

Corporate Governance in Australia

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The state of corporate governance in Australia has received media and policy attention in the last eighteen months as the social and financial implications of major corporate collapses come to light. Most prominent in the local financial press have been the investigations of governance irregularities (and allegations of illegal management behaviour) in HIH and OneTel, with supporting roles from companies such as Harris Scarfe and AMP. Overseas players in the unfolding governance drama have included the US corporations Tyco, Enron and Global Crossing.

Economists have not been active participants in framing the agenda of Australian debate on corporate governance. Indeed, what has been lacking in the debate thus far is analysis of the state of corporate governance using the tools and concepts familiar to students of economics. Financial economists, in particular, have a rich set of empirical findings that allow us to judge the necessity for and likelihood of success of reform options.

This paper presents a standard principal-agent framework to place the current corporate governance debate and policy reforms in context. This framework is used to describe the changes in the Australian corporate governance system over the last forty years, and to determine if there are lessons from this experience for current reforms. An examination of how principal-agent relationships between shareholders (and other stakeholders) and managers will be affected by the recently formulated Australian Stock Exchange (ASX) Corporate Governance Council 'Principles of Good Corporate Governance and Best Practice Recommendations' is provided. Some speculations on their likely impact on firm value and stock market behaviour are offered.

A Framework for Understanding Corporate Governance

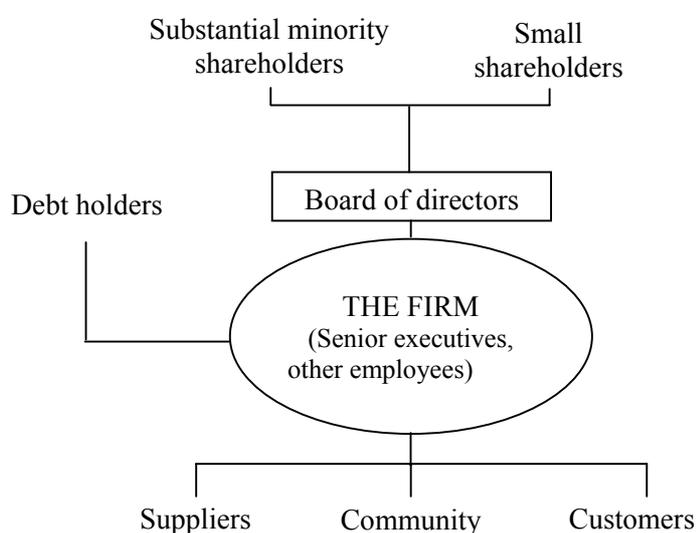
The level of transaction costs associated with various organisational structures provides the conditions under which the owners of the firm choose how to organise in such a way as to maximise profit. Firms as organisational forms (the co-location of individuals to produce goods and services) solve coordination and information problems associated with contracting over long time periods (Williamson, 1971; Alchian and Demsetz, 1972). As the firm increases in size, the benefits of specialisation lead owners to delegate day-to-day control to managers, and oversight of management to the appointed board of directors. The corporate governance of the firm, therefore, entails a set of mechanisms by which

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the owners of the firm attempt to ensure that managers undertake activities consistent with the firm's goals. In a world with full information and zero transaction costs, management can be contracted to always act in the interests of the owners. However, in practice, the principal-agent relationship between owners and managers gives rise to the possibility that managers may act opportunistically to improve their welfare at the expense of owners.

The principal-agent (or agency cost) framework has been adopted by financial economists to describe features of the corporate governance system. This framework is adopted here in order to describe the key empirical findings of the finance literature. The set of principal-agent relationships that commonly exist within the ownership structure and operational basis of the firm are summarised in Figure 1 (for a similar approach, see John and Senbet, 1998).

Figure 1: The Firm as a Nexus of Contracts



At the top of Figure 1, debt holders and equity holders are the major financial claimants over the value of the firm. Debt holders receive the risk-determined coupon on the debt obligation. Equity holders are the residual claimants on firm value, and delegate the corporate decision making to specialist managers and the board of directors. The number and type of shareholders varies, from a small group of inter-related parties (such as in a family-owned firm), to a large, dispersed group of shareholders (such as in a large publicly traded corporation). Perhaps the most common ownership structure relevant to the current corporate governance debate is the publicly listed firm with dispersed, small shareholders and a few substantial minority shareholders (usually institutional investors).

Agency relationships exist within the firm between senior executive management and other employees, depending on its organisational complexity. Intra-firm agency problems arise most in large diversified firms with divisional

managers who may 'side contract' to further their own interests, rather than that of the head office (Gibbons, 1998). Thus, remuneration design and incentive compatibility relate to all levels of the firm, rather than just to the contracts of senior executives.

The firm also has a number of relationships with other stakeholders in the normal course of its operations — suppliers, customers and the community. These relationships are illustrated in the bottom half of the diagram. The extent to which management can act opportunistically in its relationships with suppliers and customers is limited by the relative power held by each party. Management may alter ('hold-up') contracts, or other norms of business, with suppliers or customers to further their own ends (not necessarily those of the owners). The ability to do so is determined by the nature of goods and services traded, alternative supplies and the value management places on long term reputation versus short term gains (Besanko, Dranove and Shanley, 2000). A key supplier relationship in the governance process is the consumption of audit services by the firm. External audits provide third party review of the mechanisms designed to minimise agency costs; in particular, audits should ensure that the behaviour of management, the board of directors and related parties are in the best interests of equity and debt holders and the financial position of the firm is fairly and accurately communicated. Finally, the firm has an agency relationship with the community — a social agency relationship — that encompasses responsibilities in terms of being a 'good' corporate citizen. Only recently have firms in Australia explicitly recognised such a corporate governance relationship (for example in the areas of environmental sustainability, land rights, or corporate philanthropy).

Academic research on corporate governance since the 1980s has increasingly directed attention to the relationships in Figure 1, primarily to the relationships between financial claimants such as debt holders and equity holders and the firm. Financial economics now has a strong sub-field in empirical corporate governance that measures the extent to which agency costs vary by ownership structure and the type of corporate governance structures employed by firms (or indeed, types of corporate governance systems that may vary by country or legal system). The major corporate governance mechanisms found to influence the level of agency costs are the ability of directors to oversee the behaviour of management (the structure and role of the board of directors), the audit and review process (both internal audits and the external audit process undertaken by third parties), the design of executive remuneration (aligning interests through incentive-based pay), the role of large shareholders to incur monitoring costs and oversee management, and the threat of takeover from the market for corporate control. More generally, the link between 'better' corporate governance mechanisms and higher firm performance has received mixed support (see Demsetz and Villalonga, 2001).

In order to judge the necessity for the new ASX reforms we now examine how the principal-agent relationships in Australian firms have changed (if at all) over the last forty years (for similar reviews see Franks, Mayer and Rossi, 2003 on the UK; and Holmstrom and Kaplan, 2003 on the US). Our examination focuses on three of the five mechanisms above: the increases in ownership concentration,

the rise in the number of block shareholders, executive and director share ownership, and board structure. The operation of the market for corporate control in Australia was a relatively less important constraint on management, at least until the 1990s (see Walter, 1984; Brown and Horin, 1986)¹.

Corporate Governance in Australia over the Last Forty Years

Ownership Concentration

Separation between ownership and control has been a relatively recent characteristic of firms in Australia. As Ville and Merrett (2000) have argued, Australian companies in the first half of the twentieth century were best described as ‘family capitalism’ with important director and managerial positions held by a close-knit business group. There is little evidence of hierarchies of salaried managers outside the banks, pastoral companies or mining houses. Indeed, Wheelwright’s (1957) a study of the largest 102 companies in Australia in the 1950s (including financial institutions and subsidiaries of multinational corporations) indicated the founding families were in a position to control the majority of those companies through their board positions and shareholdings. Only one third of domestic companies could be identified as management controlled.

The nature of the separation of ownership from control changed in the second half of the twentieth century. In terms of Figure 1, the relative importance of substantial minority shareholders increased and that of small shareholders decreased, altering the nature of the review and monitoring of the board of directors and management.

Table 1: Ownership of Shares by Individuals, Companies and Institutions 1952 and 1995

Owner	1952	1995
	<i>Per cent</i>	
Households/persons	75.6	22.8
Rest of world	-	32.0
Companies	15.5	8.8
Life & pension funds	-	23.8
Banks & other	-	11.0
All financial	8.9	-
Government	-	1.5

Source: Wheelwright (1957); ASX (1995)

Table 1 reports data on the percentage of shares owned by various groups in 1952 and 1995. Here ownership is measured using information on the number of shares, as reported by Wheelwright (1957) for 1952, and the ASX (for 1995).

¹ The audit and review process deserves fuller treatment than available here.

Individual share owners comprised the largest shareholder type in 1952 (75.6 per cent) but had declined to a third in 1995 (22.8 per cent). This decline in relative importance is in spite of the increase in share ownership for Australian households since the 1970s (that is, the number of households owning shares has increased but their proportion of all shares has decreased). By contrast, financial institutions have risen in importance over the last forty years. All financial shareholders were 8.9 per cent of the total in 1952, and 34.8 per cent in 1995 (combining life and pension funds, and banks). Ownership of Australian corporations by overseas shareholders is more difficult to ascertain. Wheelwright's (1957) study did not identify foreign owners as a separate group (foreign owners are included in individuals and nominees, or financial categories). In 1995 foreign owners comprised 32.0 per cent of shareholders, and it is reasonable to expect that the figure was lower for 1952.

The aggregate data on ownership in Table 1 does not tell us (in a cross sectional sense) how firms have changed over the forty years. As a first attempt at mapping these longer term changes we have collected firm-specific information on the largest 50 non-financial firms in Australia for 1964 and 1997 (the firms are identified by Ville and Merrett 2000). Detailed information is available on ownership for approximately half of these firms. In Table 2 we report the summary statistics for the percentage of shares owned by the top 20 shareholders, top 5 shareholders and largest shareholder for the sample of firms in 1964 and 1997. These ownership concentration measures are not ideal, as they include the holdings of large financial institutions as monies for pension and life funds. Thus, we know less about the beneficial holdings or voting power of the shares and whether substantial minorities are now more prevalent. Nevertheless, such measures are commonly used as a litmus test of ownership concentration in the empirical finance literature and are used here.

Table 2: Ownership Concentration — Select Australian Firms

	Top 20		Top 5		Largest	
	1964	1997	1964	1997	1964	1997
	<i>Per cent</i>					
Mean	39.2	65.2	29.9	46.4	15.9	20.5
Median	30.6	64.5	15.4	44.8	7.3	16.6
Std dev	26.9	15.8	28.4	15.7	17.9	15.6
Count	23	23				

Source: Wheelwright and Miskelly (1967); Connect4 Annual Report Series

All measurements of ownership concentration reported in Table 2 show increases over the period. The top 20 and top five shareholders in 1964 held, on average, 39.2 per cent and 29.9 per cent respectively. By 1997 the corresponding groups held 65.2 per cent and 46.4 per cent. Also noticeable is that the variation in firm experience declined between 1964 and 1997. The standard deviation of top 20 and top five shareholdings fell from 27-28 per cent to 15 per cent. Thus, in

1964 there was a greater dispersion of ownership and firms adopted a range of ownership and corporate governance mechanisms to reduce agency issues between shareholders, debt holders and managers. By 1997 the greater concentration means that the governance functions are more likely to be undertaken by the same groups. Indeed, one important group — the largest shareholder — increased in size, from an average 15.9 per cent of shares in 1964 to 20.5 per cent in 1997. The median shareholding for each ownership concentration is also reported in Table 2 as a more robust measure. All median data show at least a doubling in ownership concentration for our sample firms. Top 20 shareholders held 30.6 per cent in 1964 and 64.5 per cent in 1997; the top 5 shareholders became even more important with a rise from 15.4 per cent of shares in 1964 to 44.8 per cent in 1997. The largest shareholder also increased their holding from 7.3 per cent to 16.6 per cent.

How did the trends in Tables 1 and 2 impact on the governance structure of corporations? The most likely outcome of the change in type of owner and ownership concentration is in the review and monitoring of the board and management by shareholders that could incur the transaction costs of information collection and regular briefings and meetings. Individual shareholders usually do not have the resources to monitor actively the managers of Australia's largest companies. Indeed, Wheelwright (1957) concluded that one-third of the companies in his sample were 'in the hands of management, over whom shareholders can have little control'. The diffuse ownership structures of the 1950s and of later decades, as reported by Wheelwright and Miskelly (1967) for 1962-64 and Lawriwsky (1978) for 1974-75, meant that managers faced less scrutiny than would be the norm in the 1990s. Companies were the only other shareholder type of any importance (15.5 per cent of shares) and typically inter-company share ownership tended to be supportive of incumbent management. Close personal relationships and reputations at the board level often meant that the company representatives (as shareholders) would not act in the best interests of the smaller individual shareholder when questions of priority arose.

Financial institutions have the means and incentive to provide closer scrutiny of the board and management given that they hold larger blocks of shares (as nominees) for their clients. In 1952 financial institutions held only 8.9 per cent of shares. Wheelwright and Miskelly (1967) later estimated that institutions could, if they combined as a single block of like-minded investors (all nominee companies acting in unison), control 30.6 per cent of surveyed companies (effectively replacing the one-third managerial control). However, 'non-action by institutions' meant that managers were not subject to external review from institutions. By the 1990s financial institutions had risen in importance to provide a greater shareholding block. Life and pension funds in particular can now communicate a strong shareholder view to the board and management. Whether this has occurred is difficult to ascertain, although until very recently most studies have found pension funds to be passive in their dealings with firms (see Stapledon, Easterbrook, Bennett, and Ramsey, 2000). As far as we can tell, ownership changes have not unambiguously improved corporate governance since the 1950s.

Share Ownership, Board Characteristics and Blockholders

The nature of share ownership is one aspect of the principal-agent relationship and governance process. The last forty years has also witnessed changes in three other governance mechanisms — the level of share ownership by directors and managers, the structure of the board of directors (size and composition), and the number and type of block-holders (groups with more than five per cent of shares). Recent research has shown that these mechanisms can combine to mitigate agency costs in the firm, although debate continues on the effectiveness of each mechanism — on managerial share ownership compare McConnell and Servaes (1990), and Demsetz and Villalonga (2001); on board size see Denis and Sarin (1999); and on block-holders see Bethel, Liebeskind, and Opler (1998).

Share ownership by key decision makers in the company can be used as a corporate governance mechanism to ensure that the interests of all shareholders are protected. Managerial and director shareholding aligns interests on share value maximisation and decreases the probability that managers act opportunistically or that directors monitor ineffectively. However, empirical evidence provides no definitive answer on whether managerial or director shareholding is associated with higher firm value (Demsetz and Villalonga, 2001; and Craswell, Taylor and Saywell, 1997). Indeed, it is often the case that the design of remuneration packages focus on options, rather than direct shareholdings, that induce myopic behaviour by management to the detriment of shareholders. Table 3 shows the share of equity held by directors in the years 1952, 1962-64 and 1974-75 for samples of Australian firms — there were few majority control positions held by directors, and diffuse share ownership was the norm.

Table 3: Share of Equity Held by Directors, 1952-1975

Directors/Group	Per cent	1952	1962-4	1974-5
Majority	>50	--	8.4 per cent	7.6 per cent
Minority	>10<50	33.3 per cent#	25.8 per cent	42.0 per cent
Diffuse	0<10	66.6 per cent	65.9 per cent	50.3 per cent
Sample size		72*	299	157

Notes: # This figure refers to both minority and majority categories.

* 'Industrials' only.

Source: Merrett (2002)

Board size and board composition have long been regarded as important components of the governance process. In Figure 1, the board of directors monitors management and provides strategic input into the operations of the firm. Its ability to undertake these functions effectively depends on its size and composition. Board size is positively associated with company size due to the fact that as a firm increases in size and complexity, directors with a variety of human

capital skills are needed (Chandler, 1990:232-233; Denis and Sarin, 1999; Lawrence and Stapledon, 1999). Smaller firms have less complex control and decision making systems, implying that directors require general managerial skills. As the firm increases in size, non-executive and executive directors play important roles in monitoring and strategy formulation. There are costs, however, to larger boards. Jensen (1993) and Lipton and Lorsch (1992) argue that as board size increases it becomes difficult for an additional director to increase value. A larger board negatively affects the amount of time available at typical board meetings and has a negative impact on group dynamics by leading to greater formality and less frankness and openness in strategic discussion.

Board composition refers to the number of non-executive and executive directors on the board. Executive directors hold both a board position and a senior management or executive position within the company. Owing to this dual role, executive directors have the potential to make a valuable contribution to the board, as they are able to bring firm-specific knowledge to board deliberations. Notwithstanding the benefits of executive directors, their independence from management may be impaired. Executive directors display greater loyalty to management than do their non-executive colleagues, and given their position they are subject to greater influence by the company's CEO than are outside directors. The selection and reporting process of executive directors reduces independence, as directors are charged with the responsibility for monitoring the performance of the CEO and also report to the CEO. This results in a potential conflict of interest for such directors and the presence of too many executive directors on a board may invite scepticism about the independence of such a board, especially with regards to reviewing the performance of management.

On the other hand non-executive directors are typically appointed for their industry expertise and their decision-making abilities. The role of these directors differs somewhat from that of their executive counterparts in that non-executive directors may be undertaking strategic, independent monitoring and representative roles (Fama and Jensen, 1983). Despite the fact that the company does not employ non-executive directors in other positions, there may be circumstances where their independence is threatened. For example, many authors have questioned the independence of outside directors given the dominance of a company's CEO in making such appointments, or directors' previous connections with the firm (Core, Holthausen, and Larcker, 1999).

How has the size and composition of boards changed over the last forty years in Australia? Do we find improvements in the corporate governance of boards that can be associated with greater independence and resolution of principal-agent problems? Table 4 reports board size for the sample of twenty-three Australian firms in 1964 and 1997 (the same sample as in Table 2). Median board size increased from 7 directors to 11 directors between our benchmark years, consistent with what we would expect from theory and previous empirical evidence.

Table 4: Monitoring the Company: Board Size and Block-holders of Select Australian Firms

	Board Size		No. Block-holder	
	1964	1997	1964	1997
Mean	7.5	10.4	1.0	4.0
Median	7.0	11.0	1.0	4.0
Std dev	2.1	3.0	1.2	1.4
Sample size			23	23

Source: Wheelwright and Miskelly (1967); Connect4 Annual Report Series

The change in board size, however, tells us little about what may have happened to the operation of the board and its governance role over time. If firms increased in size during that period it is difficult to ascertain from board size alone whether boards behaved better. Information on the composition of boards is not available for many of Australian firms for earlier years. We have collected data for the six companies that were dominant firms throughout the twentieth century to give a longer term perspective on governance patterns. These firms were identified by Ville and Merrett (2000) as corporate leaders in the twentieth century; the firms are icons of Australian business history — BHP, CSR, Pacific Dunlop, Coca Cola Amatil, Australian Gas Light and Burns Philp. The list is, of course, biased in focusing on large firms that have entrenched positions. Further, there have been important governance changes to several (Pacific Dunlop and Burns Philp) in recent years.

Table 5: Board Size of Major Australian Firms

Company	1913	1928	1964	1997
BHP	7	6	7	12
CSR	5	5	7	13
Pacific Dunlop	6	5	11	11
Coca Cola Amatil	10	10	9	14
Aust Gas Light	12	6	*	8
Burns Philp	7	6	*	7

Notes: * indicates that data were not available

Source: Author's calculations from individual company reports; Wheelwright and Miskelly (1967); Connect4 Annual Report Series.

Examination of these top six firms shows that board size remained relatively stable until the 1960s. Only Pacific Dunlop increased board size substantially by 1964, most likely as a result of previous mergers and acquisitions. Smaller boards may have worked efficiently between the 1910s and the 1950s as the demands of external investors for rigorous oversight and review was low. Alternatively, the

data suggest that these companies were not subjected to high levels of outside scrutiny and could persist with CEO (or chairman) appointed boards of limited size. The rise in board size is by no means uniform for these firms. Board size increased at BHP, CSR, Pacific Dunlop, and Coca Cola Amatil, but not for Australian Gas Light or Burns Philp. Table 6 adds further insight by presenting composition of the board (the percentage of non-executive directors) for the six companies. All companies initiated a change in composition over the period to include a greater number of executive officers on the board.

Table 6: Board Composition of Major Australian Firms

Company	1913	1928	1964	1997
		Per cent NED		
BHP	100	83	86	67
CSR	100	100	86	77
Pacific Dunlop	100	100	73	73
Coca Cola Amatil	90	100	100	86
Aust Gas Light	100	100	*	88
Burns Philp	100	67	*	86

Notes: * indicates that data were not available

Source: Author calculations from individual company reports; Wheelwright and Miskelly (1967); Connect4 Annual Report Series

This change suggests that board operation and strategy formulation improved as executives played an increasingly important role in board deliberations. Noticeable too is the fact that every firm maintained a majority of non-executive directors, due in large part to the professionalisation of governance practices in large organisations (it is another question whether these directors were independent non-executives — anecdotal evidence would suggest that they were not). While only conjecture, we suggest that the rise of a market for professional non-executive directors and the increased importance of director reputation has served these firms well in improving monitoring, decision making and governance practices generally (Merrett, 2002).

The final trend we note from the data above is an increase in the number of block-holders. Table 4 indicates that the importance of block-holders has grown between 1964 and 1997, with an average of four substantial shareholders for 1997 firms. This is consistent with the increase in ownership concentration in Table 2. As stated earlier, block-holders serve an important role in the governance process because they are willing to incur the transaction costs associated with monitoring companies. Block-holders often have more specialised resources to devote to monitoring shareholdings, and have access to greater levels of information than smaller, individual shareholders. In many cases block-holders are able to engage in dialogue with incumbent management over the operations of the firm and adopt a ‘voice’ strategy in communicating dissatisfaction with performance (as opposed to an ‘exit’ strategy of selling equity positions). Smaller shareholders can free ride

on the actions of block-holders and enjoy improvements in performance, better strategic decision making and greater likelihood of disbursements of excess cash (Bethel, Liebeskind and Opler, 1998). The data in Table 4 suggests that the level of external monitoring by block-holders has improved to the benefit of all shareholders, although again we provide the caveat that structural change by itself is not sufficient to improve corporate governance practices.

In summary, an examination of some of the basic features of the governance mechanisms of large Australian firms over the last forty years shows that corporate governance has changed in nature but not necessarily improved. Data on ownership concentration, share ownership by directors, and the size and composition of the board of directors certainly suggest that by the 1990s Australian managers faced greater scrutiny by a market based corporate governance system. However, structural changes by themselves do not imply improved governance and the better resolution of principal-agent conflicts than in the past. The corporate governance 'crisis' in the late 1990s provided evidence that something more than structure is required to protect shareholders from managerial agency behaviour.

The ASX Corporate Governance Council 'Principles'

The effectiveness of corporate governance mechanisms have been called into question by many commentators recently in the light of overseas experience of corporate malfeasance (particularly in the USA), the corporate collapses of major listed Australian firms, and the apparently 'excessive' remuneration packages and termination payouts of senior executives (especially when firms are making losses). It has appeared that despite greater awareness of principal-agent conflicts and interest alignment, shareholders are still not protected from governance failures.

In August 2002 the ASX Corporate Governance Council was formed to 'develop and deliver an industry-wide, supportable and supported framework for corporate governance which could provide a practical guide for listed companies, their investors, the wider market and the Australian community' (ASX Corporate Governance Council, 2003:Foreword). The Council comprised representatives from 21 stakeholder groups including major investors, firms and professions (see ASX Corporate Governance Council, 2003:4), and delivered a set of principles and best practice recommendations in March 2003. While it is too early to state unequivocally how the principles will impact firm behaviour in the next few years, we provide comments and speculations on their effect given what we know about the Australian corporate experience of the last forty years and the literature on the empirical relationships between corporate governance mechanisms and outcomes.

The Council's principles are provided below in abbreviated form:

Principle 1: Lay solid foundation for management and oversight

- Formalise and disclose the functions reserved to the board and those delegated to management.

Principle 2: Structure the board to add value

- A majority of the board should be independent directors.
- The chairperson should be an independent director.
- The roles of chairperson and chief executive officer should not be exercised by the same person.
- The board should establish a nomination committee.

Principle 3: Promote ethical and responsible decision-making

- Establish a code of conduct to guide the directors, the chief executive officer (or equivalent), the chief financial officer (or equivalent) and any other key executives as to (i) the practices necessary to maintain confidence in the company's integrity, (ii) the responsibility and accountability of individuals for reporting and investigating reports of unethical practices.
- Disclose the policy concerning trading in company securities by directors, officers and employees.

Principle 4: Safeguard integrity in financial reporting

- Require the chief executive officer (or equivalent) and the chief financial officer (or equivalent) to state in writing to the board that the company's financial reports present a true and fair view, in all material respects, of the company's financial condition and operational results and are in accordance with relevant accounting standards.
- The board should establish an audit committee.
- Structure the audit committee so that it consists of only non-executive directors, a majority of independent directors, an independent chairperson, who is not chairperson of the board, and has at least three members.
- The audit committee should have a formal charter.

Principle 5: Make timely and balanced disclosures

- Establish written policies and procedures designed to ensure compliance with ASX Listing Rule disclosure requirements and to ensure accountability at a senior management level for that compliance.

Principle 6: Respect the rights of shareholders

- Design and disclose a communications strategy to promote effective communication with shareholders and encourage effective participation at general meetings.
- Request the external auditor to attend the annual general meeting and be available to answer shareholder questions about the conduct of the audit and the preparation and content of the auditor's report.

Principle 7: Recognise and manage risk

- The board or appropriate board committee should establish policies on risk oversight and management.
- The chief executive officer (or equivalent) and the chief financial officer (or equivalent) should state to the board in writing that (i) the statement given in accordance with best practice recommendation 4.1 (the integrity of financial statements) is founded on a sound system of risk management and internal compliance and control which implements the policies adopted by the board, and (ii) the company's risk management and internal compliance and control system is operating efficiently and effectively in all material respects.

Principle 8: Encourage enhanced performance

- Disclose the process for performance evaluation of the board, its committees and individual directors, and key executives.

Principle 9: Remunerate fairly and responsibly

- Provide disclosure in relation to the company's remuneration policies to enable investors to understand (i) the costs and benefits of those policies and (ii) the link between remuneration paid to directors and key executives and corporate performance.
- The board should establish a remuneration committee.
- Clearly distinguish the structure of non-executive directors' remuneration from that of executives.
- Ensure that payment of equity-based executive remuneration is made in accordance with thresholds set in plans approved by shareholders.

Principle 10: Recognise the legitimate interests of stakeholders

- Establish and disclose a code of conduct to guide compliance with legal and other obligations to legitimate stakeholders.

The Council (p. 5) states that the principles are 'not prescriptions' but designed to 'produce an efficiency, quality or integrity outcome'. However, all companies listed on the stock exchange (and potential listing companies) are encouraged to use the principles for 're-examining their corporate governance practices'. Companies may opt-out of implementing recommendations by clearly stating why they are not adopting the particular recommendation. Whether companies will avail themselves of such an option will depend on the transaction costs involved in explaining 'why not'. We might conjecture that the potential negative market reaction to such an explanation would deter most firms from such behaviour.

The principles can be organised into three types: structural principles, behavioural principles and disclosure principles.

Structural Principles

The structural principles assume that corporate governance mechanisms matter for the performance of the firm and the achievement of the firm's goals. These principles dictate the ideal composition of the board of directors (principles 2.1 and 2.2) and separation of roles on the board (principle 2.3), for the existence and structure of board committees (principles 2.4, 4.2, 4.3 and 9.2) and the operation of annual general meetings (encouraging effective participation — principle 6.1, and the use of auditors — principle 6.2).

The review in the previous section showed that structure alone does not necessarily lead to better governance although it influences the context of decision making. So the effectiveness of the structural principles will depend on how they influence behaviour. Further, the empirical evidence supporting the structural principles is mixed. The underlying assumption that governance structures matter for firm performance has been dismissed by most financial economists (for example, Bhagat and Black, 1998; Demsetz and Villonga, 2001). The weight of empirical evidence shows that board structure (such as a majority of independent non-executive directors) and/or that separation of board roles (such as between the chair and CEO positions) is unrelated to better average financial performance, other things being equal. There is, however, evidence that the operation of boards improves around important events (such as poor performance, CEO dismissal) and on certain key decisions-making issues (such as CEO remuneration, auditor appointment) when the board has a majority of independent non-executive directors. The number of non-executive directors in Australia are positively associated with the likelihood of CEO dismissal and negatively associated with excess CEO remuneration (Suchard, Singh, and Barr, 2001; Fleming and Stellios, 2002). Thus, we cannot expect to observe better financial outcomes for equity and debt holders as a result of adopting the principles on structure. Behavioural change is also necessary.

Behavioural Principles

Behavioural principles form the majority of the Council's recommendations. The behavioural approach assumes that adherence to structure in itself (a compliance oriented 'box-ticking') does not necessarily lead to better governance. This assumption is consistent with the review in the previous section, the empirical finance literature, and with a wider set of arguments developed in law and economics. The principles relating to the relative roles of the board and executives (principle 1.1), codes of conduct and charters (principles 3.1, 4.4 and 10.1), the necessity for sign-off of financial accounts and risk management policies (principles 4.1, 3.2, 5.1, 7.1, 7.2), and development of remuneration policies (principles 9.3 and 9.4) are designed to influence the behaviour of the management of major listed firms and generate positive spillovers in terms of changes in behaviour to all firms.

The setting of principles to influence behaviour (to achieve compliance in spirit as well as in the letter of the law) draws upon the theory associated with ‘expressive law’ — that by expressing a desired behaviour one can encourage the occurrence of that behaviour; see Cooter, 1998; Sunstein, 1996). Firms adopting the new principles will encourage a move to a new set of behaviour by management of ‘non-adopters’. Thus, a compliance culture is transaction cost minimising; even more so when non-compliance may require greater resources being devoted to explain the case for opting-out, or lead to falls in the firm’s share price as investors exit.

Disclosure Principles

Each of the 10 ASX principles has an associated disclosure principle, which outlines how the firm is to communicate corporate governance information to the stock market. In addition, disclosure is required on share trading (principle 3.2), the process of evaluating the board and senior executives (principle 8.1) and remuneration details (principle 9.1). The assumption behind the disclosure principles is that more information is better than less, and the operation of an efficient stock market requires material information to be disclosed in a timely fashion. This is consistent with the operation of the continuous disclosure rules since they were adopted in 1996.

It is not the case that all market participants are equal in their ability to comprehend the implications of new information on corporate governance practices for the value of the firm. We observe trading over-reactions to many types of information releases by different shareholders, including key strategic events such as mergers and acquisitions, which should be relatively straightforward to assess (see Aitken and Czernowski, 1992). Thus, we can expect greater volatility in market reactions to corporate governance announcements in the future, until market learning allows the information to be processed efficiently. Such learning will take time. For example, the disclosure of the remuneration packages of senior executives often attracts media attention and comparisons with national wage averages (especially the absolute dollar amount of the salary, bonuses or termination payments). Students of executive remuneration will be aware that the determination of an equilibrium remuneration package is a non-trivial task. Many variables go into the setting of wages, including firm size, firm risk, organisational complexity, and financial performance, as well as human capital factors such as industry experience, and education (Core, Holthausen and Larcker, 1999). Similarly, termination payments (or golden parachutes) have been shown to increase shareholder welfare (Lefanowicz, Robinson and Smith, 2000). The disclosure principles improve the ability of groups within the firm’s nexus of contracts to contract effectively and revise (or renegotiate) in the light of better information.

Policy Implications

Corporate governance reforms such as those provided by the *Principles* of the ASX Corporate Governance Council are welcome additions to the rules and regulations that form the legal boundaries to firm behaviour. But the important policy implication is that we should not expect the management of firms to alter governance structures and behaviour overnight. Such an expectation is unrealistic given that structural change in itself will not lead to better outcomes for shareholders, debt holders or other stakeholders of the firm. Behavioural change is a longer term process.

One unfortunate side-effect of the focus on corporate governance is that market participants (such as large institutional investors) and policy makers are calling for a faster response to the apparent failures. Our review of the last forty years shows it is not easy to judge whether the state of corporate governance has improved. Thus, short term responses to calls for reform may lack the careful reflection on what structures and behaviour are appropriate for the firms and its stakeholders, given the overriding goal of efficient resource allocation and maximising long term shareholder wealth. Certainly, rules on the behaviour of senior executives and the board will encourage oscillation to a particular structural and behavioural equilibrium. Firms should not be penalised, however, if they find alternative solutions to solving coordination and governance problems associated with the separation of ownership and control.

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