# Corporate governance, activism and the role of trustees

Can good corporate governance improve investor returns and should trustees therefore become more active in demanding better standards? It is the question of times and **MARTIN GOLD** makes an effort to answer it.

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Concerns about corporate governance standards have typically arisen in the aftermath of corporate failures and executive misdemeanours; not during periods of prosperity and investor euphoria. In many recent instances, these failures were attributable to fraud, negligence, and investor gullibility, rather than systemic defects in corporate governance or ethical standards, per se.

Some commentators have argued that these debacles could be blamed on "good" governance measures which have encouraged earnings management and perverse managerial incentive structures, along with the passivity of institutional investors and financial analysts who ignored valuation concerns (Coffee, 2004).

Because investment fiduciaries (such as superannuation trustees and fund managers) often hold substantial shareholdings in companies, and can act more effectively than small shareholders, there have been increasing expectations that they should engage proactively with issuers to encourage conformance with corporate governance best practices to increase firm value. A presumption which has been made is that "poor" corporate governance is economically undesirable, and it is suggested that investment fiduciaries owe a significantly broader responsibility to ensure that the interests of all stakeholders (not just their own clients as shareholders) are protected through improved corporate governance (Hawley and Williams, 1997).

In the US, however, legal scholars have recently cautioned that trustees risk compromising the economic justification for activism if their voting is motivated by socio-political rationales rather than the maximisation of investment returns (Camara, 2005).

Against this background, the existence of financially successful firms displaying non-conformance with corporate governance best practices may suggest that financial performance determines corporate governance structures rather than vice versa (MacNeil and Li, 2005). These findings reinforce the importance of investigating and confirming the linkage between corporate governance and improved investor returns.

By way of background, the first part of this article examines the functional application of Australia's best practice corporate governance standards and includes an analysis of recent conformance trends among Australia's largest firms. In the second part, the investment thesis of "good" corporate governance is re-examined to find if these structures provide improved investor returns and financial performance. In contrast to prior studies, we examine if "poor" governance firms *outperform*. Finally, some conclusions are drawn from the empirical findings, particularly in the context of the fiduciary duties owed by superannuation trustees and corporate officers.

## BACKGROUND AND FUNCTIONAL APPLICATION OF AUSTRALIAN CORPORATE GOVERNANCE STANDARDS

Australia's principal best practice corporate governance measures are exemplified by corporate governance guidelines which apply to entities listed on the Australian Stock Exchange (ASX). In March 2003, the ASX Corporate Governance Council (ASX CGC) guidelines were released (Finsia is a member of the council) which introduced a regime of comprehensive disclosures for corporate governance practices within Australia's 500 largest listed firms. In common with the development of corporate governance codes in the United Kingdom, the Australian system is based on the "comply or explain" principle: adoption of the guidelines by issuers was voluntary. However disclosures of non-conformance and explanations were mandated under the ASX listing rules, commencing in the 2004 annual reports to shareholders.[1] These guidelines incorporated many practices previously published by the Investment and Financial Services Association (IFSA). The trustees of large superannuation funds, via the Australian Council of Superannuation Investors (ACSI), also released its best practice corporate governance guidelines for issuers in March 2003.

### *Functional specification and application of internal governance structures*

Australian firms are subjected to three main prescriptions of corporate governance best practice. However there is considerable unanimity in the composition and functional application of these structures as shown in Table 1. From an issuer's perspective, the ASX CGC guidelines remain the primary corporate governance standards because they apply to all listed firms in the Top 500 irrespective of the composition of their shareholders.

These structures are concerned with mitigating classical agency problems which are expected to arise between shareholders and managers due to the separation of ownership and control, especially in the context of diffuse ownership. Under this theoretical prescription, managers will generally exercise full control and are expected to pursue self-serving activities to the detriment of shareholders' interests. Fama and Jensen (1983) argue that agency costs are reduced by institutional arrangements that separate decision management from decision control. An independent board of directors is therefore prescribed as the primary corporate governance structure because it acts as an oversight of managerial discretion and firm performance. In addition to agency-related concerns, more topical aspects are incorporated including: the responsible remuneration of directors and executives; enhancing the accountability of board members and senior executives; ensuring the integrity of financial statements and auditor functions; and responsiveness to shareholders and other corporate stakeholders.

**TABLE 1** MATRIX OF KEY CORPORATE GOVERNANCE STRUCTURES (RESPECTIVE GUIDELINE NUMBERS SHOWN)

| | | ASX CGC | IFSA | ACSI |
|---|---|---|---|---|
| **Corporate control, board leadership and structure, executive power** | | | | |
| Effective board control of the corporation | | 1.1 | 12 | 2 |
| Majority of independent directors | | 2.1 | 3 | 3.1 |
| Independent chairperson | | 2.2, 2.3 | 5 | 10.1 |
| Separation of chief executive and chairperson (non-duality) | | 2.2, 2.3 | 5 | 10.1 |
| Board committees with independence of decision-making | Nomination | 2.4 | 6, 7 | 11.3 |
| | Audit | 4.2 | 6, 7 | 11.1 |
| | Remuneration | 9.2 | 6, 7 | 11.2 |
| **Remuneration and accountability of corporate officers** | | | | |
| Responsible remuneration of directors and executives and timely disclosure | | 9 | 13 | 13 |
| Performance evaluation for the board and senior executives | | 2.4, 8.1 | 10 | 7, 12.1 |
| **Financial integrity** | | | | |
| CEO and CFO signoffs for financial integrity | | 4.1, 7.2 | | 16 |
| Auditor independence | | 4.4 | 7 | 17 |
| **Responsibility to shareholders and stakeholders** | | | | |
| Codes of ethics/ethical decision-making | | 3 | 17 | |
| Submit major corporate changes to shareholders' vote | | | 16 | 6 |
| Shareholders' rights and communication | | 6 | | 6, 14 |
| Respect for stakeholders | | 10 | | |

**TABLE 2** ISSUER CONFORMANCE WITH ASX CGC GUIDELINES

| Overall conformance with ASX CGC guidelines | Full conformance | Partial non-conformance |
|---|---|---|
| No. of firms | 93 | 97 |
| Ratio of total | 49% | 51% |
| **Most frequent areas of non-conformance** | **ASX CGC Recommendation** | **No. of firms disclosing non-conformance** |
| Board independence (majority of non-exec) | 2.1 | 44 |
| Independent chair | 2.2 | 30 |
| CEO/chair duality | 2.3 | 12 |
| Board nomination committee | 2.4 | 32 |
| Executive remuneration | 8.1 | 19 |

### *Early reporting trends*

As noted above, the requirement for firms to disclose their corporate governance practices became mandatory under the ASX Listing Rules from 1 January 2003. Using the ISS Proxy Australia (ISSPA) corporate governance analytics database, we analysed conformance with the ASX CGC guidelines, using the first full year of mandatory disclosures for all firms in the 2004 annual reporting season. As shown in Table 2, this confirmed a high level of overall conformance with the promulgated best practices. It also revealed that a significant number of firms adopted alternative structures suggesting heightened governance risks in the areas of board independence, concentration of executive power (CEO-chair duality), and managerial entrenchment.

### *Modes of corporate governance activism by institutional investors*

In Australia, as in other jurisdictions, the capacity of trustees to influence firms to adopt best practice corporate governance is subject to a range of legal considerations (Ali, Stapledon and Gold, 2003). Trustees are not obligated to exercise their proxies: rather they must be able to demonstrate that adequate consideration has been given to the issues to be voted. Trustees, and more frequently, their appointed fund managers, must ensure that "free rider" benefits do not arise which undermine the fiduciary's obligation to exclusively maximise the returns of their clients (as distinct from other shareholders). Trustees must also be mindful of breaching the insider trading provisions of the Corporations Law when engaging in private discussions with directors and management. Finally, while concerted efforts to organise actions on corporate governance matters with other significant investors may be laudable, the "shadow director" provisions of the Corporations Law can deem trustees to be directors with all of the attaching responsibilities and personal liability – but without the perquisites – of formal office.

The increasing trend towards institutional equity ownership has provided investment fiduciaries with the capacity to influence the corporate governance structures of investee corporations. By virtue of this ownership, the question appears to have become *how*, not *if*, investment fiduciaries can be involved in corporate governance reform efforts, although corporate governance concerns are not necessarily correlated with performance, and reform of corporate governance structures is a relatively recent phenomenon.

The consensus of empirical evidence indicates that institutional shareholders are effective in targeting firms and sponsoring changes to corporate governance structures, however the consensus of empirical evidence linking these changes to economic outcomes is equivocal.[2] Consequently, the economic efficacy of institutional investor activism in both the US and UK remains unclear.[3] A number of recent portfolio studies have bypassed the fundamental question of whether "good" corporate governance structures enhance value, and have used corporate governance ratings to construct portfolios which are then compared to a market portfolio or peer firms (Gompers *et al.*, 2003; Bauer *et al.*, 2004; Linden and Matolcsy, 2004). Given that the value of common corporate governance structures per se has not been proven, it is not surprising that emerging research into actual portfolio strategies has revealed mixed findings.

### *Insiders and perceptions of corporate governance risks*

While equity ownership by superannuation trustees and professional money managers has increased significantly, the research literature also notes increasing "insider" ownership by family founders, directors and executives (Holderness *et al.*, 1999; Anderson and Reeb, 2003). Insider influence is directly relevant to the question of optimal corporate governance because agency concerns are heightened where insiders have the capacity to extract private benefits at the cost of remaining stockholders or to make sub-optimal corporate investments (Fama and Jensen, 1983; Shleifer and Vishny, 1997) or to entrench themselves in management. In this context, it is particularly interesting that a positive association between insider ownership and control, and firm performance is found in the literature in both the US and Australia (Anderson and Reeb, 2003; Craswell *et al.*, 1997).

## TESTING THE LINK BETWEEN CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE

In contrast to earlier studies which have sought to validate the linkage between "good" governance and improved returns using tests of broad correlation (e.g. Gompers *et al.*, 2003; Bauer *et al.*, 2004), this study tests the "good" governance investment thesis, using a principle of mutual exclusion, by constructing an investment strategy which targets non-conforming firms, and from which inductive generalisations can be drawn about "poor" corporate governance.

**FIGURE 1** "POOR" GOVERNANCE SCREENING PROCESS

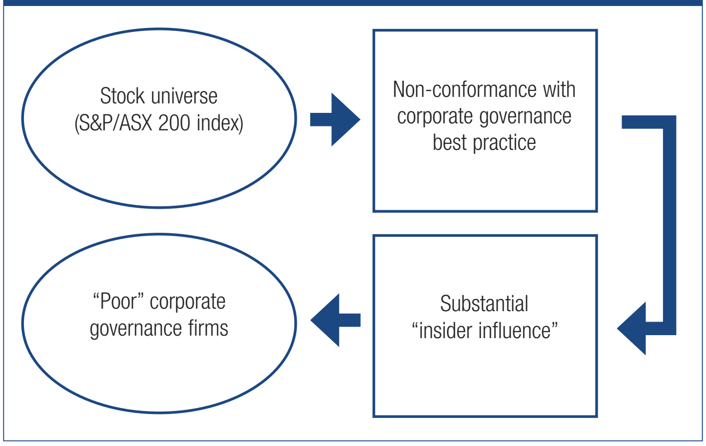



**FIGURE 2** "POOR" CORPORATE GOVERNANCE NON-CONFORMANCE SCREENING CRITERIA

| Board independence and entrenchment | | Board leadership/duality |
|---|---|---|
| Lack of majority of independent directors | AND | Non-independent chair |
| Lack of an independent nomination committee | | CEO/chair duality |

In designing this testing methodology, therefore, the main analytical task is to define poor governance. Since the various codes (shown in Table 2) represent a consensus of academics and industry best practice, non-conformance with them should provide a strong indicator of heightened corporate governance risks. It is also valuable to incorporate perceptions that both minority and dispersed shareholders face increased corporate governance risks where substantial insider ownership and managerial control is present.

### *Selection of the "poor" corporate governance sample*

We construct a sample of poor corporate governance firms using a two-stage screening process (see Figure 1).

First, we use a positive screen which includes the constituent companies of the leading institutional Australian equity benchmark – the S&P/ASX 200 index – which exhibits non-conformance with key best practice corporate governance standards. In accordance with the agency theoretical perspective, we select firms which have not adopted the recommended internal corporate governance structures directly associated with the apex of corporate power and control (shown schematically in Figure 2): namely, independence in board composition and board leadership. Non-conformance with these structures is expected to impede the effective functioning of the board, to introduce potential (or actual) interference between decision management and control, and provide greatest potential for entrenchment by directors and/or executives.

Second, we use a positive screen which includes only those firms which also exhibit substantial insider ownership by founders, their families, executives, and related parties (including trusts).[4] Using ISSPA's database which provides an analysis of substantial shareholding disclosures based on beneficial rather than legal ownership, we collect information on substantial insider ownership to identify "insider" firms. After applying the second positive screen for insider influence, we refine our sample of "poor" governance firms (see Appendix 1).[5]

The narrowness of the sample is a function of the research design, and importantly, reflects the generally high levels of conformance among Australian firms (noted earlier). Despite its narrowness, the sample is not dominated by particular market capitalisations or industry sectors. The design of the market performance study also mitigates size and industry bias by using equally weighted constituents. Importantly, the results of this study, in direct contrast to "good" governance studies, are not assisted by so-called "survivorship" biases.

### *Market performance study*

Using the cohort of "poor" governance firms we compute a "Poor Governance Index" which measures the performance of an equally weighted portfolio of these stocks. This index is re-balanced at the end of each month to mitigate distortionary effects from individual firms on the overall performance results. For the purposes of this analysis, we use the performance variable which is most relevant from an investment fiduciary's perspective – total returns (i.e. returns which include price appreciation and dividends).

**FIGURE 3:** CUMULATIVE GAINS FROM A "POOR" CORPORATE GOVERNANCE PORTFOLIO

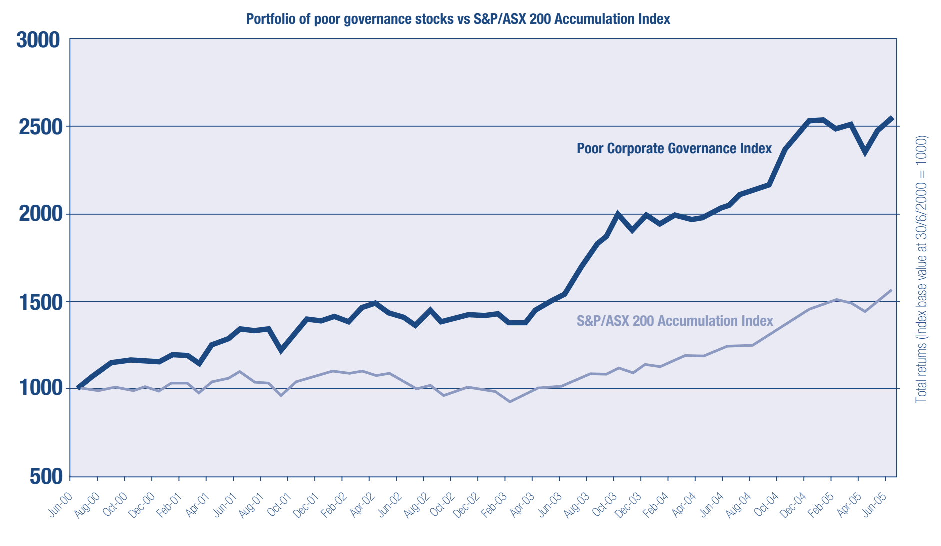



**TABLE 3** PERFORMANCE ANALYSIS OF THE "POOR" GOVERNANCE INDEX

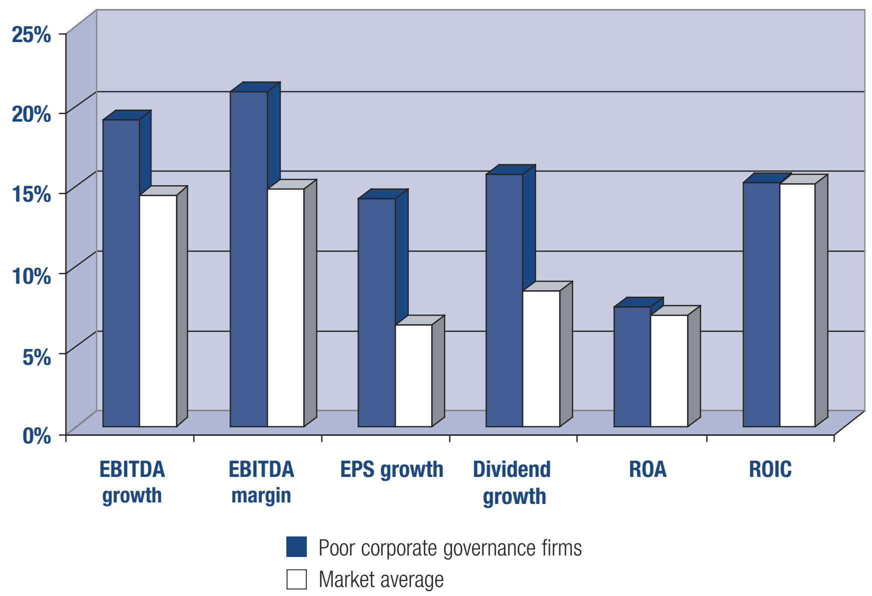
| **Total returns (to 30 June 2005)** | **1 year** | **3 years** | **5 years** | |
|---|---|---|---|---|
| "Poor" Governance Index | 26.2% | 20.4% | 22.5% | |
| S&P/ASX 200 Index | 26.4% | 14.7% | 9.4% | |
| Outperformance margin | -0.1% | 5.6% | 13.1% | |
| Persistence ratio (frequency of outperformance versus the market) | 50% | 64% | 68% | |
| **Comparative portfolio risk measures (five years to 30 June 2005)** | | **"Poor" Governance Index** | **S&P/ASX 200 Index** | **Relative** |
| Annualised standard deviation of returns | | 29.2% | 10.2% | 2.9X |
| Downside risk (ratio of negative returns) | | 30% | 37% | 0.82X |
| Beta | | 0.96 | 1.00 | 0.96X |
| Skewness of returns | | (0.28) | (0.46) | 0.62X |

Data source: Iress.

We compare the performance of the Poor Governance Index with the S&P/ASX 200 using monthly data for the five years ended 30 June 2005. This extended analysis period is selected for its statistical robustness and because it incorporates a period of heightened corporate governance concerns. As shown in Figure 3 and Table 3, the Poor Governance Index demonstrates substantial outperformance of the broad equity market over the long term of between 5–13% per annum, with higher levels of persistence and lower systematic risk.

This analysis indicates that the exclusion of these firms in constructing a "good" governance portfolio is likely to result in significant opportunity costs for investment fiduciaries in terms of forgone returns and portfolio diversification. Using a methodological principle of mutual exclusion, it can be posited that the good governance investment thesis is not supported by these empirical results.

**FIGURE 4** COMPARATIVE FINANCIAL PERFORMANCE SCORECARD




### *Analysis of financial performance*

We analyse the financial performance of our cohort of poor corporate governance firms by focusing on metrics which are considered to be most insulated from accounting adjustments, are largely independent of financial structure, and exclude the distorting effects of market valuation.[6] In accordance with market practice, we use earnings before interest, taxes, depreciation and amortisation (EBITDA) as the main proxy for operating performance. We create financial performance aggregates for the "market" using a large sample of firms with reported revenue exceeding $100 million and positive earnings before interest and taxes (EBIT). This is a stringent sample for comparison purposes because it excludes smaller firms and those with poor underlying profitability.

As shown in Figure 4 and Table 4, our analysis of the financial performance reveals that the cohort of poor governance firms exhibit superior operational and financial efficiency than the market overall. Over an extended analysis period incorporating five years of annual financial returns, poor governance firms show stronger growth in underlying cash flow (EBITDA), normalised earnings per share and dividends. Significantly, the poor governance firms show higher underlying operating profit margins (EBITDA margin), while their capital efficiency (ROA and ROCI) is also higher than the market overall.

Interestingly, from an agency perspective, poor governance firms generate higher growth in dividends than the market average, however this appears to have been achieved as a function of superior earnings rather than simply increasing dividend payout ratios. Finally, as an expected corollary of our market performance survey results, the market valuation of poor

TABLE 4: FINANCIAL PERFORMANCE VARIABLES

| Key variables for operating and financial efficiency | "Poor" corporate governance firms | | Market average | |
|---|---|---|---|---|
| | Median | Mean | Median | Mean |
| EBITDA growth – 5 year average (%) | 19.2 | 27.2 | 14.5 | 17.8 |
| Core earnings per share growth – 5 year average (%) | 14.3 | 19.1 | 6.4 | 8.8 |
| EBITDA margin (%) | 21.0 | 26.5 | 14.9 | 19.1 |
| Return on assets (ROA) (%) | 7.5 | 10.2 | 7.0 | 7.9 |
| Return on capital invested (ROCI) (%) | 15.3 | 43.2 | 15.2 | 26.7 |
| Dividends per share growth – 5 year average (%) | 15.8 | 24.0 | 8.5 | 9.8 |
| Dividend payout ratio (%) | 59.8 | 71.2 | 62.1 | 67.4 |
| Price to gross cash flow (X) | 8.9 | 11.1 | 7.8 | 8.9 |
| Enterprise value/EBITDA (X) | 8.7 | 9.1 | 7.5 | 8.6 |

All data is reported according to latest company balance dates. Core earnings are reported earnings pre-abnormal items and adjusted for dilution from corporate actions. Growth shown over 5 years unless shown otherwise. Market sample excludes financial and real estate firms ($n$ = 308). Source: Aspect Financial.

governance firms (gross cash per share/price and enterprise value/EBITDA multiples) reflects investors' willingness to pay a premium for these firms versus the broader equity market. These findings suggest, from the shareholder perspective, that the exclusion of poor governance firms from a portfolio would result in lower economic value-added. In summary, our empirical analysis of financial performance does not support the "good" governance investment thesis.

## CONCLUSION

This paper has noted that Australia's best practice corporate governance standards exemplify a high standard of formalisation. The analysis of early reporting trends has also revealed that Australian firms exhibit high levels of conformance with these structures, however a significant number of firms, especially those exhibiting substantial insider influence, have chosen to adopt alternative structures of corporate governance.

This paper has attempted to address fundamental question of determining the value of common corporate governance structures by deliberately selecting firms with "poor" corporate governance structures, and with substantial insider ownership present. The analysis reveals that they generated superior investment returns and financial performance. These findings do not support the good corporate governance investment thesis for Australian firms and similar findings emerging offshore.

For trustees and fund managers, these results reinforce the importance of scrutinising portfolio selections based on corporate governance assessments, and ensuring that any efforts to exert pressure on issuers to adopt corporate governance best practices are motivated on economic grounds. These findings also have significant implications for corporate officers who are ultimately accountable to shareholders for the economic rationale of any expenditure incurred adopting these measures in the context of their fiduciary duties to the firm. An important empirical issue remaining for the corporate sector, therefore, is to quantify the direct costs and indirect effects associated with conformance with best practice corporate governance guidelines.

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## Notes

1 Following a post-implementation review, the ASX CGC revised its guidelines with respect to the composition of audit committees, scaling this back to the 300 largest entities. This change was made as smaller firms, which on average had fewer than five directors, were unable to attract suitable

candidates or found it was impractical to expand their boards. The corporate law has also been reformed, making the requirement that CEO/CFO sign-off financial statements showing conformance with accounting standards (the "true and fair view") mandatory effective from 1 July 2004.

2 There are a number of studies which have examined this linkage. For example, a study by Bhagat and Black (2002) argue, that independence of boards subtracts value.

3 See further: Karpoff, 1998; Gillan and Starks, 2003; Dedman, 2002; Faccio and Lasfer, 2000.

4 Under Australian corporate law regulations, shareholdings which exceed 5% of issued capital are deemed to be "substantial".

5 We exclude firms which have been in operation for less than three years to enhance the robustness of our empirical results.

6 Several studies use Tobin's $q$ to measure value-added, however this metric incorporates the effects of market valuation. J

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If you have a view on the subject matter contained in this article, or any other articles in this issue of JASSA, then let's hear from you. Please direct all correspondence to the Editor, John Arbouw, at **jarbouw@bigpond.net.au**

**APPENDIX 1** DESCRIPTIVE STATISTICS FOR AUSTRALIAN "POOR" CORPORATE GOVERNANCE FIRMS

| Stock code | Firm name | Industry (GICS classification) | Market capitalisation ($ million) | Operating revenue ($ million) | Assets ($ million) | Reported net profit after tax ($ million) | Top 20 shareholders (%) |
|---|---|---|---|---|---|---|---|
| AEO | Austereo Group Ltd. | Media | 608.8 | 240.4 | 1,039.0 | 41.9 | 94.7 |
| APN | APN News & Media | Media | 2,484.8 | 1,257.0 | 2,801.3 | 128.3 | 62.5 |
| CPU | Computershare Ltd | Software & Services | 1,738.7 | 872.4 | 1,187.1 | 79.9 | 65.3 |
| FWD | Fleetwood Corp | Automobiles & Components | 348.2 | 251.2 | 165.8 | 20.2 | 60.8 |
| GNS | Gunns Limited | Materials | 1,111.7 | 649.7 | 951.4 | 105.3 | 72.2 |
| HIL | Hills Industries Ltd | Capital Goods | 540.6 | 717.0 | 428.1 | 31.1 | 38.9 |
| HVN | Harvey Norman | Retailing | 2,980.3 | 1,735.6 | 2,369 | 176.1 | 82.7 |
| HWI | Housewares Internat. | Retailing | 252.2 | 457.6 | 278.8 | 22.9 | 71.3 |
| IFM | Infomedia Ltd | Software & Services | 240.3 | 69.9 | 69.4 | 20.7 | 88.5 |
| JBM | Jubilee Mines NL | Materials | 499.8 | 235.4 | 224.0 | 95.1 | 58.3 |
| MTS | Metcash Limited | Food & Staples Retailing | 1,579.2 | 7,201.2 | 1,488.7 | 101.8 | 86.1 |
| NWS | News Corp | Media | 26,627.0 | 29,428.0 | 73,738.0 | 2,312.0 | 91.1 |
| PBL | Publishing & Broadcasting Limited | Media | 8,505.7 | 2,894.3 | 7,541.5 | 668.2 | 80.2 |
| RHC | Ramsay Health Care | Health Care Equipment & Services | 701.4 | 767.6 | 690.2 | 38.4 | 85.4 |
| SEV | Seven Network | Media | 1,111.6 | 1,141.5 | 2,067.9 | 93.3 | 82.2 |
| SPT | Spotless Group Ltd | Commercial Services & Supplies | 991.7 | 2,455.0 | 1,346.7 | 22.7 | 61.7 |
| THG | Thakral Holdings Grp | Property Trusts | 386.7 | - | 763.2 | 35.0 | 82.6 |
| WDC | Westfield Group | Property Trusts | 27,653.3 | 1,612.9 | 34,821.0 | 832.9 | 72.1 |
| | | | | | | | |
| | Sample median | | 1,051.7 | 872.4 | 1,113.1 | 86.6 | 76.2 |
| | Market median | | 481.8 | 404.5 | 455.4 | 23.6 | |