)\) and \([\text{BrdIndMon}](+)\) but with dual direction marker
    - Coverage/Rating of +/- 7/87.50 rprox
- Likelihood of dismissal is suggested to be substantially less than when these functions are separated (Goyal and Park, 2001)\(^103\)
- Likelihood of fraud is suggested to be greater when these roles are combined (Chapple, Ferguson and Kang, 2007)\(^104\)
- Coverage/Rating of -7/87.50 rprox
- ‘Marginal evidence’ that this participation was reduced by the dual CEO/Chairperson role, perhaps through the meeting agenda-setting function (Ruigrok, Peck and Keller, 2006)\(^105\)
  - Coverage/Rating of -4/50.00 rprox

---


\(^95\) Fuerst and Kang, above n 51, 4.


\(^97\) Duality of CEO/Chair Positions – Monitoring and Decision-Quality 'Trade-off' – see discussion in section 7.3.7.1.1 of this chapter 7.

\(^98\) Duality of CEO/Chair Positions – CEO Dismissal Probability – see discussion in section 8.6.3 of chapter 8.

\(^99\) Duality of CEO/Chair Positions – Effect on Strategic Decision-making – see discussion in section 8.6.3 of chapter 8.
APPENDIX D2:

RECURRING THEMES AND TENSIONS IN EMPIRICAL STUDIES KEY FIELD NO. 4 (PART 3)

Summary Table D2: Benefits and Effects from the Board and Audit Committee Factors and Earnings Manipulation

Chapter 9 examined further studies in relation to the thesis’ over-arching purpose of the long-term efficiency and/or survival or sustainability of the for-profit corporation. Instead of measures of firm operating performance and firm value, chapter 9 used as a proxy for long-term efficiency and sustainability of the firm the probability of earnings manipulation or management.

Thus, Summary Table D2 represents further contour lines on a map of the thesis’ Relational Corporate Governance Framework106 - a summary of the hypothesised effects on the probability of earnings manipulation of the firm-specific ‘good’ Governance Variables examined in the studies contained chapter 9:

102 Weir, Laing and McKnight, above n 93, 7.
106 See Figure 2.8 of chapter 2.
### Summary Table D2:
**Benefits and Effects from the Board and Audit Committee Factors and Earnings Manipulation**

<table>
<thead>
<tr>
<th>Section</th>
<th>Governance Variable</th>
<th>Perceived/Claimed Benefit/Effect</th>
<th>Summary of Finding</th>
</tr>
</thead>
<tbody>
<tr>
<td>9.1</td>
<td>Earnings Manipulation and Purpose and Approach of Chapter 9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9.1.1</td>
<td>Principal Aim of Reporting – To Reduce Information Asymmetry and Agency Risk</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| 9.1.2.1 | Increases in the Transparency and Timeliness of Reporting | Reduction in agency costs and consequent reduction in cost of equity capital | • Confirmed in two studies (Ashbaugh-Skaife, Collins and LaFond, 2004)\(^{107}\) and (Patel and Dallas, 2002)\(^{108}\)  
  - Benefits of higher quality of board monitoring:  
    - \([\text{TransTimeMon}]\) \(\text{(+)}\)\(^{109}\)  
    - Relational effect path hypothesised to be similar to \([\text{BrdSkills}]\) \(\text{(+)}\)\(^{108}\) and \([\text{BrdIndMon}]\) \(\text{(+)}\)\(^{111}\) but with an additional overriding requirement of Compliance Factor No. 2 (Corporate Governance and Legal Compliance).  
    - Coverage/Rating \(+8/100.00\) rprox  
  - Must be balanced against possible ‘trade-off’/negative effect on quality of information flow to the board (see section 7.3.2.1.3) and more intensified monitoring of CEO and management which may increase executive compensation claims (Hermalin and Weisbach, 2007)\(^{112}\):  
    - \([\text{TransTimeRedn}]\) \(\text{(-)}\)\(^{113}\)  
    - The relational effect path of this variable is identical to the corresponding \([\text{BrdIndInfo}]\) \(\text{(-)}\)\(^{114}\) variable.  
    - Coverage/Rating \(-4/50.00\) rprox |

---

\(^{109}\) Transparency and Timing of Reporting – Monitoring Effect – see discussion in section 9.1.2.1 of chapter 9.  
\(^{110}\) Board – Director Skills ‘Mix’ – see Figure 7.3.1.2.1B and discussion in section 7.3.1.2.1 of chapter 7.  
\(^{111}\) Board – Independent Director: Executive Director Proportion – Monitoring Effect – see discussion in sections 7.3.2.1.1-2 of chapter 7.  
### 9.2 Earnings Manipulation and Board and Committee Structures

#### 9.2.1 Board and Audit Committee Independence, Time, Financial Expertise and Duality of CEO/Chairperson

<table>
<thead>
<tr>
<th>9.2.1</th>
<th>Independence</th>
<th>Quality and integrity of financial information</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Some support for the effect of independence alone on minimizing earnings manipulation but results are inconclusive:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>o There is a positive relationship between independence and a reduction in earnings manipulation on account of enhanced monitoring (Klein, 2006)(^\text{115})</td>
<td></td>
<td></td>
</tr>
<tr>
<td>o Support for the enhanced monitoring of independent directors in relation to upward earnings manipulation (Peasnell, Pope and Young, 2000)(^\text{116})</td>
<td></td>
<td></td>
</tr>
<tr>
<td>o Independence of the board and audit committee is not related to the probability of earnings manipulation. (Agrawal and Chadha, 2004)(^\text{117})</td>
<td></td>
<td></td>
</tr>
<tr>
<td>o A majority of independent directors is associated with a reduction in earnings manipulation (Klein, 2006)(^\text{118}) but no relation between earnings manipulation and 100% independence on the audit committee (Klein, 2006)(^\text{119})</td>
<td></td>
<td></td>
</tr>
<tr>
<td>o Risk of earnings misstatement reduces with 100% audit committee independence if the audit committee meets regularly with more than two meetings per year (Marrakchi Chtourou, Bédard and Courteau, 2001)(^\text{120})</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

---

\(^{113}\) Transparency and Timing of Reporting – Information Flow Reduction Effect – see discussion in section 9.1.2.1 of chapter 9.

\(^{114}\) Board – Independent Director: Executive Director Proportion – Information Flow and Decision Quality ‘Trade-off’ – see discussion in section 7.3.2.1.3 of chapter 7.


\(^{117}\) Agrawal and Chadha, above n 1, 4.

\(^{118}\) Klein, above n 115, 22.

\(^{119}\) Ibid.

9.2.1.1.1

- time spent in review or number/regularity of audit committee meetings (Agrawal and Chadha, 2004)\footnote{121}, (Farber, 2004)\footnote{122}, (Abbott, Parker and Peters, 2002)\footnote{123}, (Anderson, Deli and Gillan, 2003)\footnote{124}, (Bryan, Liu and Tiras, 2004) and (Marrakchi Chtourou, Bédard and Courteau, 2001)\footnote{125} – see [AudIndFreq] (+)\footnote{126}

- financial expertise (Agrawal and Chadha, 2004)\footnote{127} and particularly accounting expertise (Carcello, Hollingsworth, Klein and Neal, 2006)\footnote{128} and (Cunningham, 2007)\footnote{129} of the audit committee - see [AudAccEarn] (+)\footnote{130} and

\footnotesize
\[\text{\footnotesize 121 Agrawal and Chadha, above n 1, 4-5.}\\ \text{\footnotesize 122 D B Farber, "Restoring Trust After Fraud: Does Corporate Governance Matter?", (October 4, 2004), available}\\ \text{\footnotesize at SSRN: http://ssrn.com/abstract=485403, 27.}\\\ \text{\footnotesize 123 L J Abbott, S Parker and G F Peters, "Audit Committee Characteristics and Financial Misstatement: A Study of}\\ \text{\footnotesize the Efficacy of Certain Blue Ribbon Committee Recommendations", (March 2002), available at SSRN:}\\ \text{\footnotesize http://ssrn.com/abstract=319125, 3 and 31.}\\\ \text{\footnotesize 124 K L Anderson, D N Deli and S L Gillan, "Boards of Directors, Audit Committees, and the Information Content of}\\ \text{\footnotesize Earnings", Weinberg Center for Corporate Governance Working Paper No 2003-04, (September 2003), available}\\ \text{\footnotesize at SSRN: http://ssrn.com/abstract=444241, 24.}\\\ \text{\footnotesize 125 Marrakchi Chtourou, Bédard and Courteau, above n 120, 4.}\\\ \text{\footnotesize 126 Audit Committee – Independence in Combination with Frequency of Meeting – Reduction in Earnings}\\ \text{\footnotesize Manipulation Effect – see discussion in section 9.2.1 of chapter 9.}\\\ \text{\footnotesize 127 Agrawal and Chadha, above n 1, 4.}\\\ \text{\footnotesize 128 J V Carcello, C W Hollingsworth, A Klein and T L Neal, "Audit Committee Financial Expertise, Competing}\\ \text{\footnotesize Corporate Governance Mechanisms, and Earnings Management", (February 2006), available at SSRN:}\\ \text{\footnotesize http://ssrn.com/abstract=587512, 3.}\\\ \text{\footnotesize 129 Lawrence A Cunningham, "Rediscovering Board Expertise: Legal Implications of the Empirical Literature",}\\ \text{\footnotesize GWU Law School Public Law Research Paper No. 363, (October 23, 2007), available at SSRN:}\\ \text{\footnotesize http://ssrn.com/abstract=1024281, 11, 16-17 and 32.}\\\ \text{\footnotesize 130 Audit Committee – Accounting Expertise – Earnings Manipulation Reduction Effect – see discussion in section}\\ \text{\footnotesize 9.2.1.1.2 of chapter 9.}\\\ \text{\footnotesize 131 Farber, above n 122, 27.}\\\ \text{\footnotesize 132 Anderson, Deli and Gillan, above n 124, 24.}\\\ \text{\footnotesize 133 Duality of CEO/Chair Positions – Probability of Earnings Manipulation – see discussion in section 9.2.1.1.3 of}\\ \text{\footnotesize chapter 9.}\\\ \text{\footnotesize 134 Audit Committee - Independence - Monitoring Effect – see discussion in section 8.4.3 of chapter 8.}\\\ \text{\footnotesize 135 Board Independent Director: Executive Director Proportion – Monitoring Effect – see discussion in section}\\ \text{\footnotesize 7.3.2.1.2 of chapter 7.}\\\ \text{\footnotesize 136 Audit Committee – Accounting Expertise – Earnings Manipulation Reduction Effect – see discussion in section}\\ \text{\footnotesize 9.2.1.1.1 of chapter 9.}\\\ \text{\footnotesize 137 Agrawal and Chadha, above n 1, 6.}\\\ \text{\footnotesize 138 Audit Committee – Non-Accounting Expertise – ‘Free Rider’ Effect – see discussion in section 9.2.1.1.2 of}\\ \text{\footnotesize chapter 9.}\\\ \text{\footnotesize 139 Audit Committee – Financial Expertise (Accounting) – see discussion in section 8.4.4 of chapter 8.}\\\ \text{\footnotesize 140 Duality of CEO/Chair Positions – Monitoring and Decision-Quality ‘Trade-off’ – see discussion in sections 8.6.1}\\ \text{\footnotesize – 8.6.2 of chapter 8.}\\\ \text{\footnotesize 141 Board Independent Director: Executive Director Proportion - Monitoring Effect – see discussion in sections}\\ \text{\footnotesize 7.3.2.1.1-2 of chapter 7.}\\\ \text{\footnotesize 142 Board – Director Skills ‘Mix’ – see discussion in section 7.3.1.2.1 of chapter 7.}}\]
9.2.1 and 9.2.1.1.3

9.2.1 [AudIndFreq] (+): Audit Committee – Independence in Combination with Frequency of Meeting – Reduction in Earnings Manipulation Effect

<table>
<thead>
<tr>
<th>9.2.1.1.1</th>
<th>Financial Expertise</th>
<th>Likelihood of earnings manipulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>[AudIndFreq] (+): Audit Committee – Independence in Combination with Frequency of Meeting – Reduction in Earnings Manipulation Effect</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- Zone of effect of the [AudIndFreq] (+) variable is hypothesised to be identical to the [AudIndMon] (+) and, in turn, the [BrdIndMon] (+) variables.
  - Coverage/Rating of +7/87.50 rprox

- Accounting expertise appears more likely than other types of financial expertise to reduce the likelihood of earnings manipulation (see above - Carcello, Hollingsworth, Klein and Neal, 2006 and Cunningham, 2007)
  - [AudAccEarn] (+)

- However, the presence of financial experts may lead to some 'free rider' effects on the quality of monitoring by other directors on the audit committee (Agrawal and Chadha, 2004)
  - [AudFree] (-)

- The relational effect path of [AudAccEarn] (+) is hypothesised to be identical to that of [AudExpAcc] (+) but with the reduction effect targeted at the probability of earnings manipulation rather than firm value and/or operating performance.
  - Coverage/Rating of +6/75.00 rprox

9.2.1.2 [AudAccEarn] (+): Audit Committee – Accounting Expertise – Earnings Manipulation Reduction Effect

<table>
<thead>
<tr>
<th>9.2.1.2</th>
<th>[[DualEarn] (-): Duality of CEO/Chair Positions – probability of Earnings Manipulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>[AudAccEarn] (+): Audit Committee – Accounting Expertise – Earnings Manipulation Reduction Effect</td>
<td></td>
</tr>
</tbody>
</table>

- Probability of earnings manipulation is increased by combination of the dual roles of CEO and Chairperson.
- The relational effect path for [DualEarn] (-) is hypothesised to extend to all eight Core Field Factors except No 2 (Corporate Governance and Legal Compliance) in the same manner as

9.2.1.3 [DualEarn] (-): Duality of CEO/Chair Positions – probability of Earnings Manipulation
<table>
<thead>
<tr>
<th>9.2.2</th>
<th>Board and Audit Committee Size and Earnings Management</th>
</tr>
</thead>
</table>
| 9.2.2 Board and audit committee size | Likelihood of earnings manipulation | • Suggestions (though not conclusive) that the likelihood of earnings manipulation is reduced by reductions in board and audit committee size  
• This is consistent with findings presented earlier relating to board effectiveness (see sections 8.2.1 - 8.2.2)  
• Ching, Firth and Rui (2002) review Hong Kong companies and find that earnings manipulation is greater as board size increases  
• But, for Anderson, Deli and Gillan (2003), the degree of information relating to reports is not increased by increasing the size of the board but is increased by a reduction in audit committee size  
• Relational effect path for the [BrdCmEarn] variable is given a dual-direction marker (+/-) and has a zone of effect identical to [BrdCmSize] (+/-)  
• Therefore, [BrdCmEarn] (+/-) has a Coverage/Rating of +/- 6/75.00 rprox |
| 9.2.2 [BrdCmEarn] (+/-) Variable Relational Effect Path | Likelihood of earnings manipulation |

<table>
<thead>
<tr>
<th>9.2.3</th>
<th>Review of Auditors, Non-Audit Services and Earnings Management</th>
</tr>
</thead>
</table>
| 9.2.3.1 External Audit – Independence, reputational Constraints and Auditor ‘Attachment’ | Likelihood of Earnings Manipulation | • Risk of legal liability and damage to reputation should act as motivations for the auditor in performing its role (Coffee, 2001)  
• Some loss in firm value because of the Andersen failure but less than expected (Callen and Morel, 2002). |

---

143 Board and Committee (Non-audit) Size – Earnings Manipulation Effect.
146 Board and Committee Size – see discussion in section 8.2.2.2 of chapter 8.
147 External/Independent Audit Function.
<table>
<thead>
<tr>
<th>9.2.3.2</th>
<th>Provision of non-audit services by auditor</th>
<th>Likelihood of earnings manipulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>9.2.3.3</td>
<td>[ExtAudEarn] (+)(^{147}): External/Independent Audit Function</td>
<td></td>
</tr>
</tbody>
</table>

- Discretionary accounting principles contribute to earnings management (Coffee, 2001)^{150}
- Auditor ‘attachment’ – the pressure to give a clean audit opinion to retain existing business and foster new business – may be a problem for auditor independence (Barrett)^{151}
- Suggestions that the provision of non-audit services by auditors increases the likelihood of earnings manipulation by reducing auditor independence but conflicting studies found.
- Governance issue is a decrease in independence owing to “the risk of foregoing lucrative non-audit services” (Larcker and Richardson, 2003)^{152}
- Provision of non-audit services is linked to accruals/earnings management for approximately 20\% of sample firms (Larcker and Richardson, 2003)^{153}
- Critical Features contributing to earnings manipulation include (Larcker and Richardson, 2003):
  - higher insider holdings;
  - smaller board of directors (and audit committee); and
  - lower percentage of independent board (and audit committee) members^\(^{154}\)
- Brown, Falaschetti and Orlando (2008) found that a negative relationship existed between non-audit services and earnings quality but that its effect was reduced by the effect of the market and, possibly, mandatory disclosure rules^\(^{155}\)
- The thesis hypothesises that the [ExtAudEarn] (+) variable is a ‘strong form’ independence variable.
- Therefore, the relational effect path of the [ExtAudEarn] (+) variable has a positive (+)

---

^{150} Coffee, above n 147, 5.
^{153} Ibid, 25.
^{154} Ibid.
^{156} Board Independent Director: Executive Director Proportion – Monitoring Effect - see discussion in sections 7.3.2.1.1-2 of chapter 7.
^{157} Audit Committee – Independence – Monitoring Effect - see discussion in sections 8.4.1 – 8.4.3 of chapter 8.
9.2.3.3 [NonAuditS] (-): Non-Audit Services of External Auditor

directional marker that hypothesises a reduction in earnings management consequent on the external audit function
• Zone of effect of the [ExtAudEarm] (+) variable is hypothesised to extend to all Governance Factors except Compliance Factor No. 2 (Corporate Governance and Legal Compliance) in the same manner as the [BrdIndMon] (+)156 and [AudIndMon] (+)157 variables
• This gives rise to a Coverage/Rating of +7/87.50 rprox

• Though not conclusive, relational effect path of the [NonAuditS] (-) variable will be negative (-) suggesting an increase in the probability of earnings management
• Zone of effect of the [NonAuditS] (-) variable extends to all Governance Factors except Compliance Factor No. 2 (Corporate Governance and Legal Compliance) in the same manner – but opposite direction – as the [ExtAudEarm] (+) variable in this section 9.2.3.3
• Equates to a Coverage/Rating for the [NonAuditS] (-) variable of -7/87.50 rprox
APPENDIX E:

ADDITIONAL REFERENCES FOR EMPIRICAL STUDIES KEY FIELD NO. 4 (PART 4)

E1: Additional References on Director, CEO and Management Compensation


E2: References on the Practice of “Backdating” Options

E3: Recurring Themes And Tensions In Empirical Studies Key Field No. 4 (Part 4)

Summary Table E3 represents further contour lines on a map of the Relational Corporate Governance Framework\(^{158}\) - a summary of the hypothesised effects on firm value, operating performance and the probability of earnings manipulation of firm-specific ‘good’ Governance Variables relating to executive, CEO and director compensation:

**Summary Table E3:**

**Firm-Specific ‘Good’ Governance Variables and Director, CEO and Management Compensation**

<table>
<thead>
<tr>
<th>Section</th>
<th>Governance Structure or Variable</th>
<th>Perceived/Claimed Benefit/Effect</th>
<th>Summary of Findings</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>‘Good’ Corporate Governance and Director, CEO and Management Compensation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10.1</td>
<td>Overview of Governance Approaches and Purpose of Chapter 10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10.2</td>
<td>Compensation, the Level/Quality of Monitoring and Firm Value and Operating Performance</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| 10.2.1  | Director and Management Equity Ownership | Increase in firm value/ performance | • ‘Trade-off’ between the ‘incentive alignment’ and ‘entrenchment’ effects (identified by Fuerst and Kang)\(^{159}\)  
• Strength of the national/shareholder protection regime relevant in determining the balancing point.  
• Some support (at this time, no higher than this) of causative relation between these two variables provided that  
o. the directors are independent (Perry, 2000)\(^{160}\) and (Fernandes, 2005)\(^{161}\) and/or  
o. the compensation is incentive-based  
   – i.e., performance-based payments |
| 10.2.2  | Increases in level of director compensation | Increase in quality of monitoring of management |                     |

---

\(^{158}\) See Figure 2.8 of chapter 2.


10.2.3 CEO/Executive compensation level

<table>
<thead>
<tr>
<th>Firm operating performance and/or value</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Inconclusive relationship (conflicting studies).</td>
</tr>
<tr>
<td>• Some studies find no relationship between CEO/executive pay levels and firm performance (Fernandes, 2005)\textsuperscript{167} and/or firm value (Brick, Palia and Wang, 2005)\textsuperscript{168}</td>
</tr>
<tr>
<td>• For (Fernandes, 2005), the level of executive</td>
</tr>
</tbody>
</table>


\textsuperscript{166} Daines, Nair and Kornhauser, above n 161, 27.

\textsuperscript{167} Fernandes, above n 161, 2 and 17.


\textsuperscript{169} Fernandes, above n 161, 2 and 17.

\textsuperscript{170} Ibid.


\textsuperscript{172} Ibid.

\textsuperscript{173} Ibid.

\textsuperscript{174} Fernandes, above n 161, 2 and 17.


\textsuperscript{176} Ibid, 19-20 (formatting altered).

\textsuperscript{177} Ibid.


\textsuperscript{179} Equity/Option Plans and Holdings of Directors/Executives – Incentive/Alignment Effect (excludes short-term options) – see discussion in section 10.2.4 of chapter 10.

\textsuperscript{180} Equity/Option Plans and Holdings of Directors/Executives – ‘Entrenchment’ Effect (excludes short-term options) – see discussion in section 10.2.4 of chapter 10.

\textsuperscript{181} Compensation Committee - Presence, Operation and Frequency – see discussion in section 10.2.4.1 of chapter 10.

\textsuperscript{182} Marrakchi Chtourou, Bédard and Courteau, above n 120, 4 and 27.

Independence of directors

Equity/Option Plans and Holdings of Directors/Executives – Incentive/Alignment Effect (excludes short-term options)

CEO/executive compensation

Relational effect path

- Increases in the proportion of non-executive directors increase executive compensation levels (Fernandes, 2005)\textsuperscript{170}
- If a causative relation exists between CEO/executive pay levels and firm value, it may well be negative (Bebchuk, Cremers and Peyer, 2007 revised 2008)\textsuperscript{171}
- Negative relationship between ‘CEO centrality’ and firm value (Bebchuk, Cremers and Peyer, 2007 revised 2008)\textsuperscript{172}
  - authors define ‘CEO centrality’ as the relative importance of the CEO in the corporation’s upper management. This is measured by the ‘CEO’s pay slice’ or ‘CPS’ being the percentage of the total compensation of the top 5 executives captured by the CEO\textsuperscript{173}
- Increases in the proportion of non-executive directors increase executive compensation levels in Portugal (Fernandes, 2005)\textsuperscript{174}
- Guthrie, Sokolowsky and Wan, 2010)\textsuperscript{175}:
  - *(i) board independence does not affect the level of CEO pay;
  - *(ii) compensation committee independence causes CEO pay to increase; and
  - *(iii) the increase in CEO pay occurs only in the presence of blockholder directors or high institutional ownership concentration, both of which are considered to be monitoring substitutes.\textsuperscript{176}
  - Similar conclusions for the change in pay for non-CEO executives.\textsuperscript{177}
- Alternative explanations for these findings (Guthrie, Sokolowsky and Wan, 2012 revised 2013)\textsuperscript{178}:
  - executive or inside directors with better information monitor the CEO more closely which reduces the level of CEO pay
  - By contrast, independent directors with inferior information and less effective monitoring judge the CEO less harshly than their inside counterparts leading to CEO pay increases
- Relational effect path is the same as the Shareholder-Primacy Model ‘Umbrella’ in Figure 2.6.3A with the exception of the exclusion of the overriding requirements of The Compliance Factor No. 2 (Corporate Governance and Legal Compliance):
  - Coverage/Rating of +7/87.50 rprox
<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
<th>Details</th>
</tr>
</thead>
</table>
| 10.2.4  | [EqOptEntrch] (-) – Equity/Option Plans and Holdings of Directors/Executives – ‘Entrenchment’ Effect (excludes short-term options) | Same relational effect path as for [EqOptIncent] (+) but with a negative direction (-)  
- hypothesised to lead to reductions in the alignment of shareholder and management interests and to consequently reduce the quality of monitoring on behalf of shareholders  
- Coverage/Rating of -7/87.50 rprox |
| 10.2.4  | [DirCEO$] (+/-) – Director/CEO Compensation Levels | Behaviour of the [DirCEO$] (+/-) variable may be positive or negative depending on the behaviour and strength of the [EqOptIncent] (+) and [EqOptEntrch] (-) variables (and which dominates over the other) acting in opposition to each other at any time.  
- This gives rise to a ‘dual direction’ marker for the [DirCEO$] (+/-) variable with an identical relational effect path to both [EqOptIncent] (+) and [EqOptEntrch] (-):  
  - Coverage/Rating of +/- 7/87.50 rprox |
| 10.2.4.1 | [CompCom] (+/-) – Compensation Committee – Presence, Operation and Frequency | The levels and structure of the [DirCEO$] (+/-), [EqOptIncent] (+) and [EqOptEntrch] (-) Governance Variables are themselves dependent on the operation and structure of the [CompCom] (+/-) variable because the composition and levels of director, CEO and executive compensation flows (at least internally) from decision-making within the compensation committee  
- This gives rise to a ‘dual direction’ marker for the [CompCom] (+/-) variable with an identical relational effect path to [EqOptIncent] (+), [EqOptEntrch] (-) and [DirCEO$] (+/-):  
  - Coverage/Rating of +/- 7/87.50 rprox for [CompCom] (+/-) |
| 10.2.5  | Granting of short term options to directors and option incentive plans | Cautionary findings (two studies)  
- Risk of earnings misstatement increases with short-term options granted to outside audit committee directors thus inhibiting the function of such directors to monitor financial statement integrity (Marrakchi Chtourou, Bédard and Courteau, 2001)  
- Option incentive plans increase earnings manipulation but not performance (Tehranian, Cornett, Marcus and Saunders, 2006) |
| 10.2.5.1 | [AudShortOpts] (-) – Audit Committee – Short Term Options Granted to Outside | Flowing from (Marrakchi Chtourou, Bédard and Courteau, 2001) above, the relational effect path for [AudShortOpts] (-) is identical to that of both the [EqOptIncent] (+) and |
10.2.5.1 [ShortTOpts] (-) – Short-Term Option Holdings/Plans of Directors and Executives

<table>
<thead>
<tr>
<th>Directors – Reduction in Monitoring Effect</th>
<th>[EqOptEntrch] (+) variables:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Relational effect path</td>
<td>o Coverage/Rating of - 7/87.50 for [AudShortOpts] (+)</td>
</tr>
<tr>
<td></td>
<td>- Flowing from (Tehranian, Cornett, Marcus and Saunders, 2006) above, the relational effect path for [ShortTOpts] (+) is identical to that of both the [EqOptIncent] (+) and [EqOptEntrch] (-) variables:</td>
</tr>
<tr>
<td></td>
<td>o Coverage/Rating of - 7/87.50 for [ShortTOpts] (-)</td>
</tr>
</tbody>
</table>

10.2.6 Possible Connection Between Director and CEO Compensation Level:

*Is Director Compensation Linked to the Difficulty of Monitoring the Firm and therefore CEO Compensation?*

<table>
<thead>
<tr>
<th>10.2.6</th>
<th>Director compensation</th>
<th>CEO compensation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(Brick, Palmon and Wald, 2002) hypothesize “that director compensation is related to the difficulty of monitoring the firm” and therefore also related to CEO compensation.184</td>
<td></td>
</tr>
</tbody>
</table>
|        | Thus, the authors find a positive relationship between director and CEO compensations185 and determine whether this relationship is due to ‘unobserved firm complexity’ as opposed to ‘cronyism’:
|        | o These authors find a negative relationship between firm performance and excess director compensation186 leading them to adopt the latter explanation.187 |
|        | Shareholdings of non-executive directors operate as a ‘restraint’ on CEO compensation levels (Evans and Evans, 2001)188 |
|        | Consistent with the findings of Brick et al, Evans and Evans find that increases in non-executive director compensation are linked to increases in the CEO compensation level189 |

185 Ibid.
186 Ibid, 3.
189 Ibid.
### 10.3 Possible Connection between Firm Size and Director/Executive Compensation

| 10.3 | Increases in firm size | Increase in compensation of outside directors and/or executives | • There is some suggestion that the level of compensation is linked to firm size for:  
  o outside directors (Lee, 2007)\(^{190}\)  
  o executives (Fernandes, 2005)\(^{191}\)  
• Firm size (determined by sales) is a determinant of CEO compensation but firm performance does not affect CEO compensation (Michaud and Gai, 2009)\(^{192}\):  
  o as firm size increases, the ‘pool of talent’ capable of managing the firm is reduced and this smaller pool has greater power to increase its compensation claims\(^{193}\)  
  
| 10.3 | Global Financial Crisis | Increases in executive pay | • (Mehran, Morrison and Shapiro, 2011)\(^{194}\) examine governance lessons learned from the GFC. Executive pay is related to:  
  o size of the firm’s assets (market value of equity or book value)  
  o asset complexity and  
  o industry structure and competition\(^{195}\)  
• For (Mehran, Morrison and Shapiro, 2011), “leverage has an insignificant effect on pay, and, on average, firms judiciously choose their leverage for its effects on their credit ratings and potential costs of distress.”\(^{196}\)  

| 10.3 | Increases in the proportion of non-executive directors | Increases in executive pay | • A study by (Fernandes, 2005) further suggests a positive link between executive pay and increases in the proportion of non-executive directors on the board.\(^{197}\)  

---

\(^{191}\) Fernandes, above n 161, 2 and 17.  
\(^{193}\) Ibid.  
\(^{195}\) Ibid, 5 (formatting altered and footnote omitted).  
\(^{196}\) Ibid.
### 10.4 Compensation, Governance and Reputational Constraints

<table>
<thead>
<tr>
<th>10.4.1</th>
<th><strong>Reputational constraints on board</strong></th>
<th><strong>Level of executive remuneration</strong></th>
<th><strong>10.4.1</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>[ReputDiscl] (+) – Reputational Constraints – ‘Disclosure Standards’ and [ReputRep] (+) – Reputational Constraints – ‘Transparent Reporting’</td>
<td>Level of executive remuneration</td>
<td><strong>• Reputational constraints limit the level of executive remuneration (Singh, 2006)(^{198})</strong>&lt;br&gt;<strong>• Operation of these constraints is dependent on presence of ‘disclosure standards’ and ‘transparent reporting’ (Singh, 2006)(^{199})</strong></td>
<td><strong>• These Governance Variables are hypothesised to be acting downwards on the Compensation Factor No. 4 (Board, CEO and Management Compensation and Incentives) and operate in the same manner as the [TransTimeMon] (+)(^{200}) variable depicted in Figure 9.1.2.1A of chapter 9:</strong>&lt;br&gt;<strong>o [ReputDiscl] (+) and [ReputRep] (+) variables are each hypothesised to affect all Governance Factors with a Coverage/Rating of +8/100.00 prox</strong></td>
</tr>
</tbody>
</table>

---

BIBLIOGRAPHY F1:

KEY FIELD NO. 1 – THE APPLICATION OF THE PRINCIPAL THEORIES OF THE FIRM TO THE RELATIONAL APPROACH

Books, Working Papers and Journal Articles


Hill, Jennifer G, “Why Did Australia Fare So Well in the Global Financial Crisis?” The Regulatory Aftermath Of The


Statutes


Cases


Government and Regulatory Body Reports, Codes and Publications

ASX Corporate Governance Council, _Principles of Good Corporate Governance and Best Practice Recommendations_, Australian Securities Exchange, March 2003 (‘ASX 2003 Best Practice Recommendations’).


BIBLIOGRAPHY F2:

KEY FIELD NO. 2 - AUTOPSIES OF THE ENRON AND HASTIE CORPORATE COLLAPSES

Books, Working Papers and Journal Articles


Larcker, David F and Tayan, Brian, “Is a Powerful CEO Good or Bad for Shareholders?”, Rock Center for Corporate Governance at Stanford University Closer Look Series: Topics, Issues and Controversies in


Statutes


Government and Regulatory Body Reports, Codes and Publications


Administrators’ Report

BIBLIOGRAPHY F3:

KEY FIELD NO. 3 – COMPARATIVE CORPORATE GOVERNANCE CODES

Books, Working Papers and Journal Articles


de Zwart, Francesco (95% author) and Gilligan, George, "Sustainable Governance in Sporting Organisations” in Placido Rodriguez, Stefan Kesenne and Helmut Dietl (editors), Social Responsibility and Sustainability in Sports, Ediciones de la Universidad de Oviedo, 2009.


Statutes


Government and Regulatory Body Reports, Codes and Publications

(i) Australian Securities Exchange (ASX) (Aust)

The original ASX best practice recommendations were contained in the ASX Corporate Governance Council, Principles of Good Corporate Governance and Best Practice Recommendations, Australian Securities Exchange, March 2003 (‘ASX 2003 Best Practice Recommendations’). Proposed changes to the ASX 2003 Best Practice Recommendations were the subject of public comment. See ASX Corporate Governance Council, Principles of Good Corporate Governance and Best Practice Recommendations, Exposure Draft of Changes, Australian Securities Exchange, 2 November 2006 (‘ASX Draft Recommendations’).

The ASX 2003 Best Practice Recommendations were revised on 2 August 2007. See ASX Corporate Governance Council, Corporate Governance Principles and Recommendations, Second Edition, Australian Securities Exchange, 2 August 2007. These Principles and Recommendations were further amended in June 2010. See ASX Corporate Governance Council:

- Corporate Governance Principles and Recommendations with 2010 Amendments, June 2010 (‘ASX 2007-10 Revised Principles’);
- Revised Corporate Governance Principles and Recommendations (Second Edition, August 2007);
- Marked-Up Amendments dated 30 June 2010 to the Second Edition of the Corporate Governance Principles and Recommendations (‘ASX 2010 Marked-Up Amendments’); and
- Summary Table of the 30 June Changes to the Second Edition of the Corporate Governance Principles and Recommendations (‘ASX 2010 Summary Table’).


(ii) Financial Reporting Council (UK)


Financial Reporting Council (FRC): Other documents published by the FRC:

- *Challenges for Audit Committees Arising from Current Economic Conditions*, November 2009, London;
- *Internal Control: Guidance to Directors*, (formerly known as the Turnbull Guidance), originally published in 1999 and last revised in 2005, London; and


(iii) Other Government and Regulatory Bodies


Commonwealth Association for Corporate Governance, *CACG Guidelines of Corporate Governance*, November 1999, (‘CACG Guidelines’).


BIBLIOGRAPHY F4:

KEY FIELD NO. 4 – EMPIRICAL STUDIES ON THE EFFECTIVENESS OF GOVERNANCE VARIABLES

Books, Working Papers and Journal Articles


**Statutes**


**Government and Regulatory Body Reports, Codes and Publications**


