



UNIVERSITY OF CANBERRA, AUSTRALIA

Corporate Governance ARC Project

# Corporate Governance and Performance

## An Exploration of the Connection in a Public Sector Context

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# Preface

This paper is part of a major [project](#) - *Corporate Governance in the Public Sector: An evaluation of its Tensions, Gaps and Potential*. The project will provide the first comprehensive theoretical and empirical work on corporate governance in the Commonwealth public sector. It has been designed to enhance communication and participation in governance across government, industry, and the community by improving corporate governance literacy and making information publicly available.

The project is a collaborative venture between three University of Canberra research centres and key governmental and industry partners including the [Australian National Audit Office](#), the [Australian Government Department of Finance and Administration](#), [Deloitte, Touche, Tohmatsu](#), [CPA Australia](#) and [MinterEllison Lawyers](#).

This paper is the first in a series that will be produced by researchers and industry partners involved in the project. The aim of the series is to identify and explore key emerging public sector governance issues and encourage wider discussion and activity.

The series has been designed for public sector practitioners and corporate governance 'enthusiasts' across the public and private sectors. All papers will be broadly distributed and will be available online - [www.canberra.edu.au/corpgov-aps](http://www.canberra.edu.au/corpgov-aps)

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# 1. Introduction

## 1.1 About this paper

The focus of this paper is on the relationship between governance practices and performance of organisations. It examines what private sector evidence has to tell us about this relationship and explores the extent to which that evidence is relevant to the public sector. It goes inside the black box of the board room.

The central issue that emerges is that the relationship between players in the decision-making process is critical for organisational performance. Yet to-date, this aspect of corporate governance has been largely neglected in studies that test the links between governance attributes and organisational performance. Good business relationships, in common with personal relationships, require nurturing, being worked on, and protected. Once the concept of good relationships is brought into the governance-performance equation, our perception of what good governance is and what to look for to enhance performance changes.

### ***Structure of paper***

The remainder of this section includes a brief discussion of governance concepts and the rationale behind exploring the links between corporate governance and organisational performance. Section 2 of the paper provides a survey of the literature on the extent to which conventional “good” governance factors lead to company performance. Alternative or “soft” factors of governance that current research suggests appear to be important for performance are then introduced. The ways in which private sector findings could be applicable to the public sector are then addressed in section 3. This includes a brief discussion of the differences between the public and private sectors, and the findings of recent research into public sector corporate governance. The paper then turns to the measurement of (good) governance - both conventional and emerging – in section 4. The concluding section provides a summary of issues and suggests some next steps for taking the issue of public sector corporate governance and organisational performance forward.

## 1.2 Governance concepts

In its narrowest sense, corporate governance is about how an organisation is directed and controlled. It is about the structures and processes in place to facilitate and monitor effective management of an organisation, including mechanisms to ensure legal compliance and prevent improper or unlawful behaviour. However, as the Organisation for Economic Co-operation and

Development (OECD) definition below indicates, the emphasis on relationships is central to broader definitions of corporate governance.

The OECD takes a broad view of corporate governance and defines it as the full set of relationships among a company's management, its board, its shareholders and other stakeholders. It provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance determined. (1999a: 10)

The term 'corporate governance' finds its genesis in the private sector and conceptions have traditionally focused on the corporation-shareholder relationship. Increasingly, however, definitions of corporate governance place attention on a broader set of relationships to include those involved with, or with an interest in, the organisation (for example, employees, directors, suppliers, shareholders) and stakeholders served or affected by the organisation (for example, customers and local communities).

A definition of governance we find most appropriate within the context of this paper is that of the Australian Auditor-General:

I generally define corporate governance to encompass how an organisation is managed, its corporate and other structures, its culture, its policies and strategies, *and the ways in which it deals with its various stakeholders.*<sup>1</sup> (Barrett 2002: 2, emphasis added)

Corporate governance involves the following two dimensions, which are the responsibility of the board (or governing body/individual):

- Performance – monitoring the performance of the organisation and CEO. This also includes strategy - setting organisational goals and developing strategies for achieving them, and being responsive to changing environmental demands, including the prediction and management of risk. The objective is to enhance organisational performance;
- Conformance - compliance with legal requirements and corporate governance and industry standards, and accountability to relevant stakeholders.

(see for example, ANAO, 2003, Vol 1: 6)

Increasingly, the concept 'corporate governance' is used in the public sector as well as the private sector. While there are some similarities between the two sectors in governance terms, there are also significant differences that shape the way government departments, authorities, corporations and even government business enterprises are organised and governed (see section 3.1). For this reason 'public sector governance' is, for some, the preferred term.<sup>2</sup> However, for

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<sup>1</sup> Public sector stakeholders include: clients, ministers, local communities, inter-government agencies, other levels of government, business/industry representatives, NGOs, community and private partnership agencies, private contractors and academics.

<sup>2</sup> For example, the ANAO has opted for the term 'public sector governance' in its governance better practice guides (2003), and the literature suggests that the term 'corporate governance' is rarely associated with the public sector in the American context.

the purposes of this paper, the term ‘corporate governance’, or simply ‘governance’, is employed.<sup>3</sup>

### ***Separation of governance and management***

While, as noted by the Auditor-General above, governance is concerned with “*how an organisation is managed*”, it is important to understand that governing is not the same as managing. Broadly, governance involves the systems and processes in place that *shape, enable* and *oversee* management of an organisation. Management is concerned with *doing* – with co-ordinating and managing the day-to-day operations of the business.

The following table is helpful in understanding the conceptual difference between governing and managing.

<b>The Board</b>	<b>Management</b>
The mind	The hands
Directors direct	Managers manage
Policy	Action

(Source: AICD, 2003: 20)

However, whilst theoretically distinct, in practice an inflexible division between those who govern and those who manage may be impractical and inefficient or simply not relevant. For smaller organisations – particularly in the not-for-profit sector – with limited staffing and financial resources, board members may be called on to play a more hands on role. In the private sector, the separation of chair and CEO is a contested area and by no means a given in practice (this is discussed in more detail below).

Importantly, within the context of this paper, many public sector entity heads are responsible for both governance and management. The majority of Commonwealth public sector entities under the *Financial Management and Accountability (FMA) Act* do not have legally based decision-making boards and legal responsibility rests with the entity head. Some governance functions may be delegated to other officers and it is common practice to establish an executive committee or board to provide advice and support. Ultimately, however, the entity head will be held to account.

For board-based entities, staff and board member clarity about the differences between governing and managing will help to:

- avoid a board that micro-manages – interfering with day-to-day operations at the expense of strategically directly
- avoid a passive, ‘rubber-stamping’ board culture, controlled by the CEO.

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<sup>3</sup> Extensive consideration will be given to terminology and its appropriateness in the public sector context in other project publications.

Even when the two roles – directing and managing - are carried out by the same person or people, clarity about the different responsibilities and functions of each role and achieving a balance between the two will contribute to a smoother running organisation.

### ***Principles of good governance***

There are some commonly accepted key principles or elements of good governance that are applicable to both the public and private sectors. The three most common are: accountability – both internal and external; transparency/openness; and recognition of stakeholder/shareholder rights. Often to these are added: efficiency, integrity, stewardship, leadership, an emphasis on performance as well as compliance, and stakeholder participation or inclusiveness.<sup>4</sup>

At different times and in different organisations, different elements will be given emphasis and it is always a matter of balancing them. Indeed, there are inevitable tensions in attempting to practice good governance principles. Examples of tensions include between external and internal accountability, accountability and transparency, and efficiency and inclusiveness.

More generally, tensions are created between those who govern and those who manage and role conflicts will come into play - especially in the public sector, when participants wear more than one hat. As will be discussed later in this paper, a key to success in balancing these tensions is clarity around role, responsibilities and expectations. Essential to managing tensions well is to establish and maintain good relationships.

### **1.3 Why explore the relationship between corporate governance and organisational performance?**

The connection between corporate governance and organisational performance lies in the multi-dimensional nature of (good) governance. Narrowly conceived, corporate governance involves ensuring compliance with legal obligations, and protection for shareholders against fraud or organisational failure. Without governance mechanisms in place – in particular, a board to direct and control - managers might ‘run away with the profits’.<sup>5</sup> Understood in this way, good governance minimises the possibility of poor organisational performance.

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<sup>4</sup> See for example: The ASX [Principles](#) of Good Corporate Governance (2003), The OECD [Principles](#) of Corporate Governance (2004) and the ANAO [Principles](#) of Public Sector Governance (2003). See also the [characteristics](#) of good governance identified by the United Nations, within the context of a broad understanding of governance (1997).

<sup>5</sup> This understanding of corporate governance as, primarily, a protective mechanism stems from agency theory. Agency theory emphasises individual action and specifically the self-interested individual who will seek to maximise her/his personal gain. This creates an inherent tension or conflict between managers and owners. The board is there to safeguard the interests of the owners from managerial opportunism (Smallman, 2004: 80-82 and Donaldson & David, 1991: 50-51)

As noted earlier, however, more recent definitions of good governance emphasise the contribution good governance can make to improved organisational performance by highlighting the strategic role of the board. Legal compliance, ongoing financial scrutiny and control, and fulfilling accountability requirements are fundamental features of good corporate governance. However, a high-performing board will also play a strategic role. It will plan for the future, keep pace with changes in the external environment, nurture and build key external relationships (for example, business contacts) and be alert to opportunities to further the business. The focus is on performance as well as conformance. The board is not there to simply monitor and protect but also to enable and enhance.

The question arises then: what are the governance elements that add value to organisational performance and how can these be measured?

## 2. Private Sector Evidence

### 2.1 Conventional “good” governing boards

What governance features would we expect to find if a board practiced good governance? What structures and processes lead to good governance?

Recent corporate governance failures have led to a proliferation of corporate governance codes which emphasise, in particular, accountability and conformance measures. Corporate governance codes such as the *Cadbury* code in the UK, the *ASX* guidelines, and the *OECD* corporate governance principles can be found to contain certain (usually implicit) assumptions about what governance factors make for a good performing organisation. Some of the factors most commonly found in the literature and/or in corporate governance codes are:

- Separation of the roles of Chair and CEO
- Majority of non-executive or independent directors
- Small board size
- Balance of director skills and competencies
- Audit and other board committees
- Effective board performance evaluations
- Linking CEO rewards to performance
- Transparent appointment processes
- Adequate communication with investors.

(see for example, Heracleous 2001:4; Leblanc 2001).

These are what can be called “conventional” good governance attributes that are assumed to lead to good performance. On the whole, they are measures that can be assessed objectively from externally available and verifiable information. They form the basis of what many commercial organisations use to rate organisations (see section 4.1) according to their governance attributes.

### 2.2 Measures of performance

The surprising finding from the relevant literature, based on external observations of these variables, is how weak or even negative the relationship is between many of these variables and the financial performance<sup>6</sup> of an organisation. This

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<sup>6</sup> It should be noted that there are different measures of financial performance, for example, shareholder value, shareholder returns or stock market appreciation, which is often used to grade CEO performance. Van den Berghe and Levrau point out that “corporate governance matters to investors and creditors”. Primarily the driving factor is that strong corporate governance is seen to decrease financial risk. As a result, putting perceived good governance mechanisms in place can boost a company’s capacity to attract capital (2003: 74). On a different point, it is worth noting that with the

is the case particularly with structural governance factors such as whether the roles of CEO and chair are separate; whether there is a majority of independent directors; or the size of the board (Leblanc and Gillies 2004).<sup>7</sup>

Heracleous (2001) is one of many authors who claim that, while many of the above factors might be *necessary* for good organisational performance, they certainly are not *sufficient*. Heracleous states that what is generally accepted as “best practice” in corporate governance ‘generally failed to find convincing connections between these facts and organisational performance’ (2001: 2 ). Most recently this has been echoed by Leblanc and Gillies (2004). Given below is some evidence on findings in relation to the separation of chair and CEO, board independence, board size and CEO remuneration.

### ***Separation of chair and CEO***

*Rationale* – the recommended separation of chair and CEO is primarily grounded in the understanding that when the CEO plays the dual role of chair, owner interests will be, to some extent, “sacrificed” to the benefit of managerial interest (Donaldson & David, 1991: 51). Whilst the board provides a mechanism for keeping in-check managerial action, an independent chair will enhance the board’s capacity to achieve this.

A more generous rationale for separating the roles is that, ideally, the chair can serve as a confidant, perhaps even a mentor, to the CEO. Kocourek et al. note that a common concern for CEOs is that there is no one to talk openly and in depth to about the difficulties experienced in heading an organisation. The chair can play this supportive role (Kocourek et al., 2003: 6).

*Study results* - Heracleous (2001:49) provides a literature review of evidence that shows that whether the chair and CEO are separate or the same person does not, on its own, appear to make much difference to performance. Leblanc and Gillies similarly argue that empirical research has failed to find a clear link between the separation of CEO/chair positions and enhanced firm performance (2004: 7).

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recent demand for triple bottom line reporting organisations are increasingly required to focus on social and environmental as well as financial performance. Reputex is an independent agency that focuses on social responsibility ratings. It measures risk management performance in the following four areas: corporate governance, social impact, environmental impact and workplace practices ([www.reputex.com.au/](http://www.reputex.com.au/)).

<sup>7</sup> One exception to this is the results of recent studies on emerging markets, which show a positive relationship between corporate governance and financial ratios, valuations and share-price performance (Van den Berghe and Levrau, 2003: 73). Van den Berghe and Levrau suggest the reason for this lies in the weaker legal regimes regulating emerging markets in contrast to the more robust legal frameworks in developed countries. Put simply, a firm’s corporate governance practices can make a big difference in an under-developed regulatory environment by operating as a self-regulatory mechanism. While this suggests that a robust regulatory regime is conducive to acceptable – possibly good - performance, it does not tell us what forms the best regulatory approach. Following a series of high-profile corporate failures, the US opted for a tightening of regulatory control through the introduction of prescriptive regulations flowing from the *Sarbanes-Oxley Act 2002*. Critics argue that it will do little to improve corporate governance whilst substantially increasing the costs for the regulator and the regulated. Australia, alternatively, has opted for a more moderate and flexible approach.

## **Board Independence**

*Rationale* – Like the separation of chair and CEO, the issue of board independence stems from the concern to protect shareholder interests from managerial opportunism. Psaros and Seamer explain that:

...Independence is critical to ensuring that the Board of Directors fulfils its objective oversight role and holds management accountable to shareholders. (2002: 7)

Agency theory underlies this rationale. As explained in an earlier footnote, agency theory proposes a model of the individual as the rational, self-interested actor who will inevitably seek to enhance her/his own interests. Ensuring a majority of independent directors (outsiders) on the board will counterbalance the power of the CEO in decision-making and provide assurance to shareholders. Of course, in theory, all directors should exercise independent judgment in decision-making.

However, there are other reasons for appointing independent directors to the board: to ensure an appropriate mix of skills and expertise to govern effectively – in particular, to facilitate good decision-making - if they are not available in-house; to help ensure board diversity, in turn minimising 'group think';<sup>8</sup> and to gain access to external business and other contacts, information and resources, which Nicholson and Kiel identify as one key role of a board (2004:454).

Importantly, Psaros and Seamer explain that independence should not be equated with non-executive. As they point out, “[s]ome non-executive directors are independent, others are not” (2002: 7). An independent outsider will not only be non-executive – that is, not on the existing management team – but also independent in other ways. These include:

- Not a former employer
- Not a major shareholder
- Not holding a significant contractual, supplier or advisory relationship with the company
- Does not have any other significant interest in the company, which could negatively impact on the director’s ability to act in the interests of the company

(2002: 8)

*Study results* - Bhagat and Black undertook the first large sample survey to test whether the degree of board independence correlates with various measures of long-term company performance (2002). They found that, “[f]irms with more independent boards do not perform better than other firms” (2002: 231). Their results confirm earlier research that there is not a clear correlation between board independence and firm performance (2002: 236). In fact, Bhagat and

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<sup>8</sup> For a discussion of 'group think' and ways to counter it see *Boardrooms that Work* (Cairnes, 2003: 21-22).

Black say, “A few studies offer hints that firms with a high percentage of independent directors may perform “worse” (2002: 236 & see Coles, 2001: 43). This finding is echoed by Westphal (2002) after surveying over 500 outside directors from large companies:

Nearly two decades of research find little evidence that board independence enhances board effectiveness. Studies have, however, found a negative effect. (quoted in Leblanc and Gillies 2004: 5)

### **Board Size**

*Rationale* – While much attention has focused on the issue of optimal board size there is no consensus about what the actual ideal size is. In the main, it is proposed that a not-too-large board will help in efficient decision-making by minimising negative board dynamics. The ASX recommends, for example, that board size “be limited so as to encourage efficient decision-making” (2003: 22). Eight directors is cited as the upper limit, and 6.6 as the mean board size in a study by Kiel and Nicholson (2003: 194). In another study, eight is described as “typical” (Larcker et al., 2004: 7), while Leblanc and Gillies note that eight to eleven is viewed as optimal (2004: 5). Uhrig reports that six to nine is current good practice in the private sector (2003: 96) but goes on to suggest that optimal board size in the public sector may differ from one organisation to another.

Kiel and Nicholson suggest that there is an “inverted U” relationship between board size and performance in which adding directors can bring the board to an optimal skills/experience mix level. Beyond that point the difficult dynamics of a large board prevail over the skills/expertise advantage that additional directors might bring (2003: 194 & see Bøhren & Ødegaard, 2003: 5).<sup>9</sup>

*Studies* - Kiel and Nicholson (2003) found evidence in the Australian context that large sized boards are not necessarily impediments to good performance. For example, they explain that, “...with respect to market based performance, the market rewarded larger boards and also boards with a relatively lower proportion of outside directors, after allowing for the effects of company size” (2003: 201). Sonnenfeld observes that big boards exist at some of the most admired companies in the United States, for example, General Electric, and some poorly performing companies, such as US Airways. At the same time, small boards can be found at both high performing and low performing companies (2002: 108).

Departing from this, in a Norwegian context<sup>10</sup> a recent study finds a correlation between increased board size and poor performance concluding that: “small boards produce more value than large” (Bøhren & Ødegaard, 2003: 22). A

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<sup>9</sup> It is worth noting that, as Kiel and Nicholson point out, from an agency perspective it could be argued that a large board is better. The rather unconvincing logic is that the more people monitoring management action the better (2003: 193). They also note a possible positive relationship between large boards and the capacity of the board to harness external links and attract external resources to the organisation (193).

<sup>10</sup> The authors draw a number of distinctions between the United States Context and the Norwegian context, for example: US firms and Norwegian firms operate within different legal regimes, performance related pay is common in the US but not in Norway, and unlike the US, corporate boards in Norway have none or only one inside director (2003: 2).

comparative study of Australian and Japanese firms found that the conventionally large size of Japanese boards did correlate with poorer performance. However, board size in the Australian context, where boards are conventionally smaller, did not show an influence on firm performance (Bonn et al., 2004: 119). In summary, as Leblanc and Gillies point out, results are mixed and inconclusive (2004: 6).

### **CEO Remuneration**

*Rationale* – The rationale for linking CEO remuneration to organisational financial performance is simple. Working with the ‘self-interested individual’ of agency theory, the logic is that management will act in the interests of the company (the shareholders as a whole), in order to maximise self-interest – to ‘collect her/his reward’.

*Studies* – While CEO remuneration is thought to be important to performance; this is not backed up by research results. Andjelkovic et al. (2000), Collins (2001) and Coles (2001: 43) found no evidence of a positive relationship. Bhagat and Black observe that CEO compensation correlates more with the compensation paid to outside directors from their own companies than with the CEO’s performance (2002: 235). In the Australian context, Shields, O’Donnell and O’Brien undertook a study of 150 of Australia’s largest companies and concluded that there was not a positive relationship between (high) remuneration and performance: “... executive remuneration practices are defensible neither in terms of distributive justice nor organisational effectiveness” (nd.: iii).

## **2.3 The tenuous relationship**

A recent study, involving over 2000 firms and analysing many structural measures of corporate governance, found that when corporate governance is measured by the above “hard” but easy to verify variables (such as the proportion of outside directors), these factors only account for between 1.4 and 9.1 per cent of the variance in performance (Larcker et al., 2004: 39).

There are many possible reasons for findings of a weak or no relationship between conventional governance measures and organisational performance. This could be due to:

- Flaws in research methodology, for example:
  - Important processes or attributes are not measured;
  - the complexity of processes, which cannot be fully captured by statistical methods. For example, directors are counted as independent solely on the basis that they are non-executive, without reference to other features of independence;
  - Governance characteristics are treated as “internally independent” rather than inter-related (Bøhren & Ødegaard, 2003: 22). Leblanc, for example, notes that in some cases there is a failure to balance independence with knowledge of the business: “in the over-zealous

search for 'independence', occasionally appointments are made to boards of people so distant and uninformed about the business ... they are unable to provide concrete, meaningful strategic input" (Leblanc, nd.:5). In other words, the interaction between governance variables is not considered or measured;

- variations in how board attributes are measured across studies;
- variation in financial performance measures used. Bøhren & Ødegaard argue, for example, that measures such as book return on assets or market return on stocks produce "fuzzier relationships" with governance attributes than financial performance results measured by Tobin's Q<sup>11</sup> (2003:22). Dobbs and Koller argue that total returns to shareholders is not necessarily a good measure of performance. They suggests that three other elements should also be considered: underlying performance; the financial market's evaluation of a company's performance; and a company's expected future performance (1998);
- failure to account for external or environmental factors impacting on firm financial performance – for example, the general economic climate or the "irrationality of the market" (Leblanc & Gillies, 2004: 4);
- corporate governance performance is measured in isolation from other internal factors that impact on organisational performance, for example, an effective management team (Nicholson & Kiel, 2004: P448).<sup>12</sup>

- that there is no one prescription for all organisations – one size does *not* fit all!
- insufficient attention to group dynamics;

(See also Heracleous 2001:6 & Larcker et al 2004:2)

Of course, as Heracleous points out, a possibility is that perceived conventional "best practice" is simply irrelevant to performance (2001:16). However, he goes on to suggest that this is unlikely. What is possible is that "bad" practices may be more clearly related to underperformance (16). If, as Heracleous (and others) argue, conventional best practices are possibly necessary but certainly not sufficient conditions for good performance they will, at best, serve as minimal standards of governance.

It is most likely that there is complexity in the interrelationships between variables. For example while a board may have a majority of non-executive directors, they may not have the necessary skills or knowledge of the industry, and/or may be on too many boards with insufficient time to invest in each one. Under these circumstances, outside directors may well add less value to board decisions than executive directors.

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<sup>11</sup> Tobin's Q is a financial measure of a firm's returns developed by James Tobin, Yale University. The calculation is the market value of the firm divided by the replacement costs of the firm's assets.

<sup>12</sup> In fact, Kiel and Nicholson state that, "attempts to identify direct relationships between corporate performance and boards are naïve" (2004: 448).

## 2.4 “Soft” governance and performance

Systems and structures can provide an environment conducive to good corporate governance practices, but at the end of the day it is the acts or omissions of the people charged with relevant responsibilities that will determine whether governance objectives are in fact achieved. For example, the identification of the background, skills and expertise of the people who walk into the board room is a good start, *but it is what they do when they get there that is critical*. (HIH Royal Commission, 2003, Vol 1, Part 3: 105, emphasis added)

Recently, there has been a burgeoning of articles providing evidence on the importance of the “soft” side of governance or the behavioural dynamics of what takes place *inside* the black box of the boardroom. This interest has come about partly as a result of corporate collapses (such as Enron and Worldcom), where the firms in crisis broadly conformed to accepted corporate governance standards (Sonnenfeld 2002: 106).

Some of the “soft” governance factors that appear to be important for performance in the private sector include:

- A clarity in roles, responsibilities, and relationships between: CEO and chair; directors and management; directors and shareholders/ stakeholders
- Healthy chair/CEO interface
- Directors working as a team
- Culture, trust and open dissent
- Right skills, competencies and characteristics, including ‘industry/business knowledge’
- A good induction process and ongoing access to training<sup>13</sup>
- Leadership skills of chair
- Information flows
- Regular evaluation of board performance.

(see for example, Leblanc, 2001; Cook and Deakin, 1999; Lawler et al., 2002; Roberts, 2002; Nadler, 2004)

A generalised finding that ‘soft attributes’ really matter is the result of a qualitative study on “soft behaviours” by Kocourek et al.:

Our experience in advising boards and CEOs in the United States, Europe, Australia and Asia; our primary research in these markets, including interviews with hundreds of directors and corporate officers about board effectiveness; and a review of contemporary best practices leads to one universal conclusion: governance begins at home – inside the boardroom, among the directors. It is embedded in how, when and why they gather, interact and work with one another and with management ...in other words, the “soft”

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<sup>13</sup> Kocourek et al. highlight the principle “train, train, train” (2003: 9) arguing for thorough induction to the business and ongoing training to keep directors up to speed with business changes.

stuff. But qualitative reforms to the behaviours, relationships and objectives of the directors and the CEO are meaningless unless they are subjected to the “hard” mechanisms of performance criteria processes and measurements. (2003:2)

More specifically, in an interview-based study on the CEO/board relationship, Lawler et al. found that the balance of power between the board and CEO was seen to have the most significant impact on a firm’s financial performance (2002: 320). They explain:

The one theme that was consistent in our CEO interviews was the value placed on the directors’ role as a sounding board, or as one CEO told us, “an incorruptible coach” (315).

Notably, the focus is on the interaction between the CEO and chair and not the basic fact of separating the positions (see also, Crest, 2002; Roberts, 2002; Borrelli & Kendall 2004).

The development of trust and having the right culture is a common response from interviews with directors: “Talk of the importance of trust and integrity was everywhere in my interviews” (Roberts, 2002:11). Sonnenfeld sees a virtuous cycle with one good governance attribute building on another, from good team work, to development of mutual respect, out of which comes more trusting relationships. Therefore more information is shared and with the same information, board members can test each other’s conclusions and, if needed, refine their positions.

Perhaps the most important link in the virtuous cycle is the capacity to challenge one another’s assumptions and beliefs (2002:111).

Based on an empirical study of twenty-one boards and committees ‘in action’, which included interviews with close to 200 directors, Leblanc and Gillies conclude that board effectiveness depends on the inter-workings of board structure, board composition and board process. The successful balance between these three elements will facilitate good decision-making.

... for a board of directors to be effective at accomplishing the tasks assigned to it, it needs to have the *right* board structure, supported by the *right* board membership, and engaged in the *right* board processes. Without such a balance it is difficult, if not impossible, to have the effective interaction between and among fellow board members and management that is essential for overall effective decision-making. (2004: 12)

Board membership (the recruitment and removal of directors, and the, ideally, appropriate mix of competencies on the board) and board process (how decisions are made, including how board members interact) is key to understanding how effective a board will be. In line with this, Leblanc and Gillies argue that the capacity of the chair is determined by the chair’s ‘competency’ and ‘behaviour’ regardless of whether the chair is also the CEO or not:

... it is the *selection* of chair that matters most to board process, not the *separation* (of chair and CEO). (2004: 12)

Following from this, Leblanc and Gillies reason that director effectiveness stems from the interplay between directorial independence, competency and behaviour. Independent directors with the right competencies will only lead to an effective board if the interactions between them lead to good decision-making.

It is the proper combination of the varying behaviours of directors that determine whether or not the board will operate effectively. So in addition to competence and independence, the chemistry among the members of the board must be correct if the board is ... to make sound decisions. (2004: 14)

Leblanc and Gillies have developed a classification scheme based on three behavioural elements of directors: their degree of dissent (or consent); their capacity to persuade and the degree to which they are able to work collectively. From this, five 'optimal director types' and five 'dysfunctional director types' have been developed (2004: 14). Ultimately, for Leblanc and Gillies, it is "how boards work" that provides the link between board governance and organisational performance (17).

Closer to home, a recent AICD/CFO 100 commissioned study (Cairnes 2003), which puts emphasis on the interaction of human behaviour with corporate governance practices and structures, provides a useful list of early warning signs of bad board behaviours. Many relate to poor relationships or lack of adequate information flows:

- A dominant chair or CEO
- Hurried decisions based on inadequate data
- Serial restructuring and resignations of key executives
- The cover up
- Interfering with the flow of information
- Communications which are on the defensive
- Significant variance between forecasted and final accounts
- Where no one accepts responsibility.

In summary, research conducted by those working closely with boards suggests that:

1. The 'hard attributes' of governance such as board independence may be necessary but are not sufficient. At best, they form minimal standards of good governance. More accurately, it is the interplay of these 'hard' but easy to measure attributes and 'soft' attributes that lead to good governance.
2. The 'soft attributes' of governance such as the chair/CEO relationship, board behaviours and board culture are critical to good governance

Against this backdrop, and taking into account the methodological gaps outlined in section 2.3, mixed results on the relations between governance attributes and organisational performance are not surprising.

## 3. Applicability to the Public Sector

### 3.1 The differences between the private and public sectors

In attempting to take some of the lessons from the private sector to the public sector on the relationship between governance practices and performance, it is important to exercise caution because of the distinctive nature of the public sector, for example:

- Many objectives
- Minister(s) as 'shareholder'(s)
- Ministerial appointment processes
- Different types of accountability (for example, to Parliament)
- A more complex legal framework
- Serving whole of government.

(See Attachment A for a detailed breakdown of differences)

Other things being equal, we would expect there to be a stronger focus on stakeholder interests in the public than in the private sector. There are, therefore, limits to the transfer of the knowledge across the boundaries because of these differences. However, this is not to deny that the public sector can learn much from private sector practices and certainly gain much from what the literature is revealing about what governance factors seem to be critical for organisational performance.

As mentioned earlier, in spite of the differences between the public and private sectors, there are some core corporate governance principles applicable to both. These include: accountability; transparency; integrity; leadership – 'setting the tone' for the organisation; a focus on performance as well as conformance; and a recognition of shareholder/stakeholder rights. Importantly, however, these principles will be embodied or applied within a context.

Many of the features of good governance – both hard attributes and soft attributes - are relevant to both sectors. Again, they must be understood within the public sector context. For example, we are starting to see a meeting of the vertical with the horizontal in the public sector. That is, relationships and systems between different government bodies are increasingly important as the public sector shifts from a more 'silo' to whole-of-government approach. Along with this, government is entering into more partnerships with the NGO and private sectors. This means governance arrangements must look inwards on the working of an organisation and look outwards to that organisation's relations with other government bodies and stakeholders.

## 3.2 Public sector corporate governance: recent findings

### ***Australian Commonwealth public sector boards***

In 2002, the National Institute for Governance conducted a trial survey of FMA and CAC public sector boards.<sup>14</sup> Its aim was to test the extent to which the private sector framework for responsibility and accountability gives rise to tensions and conflicts in carrying out business in the public sector (see Edwards et al., 2003; Howard and Seth-Purdie, 2004). In brief it found, in relation to CAC boards in particular, the following:

- Ambiguity in roles and responsibilities of key players in the decision-making process
- Conflicts of interest, especially conflicts of roles
- Limits on CAC board independence
- Deficient appointment processes
- Variable skill diversity.

Relationship difficulties were seen to occur between: the chair and the board; the chair and the CEO; the CEO and the board; the minister and the board; the triangle relationship between minister, CEO and chair; and government representatives on boards where their roles could conflict. Note that the findings from the trial survey relate in some way to the role of players in relationship to the Minister (who could be described as the key shareholder).

A few quotes from those interviews indicate some of the difficulties:

There is considerable communication with the minister – mostly informal. (CAC Director)

Informally, the new minister knows some of the directors personally, and these relationships are used to share information informally. (CAC Director)

I sometimes find myself under party political pressures. In the case of one major decision, I was committed to it by both sides of politics and I felt bullied. I would now tell them to go jump, and I would take the matter to the board. (CAC Chief Executive)

[There is a need to] reduce the “mates” getting positions on boards. There is a need for an independent group or agency that ensures that board membership reflects the breadth of representation and background to make sure that board decisions are based on critical analysis. [the independent group would] need to protect against “mates game” being played. (CAC Director)

What is interesting about these findings is the correlation with private sector evidence on the importance of ‘soft’ governance features, as discussed in section 2.4. Along the lines of Leblanc’s and Gillies’ work on boards (2004) for example, the results of the survey highlight the interplay between governance structures, governance processes and governance behaviours. The ‘hard’ features of

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<sup>14</sup> This project builds on the 2002 trial survey.

governance such as board composition and appointment processes and the 'soft' features of governance, such as clarity on roles and responsibilities *and* appropriate behaviours and relationships work together to dictate the quality of governance.

### ***UK Public Sector: good corporate governance practice***

In the UK, the Audit Commission recently commissioned a study to explore the relationship between public sector corporate governance arrangements and organisational performance understood in terms of service quality.

The study report (Audit Commission, 2003) highlights a conclusion that resonates with the recent private sector research outlined in section 2.4. That is, that 'soft' as well as 'hard' governance elements leads to good corporate governance:

Good corporate governance combines the 'hard' factors – robust systems and processes – with the 'softer' characteristics of effective leadership and high standards of behaviour.  
(2003: 4)

The interplay between hard and soft factors is described as involving the following elements:

- Sound leadership;
- A culture “based on openness and honesty”;
- Sound processes and systems that support and enhance accountability – for example, risk, financial and performance management systems; and
- An external focus on service user and public needs, in turn, “producing greater ownership among stakeholders”.

(2003: 5)

Based on statistical analysis of data a positive correlation between corporate assessment and service inspection scores was found: “As corporate functioning improves, so generally does the quality of services. The two are associated” (27). However, while certain dimensions of governance appear to contribute to effective service delivery (for example, risk management, financial controls and codes of behaviour), the authors conclude that the measures used are necessary but not sufficient (26).

Focusing on six cases of public sector failure, the study found a set of common themes, a combination of which was evident in each failure case. These themes are:

- “the poor quality or absence of leadership;
- poor decision making and decision-making processes;
- inadequate systems and processes, such as performance management;
- lack of clarity in roles, responsibilities and activities creating poor accountability;
- poor working relationships and dysfunctional behaviours;

- an insular organisational culture and poor focus on community and user needs; and
- inadequate contingency plans or risk management strategies to deal with worst-case scenarios.”

(2003: 28)<sup>15</sup>

What is clear from the common themes outlined above, is that relationships and behaviours are as important to the quality of governance as structures and systems.

Similarly, in another UK report that responds to the question: “What makes an effective board?” (Barker, 2004)<sup>16</sup> the author identifies the ‘actions and behaviours of the board’ as one of three critical elements underlying the performance of a board (2). The other two crucial elements are structures and functions that are “fit for purpose”, and performance evaluation to be used as a tool for ongoing or continuous performance improvement (2004: 1-2). Consistent with the views of Leblanc and Gillies, discussed in section 2.3, board effectiveness is seen as a combination of relevant structures and processes.

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<sup>15</sup> From these common themes, the report outlines seven warning signs of failure: Poor leadership, poor working relationships, a closed culture, low levels of accountability, poor information for decision-makers, lack of clarity, and poor strategic risk management (29). These early warning signs are relatively consistent with those in the private sector identified by the AICD/CFO 100 study discussed on page 14.

<sup>16</sup> The report provides a practical framework for evaluating board performance. It has been developed for ‘Non-Departmental Public Bodies’ in the UK, which, in the main, have non-executive boards.

## 4. Measuring Governance Performance

### 4.1 Hard measures of governance

Many private sector organisations offer companies a service that ranks their corporate governance performance. The Institutional Shareholder Services (ISS), for example, provides a 'Corporate Governance Quotient' for US and international companies by subscription. The Quotient shows the impact of over sixty (conventional) corporate governance measures on share performance and valuations so that it can be seen which corporate governance factors have the greatest relationship with financial measures ([www.issproxy.com](http://www.issproxy.com)).

The Horwath Corporate Governance Report is an Australian service that ranks the top 250 Australian companies.<sup>17</sup> The ranking is done on the basis of national and international corporate governance codes and guidelines. This service claims to use "objective, measurable factors" such as director independence, structure of board committees and auditor independence, which they describe as "hard measures" (Crest, 2002: 2-3). They distinguish these from "soft measures", which they do not assess, such as ethical and corporate culture and skills of directors.

Rating systems have some serious deficiencies and could well be measuring the wrong variables – or, at least, failing to measure some key variables. Rating systems can:

- have selection bias (as indicated in this paper the range of attributes evaluated can be too narrow);
- be poor predictive value as the factors selected don't reveal underlying financial stress and broader risks for the company;
- show conflicting results eg. Many companies with poor financial position have similar ratings to those with a much healthy financial position;
- provide single indicators of complex and interacting governance constructs (for example, proportion of non-executive directors);
- have a sample size too small to be compared with other studies; and
- show a statistical significance that may not have a causal connection.

(Caragata, 2004:11; Brown & Caylor, 2004; Larcker et al., 2004)

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<sup>17</sup> Information on the Howarth Report, including the 2002 full report and summary reports for 2003 and 2004 are available at - <http://www.newcastle.edu.au/school/newc-business/horwath/index.html>

As the emphasis in the literature shifts toward more focus on how decisions are made within the boardroom, we can expect rating agencies to feel the challenge to modify their indicators and their related methodology.

## 4.2 Hard measures of “soft” governance?

In the past, externally observed measures of governance have informed those attempting to give advice to organisations on what good governance measures they should have (for example, board composition and size, as discussed in section 2). The quantitative ‘tick-the-box’ measurement of hard attributes currently in use can only tell us, at best, if minimal standards of governance are in place. What is now needed are supplementary surveys of a more *qualitative* kind that can go inside the black box of the boardroom and come out with concrete measures of the governance variables that recent research suggests relate to organisational performance.

It could be argued that soft governance attributes are impossible to measure (Heracleous, 2001) or, at least, measure in the same way. External political and other factors could be said to cause unexpected changes in performance making a measure of the relationship between governance variables and performance difficult. Larcker et al. (2004) do consider it difficult to use numerical tools to assess what really drives behaviour. In spite of this, however, others (for example, Kocourek 2003: 2) argue that there is little point in emphasising behavioural aspects of governance if they cannot be subject to hard evaluation.

Understanding what works and being able to assess it is critical to improving corporate governance performance. Leblanc and Gillies also support developing an evidence base for the factors contributing to board effectiveness. They write:

Board effectiveness needs to be confirmed through further qualitative inquiry and tested through quantitative means. (2004: 18, footnote 21)

We are entering embryonic territory when attempting to set out governance evaluative criteria that takes into account what happens inside the black box of the boardroom – in either the private or public sectors. One starting point might be to take commonly accepted principles of good governance which can be measured in some form, such as: accountability, transparency and participation or inclusiveness, if not the other principles (see, for example, Stewart 2004). An alternative and more direct approach would be to relate evaluative criteria more to empirical findings (outlined in section 2.4) on the factors that appear to be important in the link between governance arrangements and organisational performance. Needless to say as knowledge grows on what the important variables are, then refinement will need to be made to the chosen indicators.

Bearing in mind that it is likely to be an incremental process in finding what governance arrangements actually assist an organisation to achieve its

objectives, certain questions could be asked of boardroom participants in an attempt to get at the decision-making process inside the boardroom. In line with the emphasis on the 'soft' elements of governance in recent research (section 2.4), the following questions point to the kinds of information that a qualitative survey would need to capture:

- Are roles and responsibilities clear and explicit?
- How operative are protocols and codes on ethics and behaviour and on other issues such as conflicts of interest?
- Are good governance mechanisms in place (for example, strategies around risk management; human resources, stakeholder relations, ethical code etc)
- What proportion of board time is spent on strategic matters?
- Are skills of members of the board complementary and is there a skills audit process that accompanies each new appointment?
- How involved are independent directors in the affairs of the organisation other than attending board meetings? How well do they know the business that they are guiding?
- How many other boards are directors on?
- Who gets what information through what process?
- How inclusive is the decision-making process; which stakeholders get involved and why?
- Do boards evaluate themselves as a whole, as well as the performance of individual directors and what do they do with that information?

Perhaps the single most important starting activity that a public (as well as private) board could undertake is to gain clarity in, and make explicit, roles and responsibilities and expectations of each other and the stakeholder(s). This could be contained within a board governance charter. However, measures would need to be put in place to ensure that the charter remains a living document that is understood by all board members and referred to on an ongoing basis.

Drawing from recent performance evaluation examples, a qualitative survey could take the form of key statements or outcomes of effective board performance with associated questions that are targeted to relevant board/management members (CEO, chair, individual directors, board as a whole). For example, the areas of inquiry identified above could be expressed as features of governance with questions that encourage the board to think about (and reveal) how their board works and, ideally, why it works in the way it does. A few examples are contained in the box below.

## Governance evaluation examples

### **Feature of good governance**

The board is structured and supported to add value to the organisation. This includes effective board recruitment and induction, an understanding of the skills and expertise required on the board and access to training.

### **Sample questions to the organization/relevant individual(s)**

How are members appointed to the board? And is this process transparent and consistently applied?

How do you ensure an appropriate mix of skills/expertise on the board? Is there a skills audit process that accompanies each new appointment?

How do you ensure that board members are able to commit fully to the work of the board? (e.g. do you state up front the approximate hours/month expected of board members? Do you require potential new members to disclose other boards they are on?)

What induction processes do you have in place? Do you provide refresher courses, updates on business changes and/or access to training?

### **Feature of good governance**

There is a structured approach to decision-making supported by clear and effective meeting procedures. There is an active promotion of ethical, responsible and inclusive decision-making.

### **Sample questions to the organisation/relevant individual(s)**

How regularly are meetings held and are they well attended?

Does the board have a clear process for discussion and decision-making? (does the chair encourage input from all members? Does the chair ensure the board follows clear procedures? How do you deal with decision deadlocks?)

Is there a written code of ethical conduct for the board? Does the board refer to this in its decision-making?

How does the organisation deal with conflicts of interest? Are board members encouraged to declare conflicts on an ongoing basis? (e.g. via a standing item on the agenda)

Against the concept that 'one size fits all', recent thinking on good governance practice emphasise the importance of a more flexible approach in which the governance arrangements are tailored to the nature of the organisation (private, public or not-for-profit, size, objectives, changing external environment). The ASX Corporate Governance Council's rule of 'if not, why not' is an example of this shift towards a less prescriptive and flexible approach to governance regulation. In the ASX good corporate governance principles it states:

This document does not require a “one size fits all” approach to corporate governance. Instead, it states aspirations of best practice for optimising corporate performance and accountability in the interests of shareholders and the broader economy. If a company considers that a recommendation is inappropriate to its particular circumstances, it has the flexibility not to adopt it – a flexibility tempered by the requirement to explain why. (ASX Corporate Governance Council, 2003: 5)

Importantly, the ‘if not, why not’ approach seeks to ensure appropriate governance conduct by requiring companies to reflect on their processes or practices. It goes beyond a tick-the-box approach. This process of reflection is also at the heart of a performance evaluation approach that aims to provide not only assurance but also encourage and support improvement. A report commissioned by the UK Treasury (Barker, 2004) is a particularly good example in this regard. The report provides an evaluation framework that aims to “diagnose” board and organisational performance, *and* identify areas for improvement and actions to achieve this.<sup>18</sup> Barker, the report’s author, isolated two key questions that should be asked when using the framework:

- “What are the current strengths and weaknesses of the board’s performance?”
  - “What actions can be carried out to further improve performance?”
- (2004: 7)

Knowing *how* one governs and *why* is the key.

Of course, this form of qualitative evaluation would present some challenges. Firstly, assessing qualitative information is less objective than quantitative measurement. A lot of work would need to go into achieving consistency and transparency – for example, through the development of clear assessment guidelines, including indicators of good practice. It would require highly skilled assessors and well-developed tools. Secondly, a qualitative survey would clearly be more intrusive than current private sector ratings, which use only publicly available information. A new approach would require interviews and possibly access to paper trails (for example, tracking back how a decision was made). However, the public sector is already subject to, and therefore familiar with, relatively intense scrutiny (for example, through ANAO audits). Extending this scrutiny to the boardroom may not be overly burdensome. Importantly, if good corporate governance arrangements are in place, a board will already undertake regular self-evaluation and internal and external evaluation processes should align.

### **Getting ‘industry’ buy-in**

A report (Chartered Secretaries Australia, 2004: 2) was recently released on the findings of a survey, which aimed to understand the extent to which Australian

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<sup>18</sup> It should be noted that the evaluation framework has been designed for self-assessment by Non-Departmental Public Body boards (and other public sector boards), rather than an external evaluation framework to collect aggregate board data. However, it could form a useful basis for an external evaluation framework.

companies had embraced the “spirit” of the ASX Corporate Governance Council’s corporate governance principles and best practice recommendations.

The findings of the survey reveal that a significant number of companies are choosing to comply with the guidelines rather than take the ‘if not, why not’ option noted above. This is underpinned by the concern that a ‘why not’ explanation will result in negative repercussions for the company. In other words, the report suggests, “Australian companies are adopting a culture of conformance” (2004: 2). This could be seen to run counter to the Corporate Governance Council’s intent, which is to offer a flexible approach that recognises certain recommendations will not be relevant in all contexts or, at least, relevant in the same way.

The important lesson to learn from this is that getting ‘industry’ buy-in to the evaluation process from the start is critical to the success of any form of evaluation. Evaluation questions need to be useful to the board as well as providing assurance and/or an evidence-base to external evaluators. The process needs to be clearly understood and owned by all parties involved in its development.

## 5. Conclusions

### 5.1 What can the public sector learn from private sector experience?

Recent findings on the importance of relationships between key decision-makers and, more generally, board room behavioural dynamics, would suggest that the current focus in codes of corporate governance and in corporate governance ratings could be seriously lacking in terms of what is considered to be sound corporate governance – in so far as what that entails leads to organisational performance. AS we have seen, an example of this is the current focus on board independence. In this context, Bhagat and Black conclude:

If our results are correct, the current focus on board independence as a core measure of board quality could detract from other, perhaps more effective strategies for addressing poor firm performance. (2002: 234 )

They go on to argue that there should be more efforts by companies to experiment with different types of board structure:

Our results do suggest that investors should not complain if companies experiment with departures from the current norm of a “supermajority independent” board with only one or two inside directors. (2002:267)

It could well be that after more research the conclusion is that governance structures, board membership and processes should be tailored so they are “fit for purpose”: aligned with the goals of the organisation. A government agency with a commercial focus may need very different governance arrangements compared with an agency heavily dependent on community input to achieve its objectives, or a university that has to be externally as well as internally focussed on student and staff demands.

#### ***Issues in summary***

- Conventional ‘hard’ attributes of governance *may* be necessary but are not sufficient. Therefore attempts to link them with organisational performance are destined to lead to ambiguous results. Concentrating solely on the hard attributes may in fact take energy and attention away from more pressing governance concerns.
- We need to understand the inter-relationships between governance variables and understand them in context - and not just as discrete, unchanging units – if we are to get a more accurate picture of how governance attributes contribute to organisational performance.

- We need to direct attention to the ‘soft’ governance attributes. The hard factors take us some way, but simply adopting them is not enough. We need to focus on corporate governance inside the boardroom – on inter-relationships and behaviours, and the policies and procedures that support effective behaviours.
- Attention must be paid not only to *what* is measured but also *how* we measure it. Ratings and studies currently focus only on objective, quantifiable and publicly available information. The assessment or measurement of performance needs to get behind published/publicly available information.
- A mix of quantitative *and* qualitative measurement is required that gets inside the ‘black box’ of the boardroom. Could the ASX approach of ‘if not, why not’ to compliance with their principles be extended? That is, rather than organisations being required to demonstrate why they do what they do on an exceptions basis only, this could apply to conformance with principles as well. That is, boards would be required to reflect on their conformance with, as well as deviation from, agreed features of good governance, rather than simply ticking a box. This would require intensive training of auditors and development of tools to achieve fairness and consistency in measuring.
- Following from the above, organisations need to be encouraged to institute a pro-active culture of governance and review – a culture in which there is an explicit and shared understanding of ‘*how and why we do things in this way*’. We need to develop a culture of continuous quality improvement and move away from a tick-the-box approach in such a way that is clearer to the board how they are adding value to the organisation.
- And, of course, from the beginning we need to be clearer about what constitutes good organisational performance in the public sector.

## 5.2 Moving forward

There is probably much agreement around the fact that, so far, there has not been nearly enough research on the inner workings of boards. Heracleous suggests that in terms of the next steps in research on corporate governance, we need to:

- Show a greater concern for the validity and reliability of measurements;
- use fieldwork primary data to improve on the operationalisation of concepts;
- incorporate a contingency perspective in developing the theory and testing it;
- take a strategic focus on how a board affects various aspects of the strategic management process; and
- focus on factors related to “productive group dynamics” as part of board processes other than just board structure. (2001:18-19)

Researchers across both the private and public sectors could work together to determine through survey work the critical structural, composition, processes, and director characteristics that make for good performing boards.

There is also a need for more attention to be paid to protocols or codes of conduct about roles, responsibilities and relationships of key players, such as chair, board members, CEO and, in the public sector context, portfolio secretaries and ministers. If Board effectiveness is to be taken seriously in the public sector, there is a need for much better appointment processes – processes that move appointments away from cronyism and more towards competencies - so that the right skills and experiences can be found around the table (Edwards, 2004).<sup>19</sup>

There is also a need to determine what level of independence is required of public sector boards, and once that is determined, to have it protected from undue ministerial influence. Overseas practices on these issues in the United Kingdom, Canada and New Zealand are well worth studying for the Australian context.<sup>20</sup>

It is important to note that in a post-Uhrig environment, in which we can expect to see more statutory authorities bought into the Departmental fold, the research findings will still be applicable. The call for attention to focus on roles, responsibilities, relationships and behaviours – the ‘soft’ features of governance – is pertinent regardless of the nature of a board, be it decision-making or advisory.

For the Australian public sector, a good resource to start with is the [UK Treasury report](#) (Barker, 2004). As discussed earlier, the report’s author, Barker, develops an evaluation framework for public sector non-departmental independent boards that aims to “build” board effectiveness. The report outlays three key components that contribute to high performing boards. Each of the three components is associated with several good governance practices and indicators of good performance. Many of these could be adapted for the evaluation of public sector bodies in Australia. Further, many of the indicators could be useful for identifying good governance in the private sector.

Edwards (2004a) has isolated ten indicators in line with the UK Treasury report (Barker, 2004) that could be applied to both the public and private sectors as follows:

*“Structures and functions*

- Board objectives are set in line with the organisation’s objectives and are outcome focused;

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<sup>19</sup> Appointment processes in the public sector will be considered in a future issues paper.

<sup>20</sup> Within the Australian federal context, the Uhrig review of statutory authorities (Uhrig, 2003) only went part way in achieving this task. The Uhrig review and responses to it will be considered in another issues paper.

- Roles and responsibilities of the board and its members are clear and well understood;
- Skills of members of the board are complementary and there is a skills audit process accompanying each new appointment that takes account of board objectives;
- Information flows effectively during, and outside of, board meetings.

*Actions and behaviours*

- Independent board members are knowledgeable about their organisations and the issues affecting its performance;
- Relationships between CEO and chair, board members and management; and members and shareholders/stakeholders are considered sound;
- The chair encourages members to be open and to challenge constructively, and has a close working relationship with the CEO; and
- The decision-making process is inclusive of relevant stakeholders before major decisions are made.

*Performance evaluation*

- The board is evaluated by itself and others, and puts agreed ways of improving performance into an action plan; and
- Individual members are evaluated against clear objectives and given the opportunity for professional development where needed.”

(Edwards, 2004a)

As a final concluding point, it is clear that directors of public sector boards, unlike their private sector counterparts, are missing out on a forum where they can come together and share their experiences about what governance arrangements appear to work best in different circumstances. With little cost, a forum could be set up to enable information exchange and support. Alternatively, or additionally, public sector board members could join with the Australian Institute of Company Directors (AICD) and indeed share forums to compare notes across the private and public sectors.

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## ATTACHMENT A

### Public sector and private sector differences

	Private Sector	Public Sector
Mandate	Profit maximisation, considering corporate interests only	Welfare maximisation, considering community interests, involving trade-offs
Goals	Generally clear	Often deliberately vague to satisfy different stakeholders
Performance metrics	Standardised financial ratios	Financial ratios meaningless. Other performance indicators used
Efficiency	Technical efficiency basic requirement	Economic efficiency is often at cost of technical efficiency. Effectiveness often more important
Costs	Firm's own costs used for decision-making	Community costs, including externalities, deadweight losses
Prices	Generally constrained by market Allocation on ability to pay	Dependent on policy – from free provision through to prohibitive Allocation often on welfare grounds
Revenue	From sales	Mainly from tax, also from some natural monopolies
Investment criteria	Based on firm's interests and cost of capital	Community interests and unclear cost of capital
Financial controls	Often through profit centres Cash flow crucial to survival	Because revenue and expenses are separated, most control is through cost centres Cash not an operating constraint, but government has a macro monetary role
Sovereign risk	External	Internal
Product choice	Decided by corporation	Mandated by government – cannot abandon “loss-making” activities
Products	Goods & Services	At Commonwealth level, mainly monetary transfers
Policy	Incidental activity (marketing, product changes)	Core activity
Organization definition	Often defined by core or distinctive competencies	Often pieced together from bits and pieces of market failure – departments have to house many disparate activities
Ownership	Often complex with partially owned entities	Usually simple, but relation to assets complex – many assets held in trust rather than outright ownership Unique asset of taxation authority
Power	Related to economic strength, checked by government and the law	Strong coercive power, capacity to change own rules
Stakeholders legally defined	Shareholders, free to own or dispose of shares, with power related to holding	Voters, with limited capacity to opt in or out (Migration)
Other stakeholders	Employees, creditors, suppliers, communities	Same set of stakeholders, but weighting of communities much heavier
System boundaries	Well-defined – corporation and its environment	Poorly defined – public policy reaching into all areas of life – complex systems
Governance	Directors and managers	Agency heads, ministers, executive government, parliament – tensions between loci of authority
Continuity	Occasional takeovers, mergers	Regular hostile takeover bid, sometimes successful
Accountability	Defined by standards, generally for shareholders and creditors, otherwise closed to public	Wide, more open, fluid
Legal constraints	Binding	Can change legislation
Motivation assumption	Instrumental, personal	Public service Generally lower pay
Legacy	Protection, highly regulated economy	Job security, many GBEs overstaffed with low productivity

(Table source: Ian McAuley, University of Canberra)<sup>21</sup>

<sup>21</sup> This table was developed with the input of many colleagues and students. It was inspired by Joseph L. Bower, *The Two Faces of Management: An American Approach to Leadership in Business and Politics* (Houghton Mifflin MA, 1983).