GOOD CORPORATE GOVERNANCE: *What matters most to directors?*[1]

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

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

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

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

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

The Board of Directors is the main monitoring mechanism in firms and the importance of its independence in achieving effective corporate governance is widely known. Board independence is publicly disclosed, and affects both the reputations of the company and the directors. Previous studies have measured Board independence by the proportion of non-executive directors on the Board and also by whether the positions of CEO and Chairman are held by the same person. As Board independence is closely

TABLE 1: Corporate governance attributes

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

linked to the directors' reputation, we predict that directors will rate Board Composition and CEO Duality ahead of other attributes.

According to Fama and Jensen (1983), a director's reputation is measured by the number of directorships held, that is, more directorships indicate a better quality of director. Because the directors' reputation argument suggests that directors need to maintain their reputation in order to secure existing and future directorships, we predict that Multiple Directorships will also be important to them.

Directors are expected to be relatively less concerned with attributes related to the Audit Committee and the audit process, such as the Size and Composition of the Audit Committee, the provision of Non-audit Services and Audit Partner Tenure. These attributes will not have a direct impact on directors' reputations. We have no strong expectations regarding the relative importance of the remaining corporate governance attributes (Board Size and Remuneration Committee Composition).

Interviews

The first phase of this research involved interviews with 11 key industry figures from various backgrounds including academics, a financial analyst, professional accounting body executives, a financial commentator, an accounting practitioner and, of course, directors. The interviews were undertaken to refine the corporate governance attributes identified from the literature and to ensure that those included (summarised in Table 1) are consistent with the interviewees' notions of effective corporate governance.

Online survey

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

relative importance rank the attributes' importance, it also shows the extent to which an attribute is more important than the others. This benefit, which is not provided by other methods, is the main reason for using ACA for this study.

This survey asked respondents which attributes they perceive will constitute effective corporate governance. An ACA survey consists of four sections: (i) ACA Rating Section; (ii) ACA Importance Section; (iii) ACA Trade-Off Section and (iv) ACA Calibration Section. These are discussed in detail below.

In the ACA Rating section, the respondent is asked to provide a rating preference for different levels of a particular corporate governance attribute using a seven-point Likert-scale ranging from 'extremely desirable' to 'not desirable'. In the second section the ACA Importance section, ACA utilises the previous responses from the participant to develop questions that ask the respondent which corporate governance attribute he/she considers most important. This section also uses a seven-point Likert-scale ranging from 'extremely important' to 'not important'. The third section contains the ACA Trade-Off questions. Based on previous responses, ACA provides the respondent with combinations of two to three attributes with different attribute levels in each combination, which he/she is asked to rate. This section enables the collection of conjoint data so that relative importance scores can be calculated. The final section, the ACA Calibration section, uses the answers about which attributes are rated as most important, provided by the participant in the previous sections, to compose a set of 'calibration concepts'. Respondents are asked to rate these calibration concepts to indicate their preference. The answers obtained in this section are used to calibrate the relative importance scores calculated earlier for use in further data analysis.

Data collection

The survey instrument was pre-tested, taking approximately 20 minutes to complete. Our target respondents are members of the Australian Institute of Company Directors (AICD). As the largest directors' association in Australia, their membership is representative of the population of directors in Australia. The AICD executive agreed to provide a link to the survey in their fortnightly newsletter to all members. In total, 56 directors participated in the survey and 46 of them completed it.

Results

The output of the ACA analysis is a relative importance score (RIS) for each corporate governance attribute. Each score is a ratio, so an attribute with a score of 10 is twice as important as an attribute with a score of 5. This interpretation is consistent with Clark-Murphy and Soutar (2004) and Kilgore et al. (2011), two prior studies that use ACA to investigate the relative importance of factors affecting individuals' investment decisions and perceptions of audit quality, respectively.

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

TABLE 2: Relative importance scores of attributes

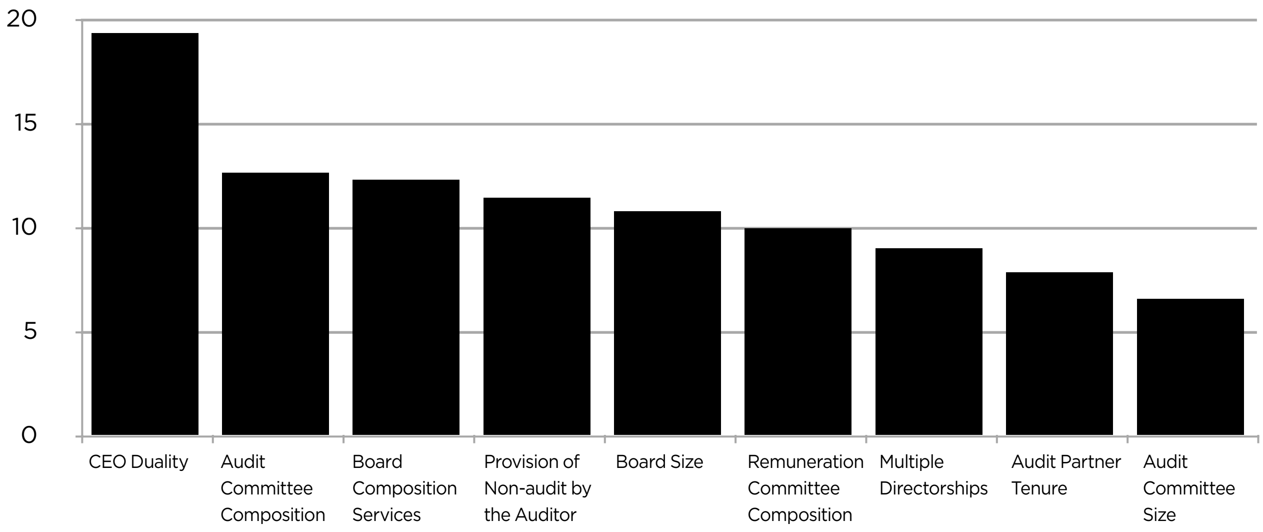
Attribute	Relative Importance Scores (RIS)
Board Composition	12.31
Board Size	10.79
Multiple Directorships	9.03
Audit Committee Composition	12.65
Audit Committee Size	6.59
Provision of Non-audit Services by the Auditor	11.45
Audit Partner Tenure	7.87
Remuneration Committee Composition	9.98
CEO Duality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

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

CEO Duality

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

FIGURE 1: Relative importance scores of attributes



Audit Committee Composition

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

Board Composition

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

Provision of Non-audit Services by the Auditor

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

Other Attributes

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

Conclusions

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

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

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

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

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