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*Compliance and Impact of Corporate Governance Best Practice Code
on the Financial Performance of New Zealand Listed Companies*

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Thesis Title

Compliance and Impact of Corporate Governance Best Practice Code on the Financial Performance of New Zealand Listed Companies

ABSTRACT

The corporate governance best practice code (Code) of the New Zealand Exchange (NZX) came into effect on October 29, 2003. However, so far there is no systematic study of compliance with and impact of NZX Code on the performance of NZX companies. This study attempts to provide some answers to the perceived knowledge gap. The NZX Code recommends certain governance mechanisms to enhance corporate performance. The mechanisms analysed in this study are the percentage of independent directors, duality, presence of board subcommittees (audit, remuneration, and nomination), and the performance evaluation of board and individual directors. This thesis examines the possible relationship between recommended governance structures and the performance of NZX companies for the years 2003 (pre-Code) and 2007 (post Code), using data from the same 89 companies for each year. Although the number of companies adopting the NZX structures has increased, the rate of full compliance of the Code remains disappointingly low, rising from 5.6% in 2003 to just 22.5% in 2007. Probably due to the small sample size relative to the number of independent variables, and the problem of co-linearity, the multiple linear regression results do not seem to be conclusive and may be unreliable as the basis to form any formal statistical inference. However, treating the 89 companies as the whole population (89 out of 90), and using a simpler and more descriptive statistical tool to analyse the impact of individual independent variables on firm performance, the 2007 results show a consistent pattern of a positive relationship between Code compliance and firm performance, assuming all other factors being constant. This positive relationship is further reinforced by dividing the population into the various industry groupings as classified by the NZX, which also results in a consistent pattern of companies which comply fully with the Code structures financially outperforming companies that only partially comply with the Code during 2007. Surprisingly, listed companies adhering to the Chairman/CEO dual role do not seem to have impacted negatively on firm performance, contrary to agency theory expectation.

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Chapter One – Introduction

Overview of the Study

Just when the spectacular collapses of Enron, WorldCom, and Arthur Anderson in the late 1990s/early 2000s are to be consigned to the pages of the history books, the ongoing 2007/2008 United States (US) sub-prime mortgage scandals and the resultant bank failures have reignited the debates on the importance of (or lack of) corporate governance in general, and the roles of board of directors (BOD) in particular. As with the 1990s/early 2000 financial scandals which resulted in the enactment of the far reaching Accounting Industry Reform Act (Sarbanes-Oxley Act) of 2002, more stringent regulations are to be expected from the US Government to monitor more effectively the operations of banks and other corporations that are now seeking government bailouts. The boards and management of these companies are now under intense public scrutiny, with their quality of corporate governance standards being the focus of attention.

Similarly, in the United Kingdom (UK), the financial scandals of the late 1980s and early 1990s involving Maxwell and Poly Peck, among others, led to the establishment of the Committee on the Financial Aspect of Corporate Governance in May 1991. The Committee, chaired by Sir Adrian Cadbury submitted its findings in December 1992, which became widely known as the Cadbury Report, 1992. The most important recommendation of the Cadbury Report is the introduction of a Code of Best Practice (Cadbury Code), which all UK companies listed on the London Stock Exchange (LSE) are expected to follow, especially after the amendment of its listing rules requiring all listed companies to provide in their annual reports a statement declaring whether the Cadbury Code is complied in full or explaining why certain aspects of the Code are not complied with. This “comply or explain” mechanism, a form of formal self-regulation, serves to ensure that investors are given the full facts of corporate governance standards compliance by listed companies.

The Cadbury Report was followed by the Greenbury Report of 1995 (on executive pay package), the Hamper Report of 1998 (review of implementation of the Cadbury and Greenbury recommendations) which together became the Combined Code

(1998). The Higgs Report of 2003 (on the role and effectiveness of non-executive directors), and the Smith Report of 2003 (on the role and effectiveness of audit committees) were incorporated into the updated and revised Combined Code, 2003 of the LSE.

The Cadbury Report (1992) inspires and spurs the development and adoption of similar corporate governance best practice codes throughout most parts of the world, including New Zealand. The New Zealand Exchange Limited (NZX, formerly known as NZSE) on May 6, 2003 announced the new proposed corporate governance framework for its listed companies. Upon consultation with listed member firms and the Securities Commission, the Corporate Governance Best Practice Code (NZX Code) of NZX was incorporated into the Listing Rules of NZX effective 29 October 2003. The NZX Code includes the mandatory standards for all listed companies to meet and a more flexible set of principles to enable individual companies to establish their own corporate governance practices, taking into consideration the difference in corporate size and culture. The mandatory standards (minimum of two independent directors or one third of total numbers of directors, whichever is larger; no director duality of CEO/Chairman; establishment of audit committee and rotation of external auditors) are to be enforced through its Listing Rules while the flexible standards are to be monitored through the requirement for all listed companies to disclose in their annual reports the extent to which their corporate governance processes *materially differ* from the principles set out in the NZX Code [Listing Rule 10.5.3 (i)].

It is to be noted that the requirement to include a corporate governance statement in the annual reports of NZX listed firms (especially to report only if there is *material difference*) is less stringent than the standard ‘comply or explain’ monitoring mechanism of the UK Cadbury Code. The flexible or discretionary standards cover the establishment of nomination committee, remuneration committee, formulation of corporate code of ethics, performance- based director stock compensation plan, provision of timely information to the boards by management, director training, and formal procedure to regularly assess individual director and board performance. The mandatory standards on board appointments (independent directors) and establishment of audit committee were enforced through amendments to Section 3.3

of the Listing Rule. The mandatory separate board leadership structure and the discretionary standards requirement were incorporated as Appendix 16 of the Listing Rule, effective October 29, 2003. However, listed firms have a grace period of 12 months to comply or explain.

The NZX Code, as a whole, is a mirror image of the UK Combined Code. Therefore, it is not surprising that just like the UK Combined Code recommendations, the NZX Code recommendations are based on the agency theory perspective, as reflected in the focus on the independence of directors and other aspects of board independence. The board is therefore expected to focus on its control role.

Since the issuance of the NZX Code in October 2003, there has not been any official or trade review of compliance with the NZX Code and so far no systemic research has been done to gather empirical data on the extent of compliance with NZX Code by listed companies. The UK Cadbury Code, which was issued in 1992, was officially reviewed by the Cadbury Commission itself in 1995 (Conyon and Mallin, 1997). The Toronto Stock Exchange (TSE) guidelines on corporate governance, issued in 1994, were officially reviewed by the TSE in conjunction with the Institute of Directors in 1999 (Leblanc and Gillies, 2005). The Australian Stock Exchange (ASX) Corporate Governance Council (ASX CGC Code) issued its corporate governance principles and recommendations in March 2003 and released its Implementation Review Group Report in March 2004. The ASX CGC Code has since been updated in 2007 (Farrar, 2008). This research therefore is timely to provide some answers to the perceived knowledge gap in New Zealand regarding the extent of compliance with the NZX Code by New Zealand listed companies.

So far, only five British cases have been published on research relating to the relationship between compliance with Cadbury Code/Combined Code and firm performance. The only Australian case reported only the ten-year period (1992 – 2002) before the introduction of the ASX CGC Code in 2003 (Henry, 2008). In addition, in Canada, Park and Shin (2004) empirically found that monitoring of abnormal accruals by outside directors is not more effective after the issuance of the Toronto Stock Exchange's Corporate Governance Guidelines in 1994. There is, however, no such empirical study ever published yet in New Zealand. The perceived

knowledge gap in New Zealand regarding the possible relationship between NZX Code compliance and financial performance of New Zealand listed firms provides the opportunity to conduct an original research in New Zealand.

Research Questions, Objectives and Process

In line with the perceived knowledge gaps as stated above, the research questions are:

- 1) To what extent have New Zealand listed companies complied with the recommendations of the NZX Code?
- 2) Would compliance with the NZX Code have any positive impact on the financial performance of listed companies, assuming all other factors being constant, as predicted by agency theory?

The research objectives here are two-fold. Firstly, to review the extent to which listed firms have complied with the NZX Code requirements and recommendations. Requirements here refer to the compulsory provisions such as the minimum of two independent directors and the establishment of an audit committee, while recommendations refer to the discretionary provisions such as establishment of remuneration and nomination committees and the performance evaluations of board and individual directors. The latter provisions are dependent on company size and culture. The second objective of this research is to test the agency theory predictions on NZX recommended board structures and practices, so as to enable the researcher to provide answer to the second research question as spelled out above.

As a result of the mandatory and discretionary aspects of the NZX Code, there is an expected discrepancy (variance) in the extent of compliance among listed firms. The difference and variance shall give rise to the possibility to observe the relationship between adopted governance structures and practices and firm performance. Such discrepancies are to be found in the annual reports of NZX Companies. This is because Listing Rule 10.5.3(i) requires all New Zealand listed companies to disclose in their annual reports the extent to which their corporate governance practices and processes materially differ from the principles as set out in the NZX Code. As such, one would be able to measure the difference in the ratio of independent directors

(continuous variable) among NZX listed firms and to determine whether such firms comply with separate board leadership structure, the setting up of board committees (audit, remuneration, and nomination), and board and director performance evaluations (binary variables). The impact of code compliance on the financial performance of NZX listed companies could then be measured through regression analysis and other statistical tools.

Thesis Structure

This thesis is organised as follows. After the introductory Chapter One, Chapter Two covers the background, theories, and different models of corporate governance. It provides the historical context to the development of the Anglo-American corporate governance model and analyses the two contrasting theories of corporate governance (shareholder value versus stakeholder value). It also examines two other models of corporate governance operating in Germany and Japan respectively. The two contrasting approaches to board roles (control versus collaboration), as reflected in the differing agency theory and stewardship theory perspectives, are also examined to facilitate discussion on the practical application of the two theories on the objective function of big public companies, as reflected in the different corporate governance structures, values, and practices between the Anglo-American system and the Germanic/Japanese system. It also discusses the issues of possible convergence of corporate governance systems, and the broad acceptance of the Cadbury Code of Best Practice as the universal common standard for what good governance is all about. It also serves as the platform to introduce the research questions.

Chapters Three and Four cover the main literature review. Chapter Three traces the development of corporate governance best practice codes, with special reference to New Zealand. It reviews the extent of U.K. listed companies' compliance with the various recommendations of the Cadbury Best Practice Code, and also investigates the relationship between compliance with the U.K. Cadbury Code and firm financial performance, the findings of which could perhaps be generalised and made applicable to similar New Zealand study. The roles and responsibilities of board of directors as seen from the various differing theoretical perspectives are discussed under Chapter Four. The control, resource dependence, and service roles of the board

and their relationships with firm financial performance are also investigated, in view of the special position of board composition and board committee structure in the NZX Code. The study of the board variables as embedded in the NZX Code, however, is done only in conjunctions with hypotheses formulation in Chapter Five.

Chapters Five and Six focus on the research framework and findings. Chapter Five outlines the research problem, the research questions, the research objectives, and the methodology of this study. Chapter Six covers data analysis and discusses the research findings to determine the extent to which New Zealand listed companies have complied with the recommendations of the NZX Code and the possible relationship between full code compliance and corporate financial performance. The research findings should provide the necessary answers to the two abovementioned research questions. Chapter Seven covers the conclusions of this thesis, and assesses the implications and significance of the research findings to the academic and professional sectors, its limitations, and suggestion on further research.

Chapter Two – Background, Theories, and Models

Introduction

This chapter discusses the various definitions of corporate governance and the two conflicting theoretical perspectives underlying them, namely, the shareholder theory and the stakeholder theory. It traces the economic and political foundations of the origin and development of the Anglo-American corporate governance model, and compares it with two other models operating in Germany and Japan respectively. It also examines the two contrasting approaches to corporate governance in relation to the roles of board of directors, and the main theories underpinning them. The two contrasting approaches to board roles (control versus collaboration), as reflected in the differing agency theory and stewardship theory perspectives, are also examined to facilitate discussion on the practical application of the two theories on the objective function of big public companies, as reflected in the different corporate governance structures, values, and practices between the Anglo-American system and the Germanic/Japanese system. It also analyses the issues of possible convergence of corporate governance systems, the adoption of Cadbury Code of Best Practice as the universal standard for good governance, and the introduction of the research questions.

2.1 Definition and Theoretical Perspective

What is corporate governance? A survey of extant literature review shows that there is no uniform definition of this term among either academic scholars or practising managers. However, two distinct characteristics can be identified among the many diverse definitions. Firstly, the term is defined either too narrowly or too widely in its scope, reflecting differing disciplines and theoretical backgrounds. Secondly, it is defined from two differing theoretical perspectives on the role and fundamental purpose of big publicly traded corporations.

On one hand, the financial economists define corporate governance as ways in which investors assure themselves of getting a return on their investment (Shleifer and Vishny, 1997) or as ways of ensuring that corporate actions, assets and agents are directed to maximise shareholder wealth (Healy, 2003). On the other hand, we have

the organisational scholars who define corporate governance as the determination of the broad users among whom organisational resources are deployed and the resolution of conflicts among the myriad participants in organisation (Daily, Dalton, and Cannella, 2003). Similarly, the Organisation for Economic Cooperation and Development (OECD), in a 1999 working paper (revised and updated April 2004), defined corporate governance as:

... a set of relationships between a company's management, its board, its shareholders and stakeholders. Good corporate governance should... facilitate effective monitoring, thereby encouraging firms to use resources more efficiently.

Other definitions include that of Scholes (1999) who, viewing from strategic management perspective, defines it as a framework that determines whom the organisation is there to serve and how the purposes and priorities of the organisation should be decided. The United Kingdom (UK) Cadbury Report (1992) defines corporate governance as the system by which companies are directed and controlled. The New Zealand Securities Commission (2003; 2004) defines corporate governance as the set of structures and behaviours upon which a company is directed and managed. It is interesting to note that the New Zealand definition includes corporate behaviours. Conger, Lawler, and Finegold (2001) identify five factors (information, knowledge, power, rewards that motivate, and opportunities) which influence effective governance behaviours. They conclude that perhaps ultimately what matters most are governance behaviours, not practices per se.

From the above definitions, one should be able to identify the role of governance and where the responsibility for governance lies in corporations. Thus, one can say that the role of governance in an organisation is to ensure the effective usage of firm resources to achieve the established objectives of its owners and to also care for the interests of its other stakeholders. The responsibility for governance lies in the hands of its board and management, whose relationships should be based on mutual respect, trust, and personal integrity. It is to be noted that all the above definitions do not mention business ethics, a topic integral (but seldom highlighted) to the current hot debates regarding reforms of the corporate governance systems.

2.1.2 Competing Theoretical Perspectives

From the above analysis, one can also deduce that the narrower scope of corporate governance definition is based on the shareholders or stockholders theory perspective, while the broader scope is based on the stakeholder theory perspective. These two different models of corporate governance compete to define and determine the fundamental purpose of the corporation, whose interest should the corporate serve, and the structure of governance arrangements as justified by the two contrasting theoretical perspectives and paradigms.

On one side is the traditional shareholder theory which regards the corporations as an instrument for share owners to maximise their investment returns, on the rationale that theoretically stockholders are residual risk bearers (Jensen and Meckling, 1976). It traces its pedigree to the works of Adam Smith (1776/1981), and Berle and Means (1932/ 1968). This historical link is acknowledged in the seminal paper of Jensen and Meckling (1976). On the other side is the relatively new stakeholder theory (emerged in the 1930s, but only came to prominence in the 1980s), which argues that the corporation should maximise not only the interest of share owners, but also that of other stakeholders such as employees, creditors, suppliers, customers, and local communities (Evan and Freeman, 1988; Blair, 1995). The stakeholder theory claims that these groups or individuals have a legitimate stake in the company, since their actions could affect organisational outcomes (Wang and Dewhirst, 1992).

This inevitably leads us to debate and to theorize on the merits and otherwise of the two differing shareholder and stakeholder perspectives, and competing national corporate governance systems, that are to be discussed later on. For the purpose of this analysis, the shareholder perspective is defined as maximisation of the long-term market value of the firm, as represented by its stock price. The stakeholder perspective is defined as maximisation of the total value of the firm, as distributed among all stakeholders including shareholders, employees, customers, credit providers, and the local community in which the corporation resides (Freeman, 1984; Jensen, 2002).

The classical articulation of the role of corporate directors as fiduciaries (equivalent to the current debate between shareholder value approach and the stakeholder value

approach) can be traced to the early days of the Great Depression in the form of a scholarly debate between Professor Adolf Berle of Columbia Law School and Professor Merrick Dodd of Harvard University. Berle (1931) argues that since the managerial powers are derived from the shareholders, it is the fiduciary duty of the managers to maximise firm value for the sole benefits of its stockholders. Dodd (1932), in language that is still very relevant today, replies that public opinion on the role and responsibility of business entity would ultimately find its way into the law book. The latter posits that public opinion is moving towards treating business entity as not only an economic institution making money for the sole benefits of its shareholders, but also to provide a social service. It is interesting to note that Berle, in the preface to the 1968 edition (reprint) of the seminal work *The Modern Corporation and Private Property*, conceded that subsequent events had proven Professor Dodd's argument to be correct (Berle and Means, 1968).

Comparing and lamenting these two opposing schools of thought, Jensen (2002) asserts that the shareholder value maximisation proposition under the shareholding theory has its role in 200 years of research in economics and finance. Accordingly, value maximisation demands:

that managers should make all decisions so as to increase the total long-run market value of the firm. Total value is the sum of the values of all financial claims on the firm – including equity, debt, preferred stock, and warrants. Stakeholder theory, on the other hand, says that managers should make decisions so as to take account of the interests of all the stakeholders in a firm. Stakeholders include all individuals or groups who can substantially affect the welfare of the firm – not only the financial claimants, but also employees, customers, communities, and governmental officials, and under some interpretations, the environment, terrorists, blackmailers, and thieves (p. 236).

Jensen (2002) argues that the other main contender competing with value maximisation for this objective function is the stakeholder theory, with its roots in sociology and organisational behaviour. However, the theory has been tainted with the politics of special interests and managerial self interest. Since it is incomplete as a specification for the corporate purpose or objective function, the stakeholder theory

therefore cannot be expected to fulfil that corporate objective role. Jensen (2002) opines that despite its incompleteness, the stakeholder theory is currently popular because it serves the private interests of those who promote it, including outsiders and many insider managers and directors of firms.

Jensen's (2002) rather harsh criticism of Freeman's (1984) broad definition of stakeholder (defined as any group or individual who affects or is in any way affected by the actions of a corporation) is similarly raised by Sternberg (1997). Even with the redefinition of stakeholder by Evan and Freeman (1988 – referring only to customers, suppliers, owners, employees, and local communities), critics of stakeholder theory (such as Jensen and Sternberg) continue to question the motives (managerial self interests) and the accountability of boards and management which adopt the stakeholder perspective. Hosmer (1995) argues that in order to count as a stakeholder, the consideration should be whether or not a group at some point in the future can affect the achievement of the objectives of the firm. This perspective is also supported by the Delaware Supreme Court, which ruled that the interest of other constituencies must have reasonable relationship to general shareholder interests (Walsh, 2002).

However, Donaldson and Preston (1995) posit that stakeholder theory is justified in the management literature, both explicitly and implicitly, on the basis of its descriptive accuracy, instrumental power, and normative validity. They conclude that although these three justifications are mutually supportive, the normative base of the theory (that is to say, why some claims, whether moral, legal, or property-based, and some relationships are legitimate and worthy of management attention) is fundamental. Justified as it may seem, McVea and Freeman (2005) lament that the original stakeholder framework which grew out of a series of clinical studies of management practitioners over a ten-year period by Freeman (1984), ironically is now having the greatest influence among the theorists and academics, rather than among the practising managers and entrepreneurs. This is possibly because the stakeholder perspective, originally proposed as a strategic management tool, has since been 'hijacked' by the management scholars to serve as a means to make business conduct more ethical in the current corporate governance debate. However, it must be noted that in situations involving business ethics and issues of conflicts of

interest that are likely to arouse public opinions, the adoption of stakeholder perspective by the board of a publicly listed company may be a more strategic option, as shown in the case of Telecom New Zealand (to be discussed below).

On the other hand, the traditional shareholding perspective, or the finance model of governance systems, continues to attract the attention of both management scholars and practitioners in the current corporate governance debate (Healy, 2003). As a finance practitioner in New Zealand, Healy (2003) argues that a shareholder value objective is important to the economic development of a nation. This line of argument is extended to competitive advantage for countries that adopt shareholding value model of corporate governance, as compared to those that adopt the stakeholders - value model of governance (refer to Section 2.5 below).

Under the finance model of corporate governance, the objective function of a corporation, as entrusted to its board of directors, is to maximise the long-run market value of the firm, as reflected primarily in the company stock price (Jensen, 2002). However, Charkham (1994) points out that the fundamental flaw of the finance model of corporate governance system is its excessive focus with short-term market value. Company performance is closely monitored on a quarterly basis, thereby forcing otherwise diligent managers to concentrate solely on the current share price and ignoring the long-term value creation of the firm. To overcome this defect, Jensen (2002) recommends that corporate managers should be given:

... a structure that will help them resist the temptation to maximise the short-term financial performance (usually profits, or sometimes even more silly, earnings per share) of the organisation. Such short-term profit maximisation is a sure way to destroy value (p. 245).

The shareholding versus stakeholder perspectives rivalry is also reflected in the debate regarding corporate social responsibility role. The question: what is the social responsibility role of business? On one hand, Friedman (1970) famously asserts that the only social responsibility of business is to increase its profits, in line with the neo-classical economic principles of free market, economic efficiency, and profit maximisation. The corporation must focus its resources to maximise profits to enhance shareholders' value. As such, the function of business in a society is to

make profit for its shareholders, leaving the social responsibility functions for the government, charities, and other similar institutions to perform.

On the other hand, Collins and Porras (1998) empirically show that maximising shareholder wealth or profit maximisation has not been the dominant driving force or primary objective through the history of their visionary companies that paradoxically make more money than the more profit-driven comparison companies. It could be argued that a firm's failure to perform its social responsibility role may undermine its shareholders' long-term interest. This assertion is to a great extent proven true in the following example.

In the domestic corporate scene, the controversy surrounding Telecom New Zealand is a case in point. In order to ensure that its competitors were not able to rival its internet broadband products and services, Telecom New Zealand offered its wholesale price to its rivals at a level near to its own retail price. But its strategy to monopolise the broadband market resulted in a public backlash when it failed to entice its own landline customers to sign up to its broadband services at a rate acceptable to the government. Widespread customer dissatisfaction with its internet products and services, coupled with public perception that low broadband penetration rate was detrimental to the economic development of New Zealand, the government (after repeated warnings and failed deadlines) announced on May 3, 2006 that it would legislate to force Telecom New Zealand to open up its broadband lines to other telecommunication and internet operators. Since then, the market price of Telecom New Zealand's shares has plunged more than 20 percent, from a high of \$5.55, wiping out \$2.2 billion from its market capitalisation (The New Zealand Herald, May 17, 2006). Thus, it could be said that the profit maximisation policy of Telecom New Zealand, though in line with pure shareholder theory prescription, has not been proven to be beneficial to its own shareholders.

So, is there a way out of the conflict between these two competing theoretical perspectives? Realising that in order to maximise value, managers must not only satisfy but also enlist the support of customers, employees, suppliers, and local communities, Jensen (2002) proposes to meld together the two theoretical perspectives into what he calls "enlightened value maximisation" or "enlightened

stakeholder theory”. Enlightened value maximisation uses much of the structure of stakeholder theory; the latter becomes enlightened stakeholder theory when it accepts maximisation of the long-run value of the firm as the criterion for making the requisite tradeoffs among its various stakeholders. With this approach, Jensen (2002) seems to be able to avoid objections that have been raised to pure shareholder theory. It is interesting to note that the term *enlightened value maximisation* could also be turned into *enlightened self-interest board*, as shown by one important UK corporate governance study, which concludes that the “findings on attitudes to stakeholding suggest that boards consider the embracing of the idea of stakeholders as one of enlightened self-interest, rather than adopting a stronger version of the principle. Details of how the boards factored in stakeholders to decision-making remained hazy, leaving a sense of ad hoc, case-by-case assessment, rather than any considered approach to stakeholder groups” (Stiles and Taylor, 2001, p.101). Thus, it is not surprisingly to find that the U.K. and New Zealand corporate governance best practice codes do not reflect the stakeholder theory perspective (see Chapter Three below).

2.2 Origin and Evolution of the Anglo-American Model

After defining corporate governance and the analysis of the two underlying theoretical perspectives, the discussion now proceeds to trace the origin and evolution of corporate governance in the context of the Anglo-American model, which is based on the shareholder value perspective. New Penguin English Dictionary defines the word ‘corporate’ as “relating to companies or the people who work in them”. The origin of the word ‘governance’ comes from the old French word ‘gouvernance’ which means control and the state of being governed. The etymology of “governance” comes from the Latin words ‘gubernare’ and ‘gubernator’, which respectively means steering a ship, and the captain of a ship (Farrar, 2005). As will be discussed later, the corporate form of organisation or corporation is fundamental to the evolution of the Anglo-American corporate governance system, especially in relation to the concept of separation of ownership and control.

The corporation as an entity was developed for public benefit and economic gain during the reign of Queen Elizabeth I. Prior to that period, corporations were more

like municipalities than businesses, formed as a protection against the centralised power of autocrats and to liberate themselves from royal domination. The early trading corporations such as the Muscovy Company (1555), and the Spanish Company (1577) were established for mixed public and private purposes. To reap the economic gains arising out of the fast emerging markets in the East Indies, the East India Company was formed and granted a royal charter in 1601 with permanent capital and shares of unlimited dimension, thereby heralding the advent of joint-stock companies (Monks and Minow, 2004). However, the development of the modern company registration system did not arrive until 1844 in the form of the UK Companies Act. Although corporation with limited liability was granted in 1862, the concept of the corporation as a separate legal entity was firmly recognised only in 1897 with the British House of Lords' decision in *Salomon versus Salomon & Company Limited* (Farrar, 2005).

The corporate form of organisation migrated to North America (now known as the United States of America) together with the early English settlers. Beatty (2001, cited in Daily, Dalton and Rajagopalan, 2003) noted the development of corporations such as The London Company (1606), later renamed the Virginia Company of London, and the Massachusetts Bay Company (chartered in New England in 1629) which spearheaded the British colonial expansion in North America. The type of public corporations that are structured as we know them today, were however developed only in the mid 19th Century, with the building of railways throughout America to cater for the transportation and distribution needs of the industries.

Chandler (1977) opines that the first modern business enterprises were those created to manage the operation of the new railway and telegraph networks, which required a large number of salaried managers to administer the central office and branch offices spread over an extensive geographical area. In order to meet operational requirements, the first America business to create the administrative hierarchies was the railway companies that employed a hierarchy of middle and top salaried managers to monitor and coordinate works. The emergence and ascendancy of a professional managerial class was further aided by a revolution in marketing and production. The Industrial Revolution introduced new technologies that enabled manufacturers to carry out several processes of production within a single factory to

capture economies of scale. The modern industrial enterprise began when manufacturers integrated mass production with mass distribution, which require the services of managers at several levels of hierarchy to man the multiunit business enterprise. Administrative coordination by managers of multiunit business enterprise resulted in greater productivity, lower costs and higher profits than coordination by market mechanism alone.

Possibly because of its size and nature of its domestic market, North America became the seed-bed of managerial capitalism. Chandler (1977) laments that historians and economists when examining the development of the American economic system, were more concerned about the continuing of family-based entrepreneurial capitalism or of financial capitalism than about the spread of managerial capitalism. Chandler (1977) argues that the managers played “a far more central role in the operations of the American economy than did the robber barons, industrial statesmen, or financiers” (p. 491).

2.2.1 Economic versus Political Foundations

So far, economic considerations are considered as the foundation to the evolution of the Anglo-American corporate governance system. Roe (1994) though, argues that the American political and legal restrictions systematically discourage, if not disallow, the formation of large block shareholders in public corporations. He opines that America’s historical aversion to private concentration of economic power were partly due to federalism, populism and interest group politics which led to corporate laws and regulation that prevented the commercial banks, insurance companies, mutual funds, and pension funds from holding large equity blocks in publicly traded companies.

Since the mid 19th Century, both State and Federal laws restricted the growth and activities of banks and other financial intermediaries. Commercial banks were not allowed to operate branches nationally, resulting in their smaller sizes and networks that were not adequate to finance the capital requirements of emerging large enterprises. More importantly, banks were barred from the securities business and from owning stock. American politics since 1906 limited the insurance industry to its core business of writing insurance and investing in debts. They were barred from

owning stock, controlling banks, or underwriting securities, though serious deregulation on stock ownership began only in the 1980s. The New Deal legislation of the 1930s, especially the Glass-Steagall Act which separated the commercial banks from investment banks, fortified the financial and ownership structures that already prevailed, thereby severing America's largest financial institutions from its largest industrial enterprises. Roe (1994) notes that the US political and economic history might be responsible for the dominance of corporate managers in publicly traded firms. He suggests that without these politically imposed constraints, the evolution of the modern American corporation might have resulted in the emergence of a very different dominant organisational form which resembles the Japanese or German industrial system in which financial institutions are the major shareholders and monitor of industrial corporations. He concludes that the American corporate governance system is far from efficient due to its discouragement of large shareholders who might otherwise use their boardroom influences to better monitor management and to address the information asymmetry and coordination problems that continue to reduce the value of some US public companies.

On the other hand, Easterbrook (2005) observes that the American corporate structure has evolved through long competitive market pressure to maximise wealth, despite the constraints, which include politics and law. The differences in corporate ownership and governance systems between the US and UK on one hand, and Germany and Japan on the other hand, reflect differences in the efficiency of their respective capital markets (see Chapter Two for the comparative study of the two differing governance structures and systems). With no restrictions on cross-border capital flows, the US and UK have large and efficient capital markets relative to Germany and Japan. There is no money to be made by holding undiversified equity blocks in publicly traded corporations in the efficient capital markets of the US and UK, where the valuation process works better. Easterbrook (2005) asserts that this is the reason why when the US and UK banks, insurance companies and mutual funds are allowed by law to increase their investment holdings in publicly traded companies, they do not do so.

From the above analysis, one can deduce that both economic and political factors contributed to the evolution and formation of the principal-agent model of the

Anglo-American corporate governance system. After all, economics and politics normally go hand-in-glove, although sometimes economic rationality ends with political considerations. Meanwhile, it might be useful to examine the development of the Anglo-American model of corporate governance.

2.2.2 Separation of Ownership from Control

The huge capital outlay needed to fund the modern business enterprises, and the managerial revolution both contributed to the phenomenon of the separation of ownership and control in corporations. As observed by Chandler (1977):

Ownership and management soon separated. The capital required to build a railroad was far more than that required to purchase a plantation, a textile mill, or even a fleet of ships. Therefore, a single entrepreneur, family or small group of associates was rarely able to own a railroad. Nor could the many stockholders or their representatives manage it. The administrative tasks were too numerous, too varied, and too complex. They required special skills and training which could only be commanded by a full-time salaried manager. Only in the raising and allocating of capital, in the setting of financial policies, and in the selection of top managers did owners or their representatives have a real say in railroad management. On the other hand, few managers had the financial resources to own even a small percent of the capital stock of the roads they managed (p.87).

The potential problems inherent in the separation of ownership and control in publicly traded companies were first observed in the 18th Century by Adam Smith (1776/1981: former Volume II, Book V):

The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company. It is upon this account that joint stock companies for foreign trade have seldom been able to maintain the competition against private adventurers. They have, accordingly, very seldom succeeded without an exclusive privilege, and

frequently have not succeeded with one. Without an exclusive privilege they have commonly mismanaged the trade. With an exclusive privilege they have both mismanaged and confined it (p.229).

The famous remarks of Adam Smith were not seriously studied until the seminal work of Berle and Means (1932/1968), which provided one of the earliest explanations to the relationship between shareholders and directors (managers) arising out of the separation of ownership and control (conflict of interest that may arise between the rights of ownership and the exercise of control) in modern (publicly traded) corporations. They posit that as countries industrialised and developed their markets, separation of ownership and control in corporations logically evolved. To reach economies of scale, firms need to tap vast pools of capital from the general public, and as investors diversify their portfolios, scattered ownership shifted control of modern corporations to managers. But, if ownership does not denote control, what do we mean by ownership? This is the paradox of the separation of ownership and control as famously highlighted by Berle and Means (1932/1968). The answer perhaps lies in the differing meanings of private property first under the old economy, and then under the modern economy. The phenomenon of separation of control and ownership altered forever the traditional meaning of private property. As asserted by Berle and Means (1932/1968):

To Adam Smith and to his followers, private property was a unity involving possession. He assumed that ownership and control were combined. Today, in the modern corporation, this unity has been broken. Passive property, - specifically, shares of stock or bonds, - gives its possessors an interest in an enterprise but gives them practically no control over it, and involve no responsibility. Active property, plant, goodwill, organization, and so forth which make up the actual enterprise, is controlled by individuals who, almost invariably, have only minor ownership interests in it (p.304).

However, like Adam Smith before them, Berle and Means (1932/1968) expressed their reservations about the likelihood that managerial and shareholder interests could be co-aligned. Lamenting on the plight of stock owners in the relationship between shareholders and managers: “ consisting of a set of relationships under which an individual or set of individuals hold powers over an enterprise but have

almost no duties in respect to it which can be effectively enforced” (p. 305).

In contrast to the above somewhat pessimistic outlook for public (joint-stock) companies, Alchian and Demsetz (1972) and Jensen and Meckling (1976) introduce the idea of the firm as a nexus of contracts among individual factors of production. The firm is perceived as a team whose members act from self-interest but with the realisation that their fate depends to some extent on the survival of their team in competitions with other teams. Jensen and Meckling (1976) argue that the primacy of shareholders is not legitimised by their security ownership of the corporation, but rather as residual risk-takers of the corporation. Fama (1980) posits that management and risk bearing are viewed as naturally separate factors of production, and that ownership of capital (security ownership) should therefore not be confused with ownership of the firm. This is particularly so when control over a firm’s decisions is not necessarily the domain of security holders. Fama and Jensen (1983a; 1983b) remark that shareholders have the right to residual claims because they are the risk bearers. Jensen and Meckling (1976) conclude that on the basis of a complex set of contracting relationships which spell out clearly the rights of the parties involved, millions of investors are prepared to trust the managers of publicly traded companies to manage their money with only the promise and hope to reap a reasonable return in the form of dividends and possibly capital gain. This is partly the answer to Adam Smith’s pessimism and cynicism on the future of joint-stock (publicly traded) companies; the other part being Adam Smith’s inability to foresee the introduction of governance mechanisms to align the managerial and shareholder interests.

The development of the contractual view of the firm marks an important milestone in the evolution of the Anglo-American corporate governance system, which is characterised by dispersed shareholders and concentrated management in large public corporations (Lutbakin, 2005). This contractual view of the firm is better known through its association with the agency theory (as popularised by the financial economists, such as Jensen and Meckling, 1976), which identifies the agency relationship where the principal (shareholder) delegates work to the agent (manager). In view of the importance of agency theory in the study of corporate governance, it might be useful to discuss the agency theory in greater detail later on, together with

another contrasting theory of corporate governance.

2.3 Contrasting Approaches to Corporate Governance

Two theories of board roles (for details, see Chapter Four below) are used here to demonstrate the two contrasting approaches to corporate governance. In the context of the relationship between board of directors and management, the agency theory prescribes a control approach, while the stewardship theory favours a collaborative approach. Each theory is to be analysed in detail, including their perceived connections to the two contrasting corporate governance system (Anglo American system versus Germanic/Japanese system, see Section 2.4 below for details).

2.3.1 Agency Theory

The Anglo-American model of corporate governance is based on the agency theory perspective (Dalton, Daily, Ellstrand, and Johnson, 1998; Shleifer and Vishny, 1997). The crux of the agency theory (which is also the cornerstone of the Anglo-American principal-agent model) is that shareholders, through the board of directors (BOD), delegate the responsibility of managing the firms to the top executives, who are supposed to use their significant information advantage, specialised knowledge, expertise and the firms' resources to maximise returns for the shareholder. It assumes that separation of ownership and control in publicly listed corporations provides incentives for managers (agents) to act in a self-interested and opportunistic manner, which in turn induces shareholders (principals) to invest in formal governance mechanisms to alleviate the agency problems through minimisation of agency costs (Jensen and Meckling, 1976; Fama, 1980; Eisenhardt, 1989).

The origin of agency theory, as developed in the financial economics literature, can be traced to the seminal work of Jensen and Meckling (1976). They define it as the study of the inevitable conflicts of interest that occur when individuals engage in cooperative behaviour. It draws primarily from the property rights literature (Alchian and Damsetz, 1972) and to a lesser extent from transaction cost economics (Williamson, 1975). Accordingly, agency theory is a theory of the firm that discusses the managerial incentive problems arising out of the separation of ownership and decision making, and defines the relationship between the managers and shareholders as a contract between agents and principals. It is to be noted that just

like in the case of the theory of shareholder value maximisation, agency theory can trace its root to the ground-breaking work of Berle and Means (1932/1968), which famously pioneers the concept of the separation of ownership and control in the wider context of the theory of a firm.

Agency relationships are formed when the principals (shareholders) delegate authority to the agents (managers) and the welfare of the former is affected by the choices of the latter (Arrow, 1985). This delegation of decision making authority from principal to agent can be problematic for three reasons. Firstly, the interests of principal and agent often are typically diverged due to the separation of ownership and control in modern corporations (Fama and Jensen, 1983). Secondly, the principal cannot perfectly monitor the actions of the agent without incurring costs. Thirdly, the principal cannot perfectly monitor and acquire the information available to or possessed by the agent without incurring costs. The above three factors together constitute the classical agency problem, that is, the possibility of opportunistic behaviour on the agent's part that works against the welfare of the principal. The scope of the classical agency problem is extended by Eisenhardt (1989) to include risk-sharing attitudes; that the principal and the agent may prefer different actions due to their differing risk preferences and partly differing goals.

Arrow (1985) notes that there are two primary sources of agency problem: moral hazard (hidden actions including shirking) and adverse selection (hidden information). Moral hazard involves situations in which the agent's actions are typically either hidden from the principal or are too costly to observe. As a result, shareholders or even directors may find it prohibitively costly to fully monitor the behaviour of their top management team, since effort and ability are difficult to observe. Adverse selection occurs when agent possesses information which is unobservable or costly for the principal to obtain; boards of directors typically are at an information disadvantage in their dealing with Chief Executive Officers (CEOs).

Agency costs are incurred when attempts are made to reduce the agents' opportunistic behaviour. Jensen and Meckling (1976) define agency costs as the sum of (1) the costs of creating and structuring contracts between the principal and the agent, (2) the monitoring expenditures by the principal, (3) the bonding expenditures

by the agent, and (4) the residual loss. The residual loss part of the agency costs acknowledges that it is generally impossible for the principal or the agent to ensure, without incurring any cost, that the agent will make optimal decisions from the principal's viewpoints. Thus, residual loss is the dollar equivalent of the reduction in welfare experienced by the principal as a result of this divergence.

Bonding involves arrangements that penalise agents for acting in ways deemed detrimental to the interests of principals or reward them for co-aligning their interests with that of the principal. Monitoring is taken to mean observing the behaviour and performance of agents. Eisenhardt (1985) argues that given the existence of agency costs, it is in the self-interest of principals to monitor agents. Jensen and Meckling (1976) opine that a firm is a nexus of contracts; within this nexus firms adopt rules about monitoring and bonding. The basic unit of analysis of agency theory is the contract, which typically specifies the monitoring and bonding arrangement between the principals and the agents.

Godfrey and Hill (1995) argue that agency costs are inherently unobservable. The entire contribution of agency theory depends on the ex ante state of unobservability of the divergence of interests between principals and agents. Otherwise, the accurate ex ante observation of this divergence of interests would render redundant the need for principals to incur agency costs, and the governance structures designed to minimise agency costs would also become superfluous.

Agency theory assumes that human beings are bounded rationality, self-interested and prone to opportunism (Eisenhardt, 1989). Bounded rationality means that those who engage in economic transactions are intently rational, but only limitedly (cognitively) so (Simon, 1947 – reported in Barney and Hesterly, 1999). Given bounded rationality, complex contracting breaks down in the face of uncertainty. Ultimately, people are self-interested; meaning that people are not perfect agents for others and as such will not act in the interest of others (their principals or partners) to the exclusion of their own preferences. According to Jensen (2000), this no-perfect agent proposition is true for everyone and leads to inevitable conflicts of interest situations whenever human beings attempt to engage in cooperative relationships, socially or commercially. Opportunism refers to the incomplete or distorted

disclosure of information calculated to mislead, distort, disguise or otherwise confuse partners (principals) in an exchange (Williamson, 1985). Although all economic actors are not assumed to be always opportunistic, some may behave opportunistically and it is costly to distinguish those who are prone to opportunism from those who are not. The threat of opportunism means that safeguards need to be designed to protect one's interest in a cooperative relationship.

The organisational assumptions in the agency theory, as noted by Eisenhardt (1989), are (1) partial goal conflict in which the principal and agent have partly differing goals and risk preferences; (2) efficiency as the effectiveness criterion; and (3) information asymmetry between the principal and the agent, with the latter typically in the advantageous position. It must be noted that information here is treated as a purchasable commodity. The key idea is that the relationships between the principal and the agent should reflect efficient organisation of information and risk-bearing costs in order to minimise future uncertainty and information asymmetry.

Jensen (1983) notes that agency theory has developed into two streams: positivist and pure principal – agent perspectives. They share a common unit of analysis – the contract, and also share common assumptions about human beings (bounded rationality, self-interested and opportunistic), organisations (uncertain future), and information (a commodity that can be purchased). They differ, however, in their mathematical rigour, dependent variable and style (Eisenhardt, 1989). While positivist theory identifies various contract alternatives, pure principal – agent theory indicates which contract is the most efficient under varying levels of outcome uncertainty, risk aversion, information, and other variables.

The positivist stream mostly concentrates on the governance mechanism that solves the agency problem. It focuses on identifying situations that principal and agent have conflicting goals and then describing the governance mechanism that minimises agency problem and agency costs. It also focuses exclusively on the special relationship between shareholders (principals) and managers (agents) of large, publicly listed companies.

Jensen and Meckling (1976) opine that the pure principal-agent perspective focuses almost exclusively on the normative aspects of the agency relationship; how to structure the contractual relation between the principal and agent to provide appropriate incentives for the agent to make choices that will maximise the principal's welfare, given that uncertainty and imperfect monitoring exist. This principal – agent paradigm requires careful specification of assumptions that are followed by logical deduction and mathematical proof. As such this stream is abstract and mathematical and thus less accessible to organisational scholars.

Eisenhardt (1985, 1988) examines the choice between commission (outcome-based incentive) and salary (behaviour-based incentive) compensation of salespeople in retailing. These two studies provide empirical evidence to support agency theory predictions that task programmability, information systems, and outcome uncertainty variables significantly predict the salary versus commission choice. Barney and Hesterly (1999) note the application of this perspective of agency theory to relationships between many stakeholders in a corporation such as those between different managers within the same firm, between employees and customers, and between employees and different groups of shareholders and debt holders.

Eisenhardt (1989) highlights the two specific contributions of agency theory to organisational thinking. The first is the treatment of information; it is regarded as a commodity that has a cost and can be purchased. This assumption is significant because better information systems can enhance effective monitoring and control of managerial opportunism. This would in turn lead to a lesser need for performance-contingent pay. Therefore, while some scholars may express surprise at the lack of performance-based executive compensation schemes, it is not that surprising when viewed from an agency perspective. The second contribution of agency theory is its risk implications; it extends organisational thinking by pushing the ramifications of outcome uncertainty to the implications for creating risk. Thus, the implication is that outcome uncertainty coupled with differences in risk aversion should influence contracts between principal and agent.

Hoskisson, Hitt, Wan and Yiu (1999) posit that agency theory helps to swing the pendulum in strategic management research by shifting the focus from the industry

level to the firm level analysis. Agency theory seeks to enter the “black box” to examine causes and consequences of agency conflict between shareholders and managers, and the effectiveness of various governance devices designed to mitigate the conflict.

Although agency theory enhances our understanding of organisation, it also presents only a partial view of the firm. Lubatkin (2005) criticises the theory of the firm as developed by Jensen and Meckling (1976) as a micro economic model “ based on a set of simplifying agency theory assumptions about the nature of individuals, organizations, and markets that take the model out of the realm of organizational reality” (p. 213). In the same vein, Donaldson (1990) laments that the agency theory assumptions are extreme, and suggests that there are alternative theories on what motivates human behaviour and that there may be no inherent problems of managerial motivation: “ The ‘model man’ underlying agency and organisational economics is that of the self-interested actor rationally maximising his own personal economic gain. The model is individualistic and is predicated upon the notion of an in-built conflict of interest between owner and manager. Moreover, the model is one of an individual calculating likely costs and benefits, and thus seeking to attain rewards and avoid punishment, especially financial ones. This is a model of the type called Theory X by organisational psychologists” (p. 372). It is interesting to note that the above criticism of the agency theory was made by Donaldson (1990) in the course of proposing an additional perspective to the theories of the board, that is, the stewardship theory. Donaldson (1990), however, makes it clear that the stewardship is promoted not a substitute to the agency theory, but rather more like an additional perspective to the relationship between shareholders and managers.

2.3.2 Stewardship Theory

If Donaldson (1990) thinks that the “model man” underlying the agency theory is Theory X type (opportunistic, self interested and individualistic), then the opposing Theory Y (both originated from McGregor, 1960) “model man” could be the dutiful manager who wants “to be good stewards of corporate assets” (Donaldson, 1990, p. 376). The “model man” underlying the stewardship theory is thus expected to be cooperative, pro-organisational and collectivistic (Donaldson and Davis, 1991).

Grounded in organizational psychology and sociology, stewardship theory posits that managers as dutiful stewards are motivated to act in the best interest of the principals (Donaldson and Davis, 1991). Even when the interest of the steward is not aligned with those of the principal, the steward accords higher value on cooperation rather than to act opportunistically. This is because the steward places greater value in cooperative behaviour and thus behaves accordingly (Davis, Schoorman, and Donaldson, 1997).

Stewardship theory presumes that managers are seeking to maximise firm performance. This is because in doing so their utility functions are maximised too. A pro-organisational steward is motivated to maximize firm performance so as to satisfy the sometimes competing interest of shareholder and stakeholder groups (Davis, Schoorman, and Donaldson, 1997). The steward perceives that by working towards organisational, collective ends, personal needs are met, even when trade off is inevitable between personal needs and organisational objectives.

Advocates of stewardship theory argue that the board of directors should empower governance structures and mechanisms in order to maximise the potential performance of the steward (Donaldson and Davis, 1991; Fox and Hamilton, 1994). Accordingly, the aim of corporate governance is to maximise firm value and not just minimising agency cost as advocated by the agency theorists. Stewardship theorists focus on structures that facilitate and empower, as compared to agency theorists' emphasis on monitor and control. The focal point of contention between stewardship theorists and agency theorists is the structure of the chair of the board. While the former advocates duality of CEO-Chairman, the latter insists on the separation of the two positions (see Section 4.3.2 below, for details on the efficacy of the two opposing views on board functions).

Besides board structures, another contrasting view between the agency theorists and the stewardship theorists is over the board's primary role. The former consider discipline and control as the board's primary role (e.g. Fama and Jensen, 1983), while the latter advocates the service role (Davis, Schoorman, and Donaldson, 1997). Also, agency theory views executive stock ownership as a means to reduce goal conflict and to avoid increasing risk differential between the agents and the

principals (e.g. Jensen and Murphy, 1990). However, stewardship perspective views executive stock ownership as fostering firm identification and long term relations (Hambrick and Jackson, 2000). Last but not least, agency theorists see the market for corporate control as a last resort mechanism to constraint self serving managerial behaviour (Kosnik, 1987; Walsh and Seward, 1990). On the other hand, stewardship perspective views the market for corporate control as curbs to manager's psychological commitment to the firm. As such, Davis, Schoorman, and Donaldson (1997) advocate anti-takeover provisions to help support long term relationships that satisfy managers' intrinsic need for affiliation. As an additional perspective to corporate governance, Davis, Schoorman, and Donaldson (1997) identify psychological, situational, and cultural factors that predispose managers to stewardship. Managers are therefore given a choice to choose to behave as stewards or as agents. Conversely, principals are given the same choice to create an agency or stewardship relationship. In this way, "the success of the relationship is a function of the mutual choice by two parties in the relationship" (Davis, Schoorman, and Donaldson, 1997, p. 42). Thus, stewardship theory and the choices of stewardship relationships in firms rely to a great extent on the trust between the principal and managers, taking into consideration the perceived risks.

From the above discussion, one could perhaps deduce that the assumptions of agency theory and stewardship theory are the contrasting ends of the same scale. As such, the criticisms and shortcomings of the agency theory, such as its assumptions being too simplified and unrealistic, could easily be applied to stewardship theory. The agency theory traces its pedigree to Berle and Means (1932) and is widely used in the research on corporate governance. However, the stewardship theory is still at its infancy.

The two contrasting approaches to corporate governance reflect the differing theoretical perspectives on the primary roles of the BOD. While the agency theory perspective advocates a control approach to corporate governance, the stakeholder theory perspective prefers a collaborative approach. While the agency theory is closely associated with the shareholder value maximisation perspective of the Anglo-American corporate governance model, the stewardship theory is more akin to the stakeholder orientated Germanic/Japanese model. Interestingly, the debate between

shareholder theory and stakeholder theory (see Section 2.1.2 above) is also examined further below to show the contrasting approaches and treatment of large public listed companies operating within the Anglo-American and Germanic /Japanese corporate governance systems. The purpose and accountability of large public corporations, which differ accordingly to the two opposing theoretical perspectives, also account for the main differences in corporate governance practices between the Anglo-American system and the Germanic/Japanese system. The differing agency theory and stewardship theory perspectives on corporate governance are also reflected in the two contrasting approaches to board roles between the Anglo-American system and the Germanic /Japanese system. It is perhaps timely now to examine below the two other rather different corporate governance models that are operating in Germany and Japan respectively.

2.4 German Corporate Governance Model

The German corporate governance model is characterised by its stakeholder-orientated approach, whereby the shareholders are but only one of the stakeholders whose interest are taken care of during the decision making process of the companies. Relative to the Anglo-American model, the German model places more importance and emphasis on employees and the whole enterprise itself. This is evidenced by the original German corporate law of 1937, which stipulated that the firm was to be managed for the good of the enterprise and its employees, the common benefit of the citizens, and the state (Fiss and Zajac, 2004). Central to the German system is good industrial relations (Charkham, 1994). Thus, it is suggested that while the Anglo American model adopts a ‘confrontation’ approach to business, the German model promotes ‘cooperation’.

The German model’s emphasis on cooperation is also reflected in the adoption of a two-tier board structure, and the concept of employee co-determination. The Works Constitution Act, 1972 outlines the rights of works council which deals with all matters relating to the conditions of employments of employees. Work councils are part of the cooperative process to provide trust and cooperation between employees and employers. Co-determination gives employees the right to be informed of all the activities of the company and to participate in decisions that may affect the employees, as provided under the Co-determination Act, 1976 (Mallin, 2004). It is

suggested that one of the main pillars of the German corporate governance model is the concept of co-determination, which “makes labour representation an integral part of the corporate governance system and reflects the German concern with the responsibility of the firm to its various stakeholders” (Fiss and Zajac, 2004: 505).

Since the early 19th century, Germany adopts a two-tier board structure which provides distinctive roles for the supervisory board (Aufsichtsrat) and the management board (Vorstand), in order to promote effective check and balance between management and shareholders. The Co-determination Act determines the proportion of employee representation in the supervisory board (one third of total members for firms with more than 500 employees and one half for firms with more than 2000 employees). The balance of the supervisory board members is to be elected by the shareholders in general meetings. The chairman of the supervisory board, always a shareholder representative, has the casting vote, thus ensuring that the shareholders have the final decision. . The supervisory board appoints supervisors and advises the members of the management board. In theory, the management of the enterprise is entrusted to a group, rather than an individual (CEO in Anglo-American model), but in practice the group elects a leader (Sprecher) who is first among equals (Iskander and Chamlou, 2000). Members (managers) of the management board are appointed for a fixed five-year term on a secured tenure basis and cannot be dismissed during the period unless with cause and only after a two-third majority vote. One of the directors of the management board must be responsible for labour-related matters, as stipulated under the Co-determination Act. It is suggested that the concept of employee representation on board has not always been good for the overall interest of the company. This is because the employee representatives in the supervisory boards tend to block restructuring plans, which may result in relocation or reduction of workforce, important as they may for the overall good of the company concerned (Roe, 1993; Mallin, 2004).

How effective is the supervisory board in monitoring the management board? By holding meetings typically only two to four times a year (minimum legal requirement is two times a year), and facing an inherent problem of information asymmetry, it is difficult to see how the supervisory board can assume its control and monitoring role effectively. Although the German managers may not be as powerful

as their Anglo-American counterparts, they nevertheless still have the upper hand in dealing with the supervisory board. As such, Roe (1993) argues that the German supervisory board should perhaps be renamed as advisory board, with “a power similar to that of the US Senate to advise and consent to treaties and appointments, which use consultation and influence but not supervisory control” (p.1942). In addition, Shleifer and Vishny (1997) highlight empirical evidence which suggests that German banks are not as effective as they should be as corporate monitors, given their control over firms’ borrowings and voting rights.

On the other hand, Coffee (1991) observes that German banks monitoring of corporate management has been close and intensive, resulting in reductions of agency and information costs. Since German banks cannot exit easily due to lack of liquidity in a relatively underdeveloped stock market, they are compelled to seek voice (see section. The relationship between the three major banks and their corporate customers (in which they also own shares in), has been developed on a highly interdependent structure based on cooperation and long term stability. The German governance model not only reduces agency costs, but also minimises the conflicts of interest between creditors and shareholders, since they are the same people. Despite its perceived shortcomings, the German system seems to be working well, as observed by Monks and Minow (2004:321). “For a long time the German defense of its corporate system was that it worked. When short-termism was the UK/US bugbear, the German system was held up as a shining example of the effectiveness of long-term relationship investing”.

Another distinctive feature of the German corporate governance model is the dominance of large financial intermediaries (usually banks) holding concentrated blocks of shares in its listed firm, as against the dispersed ownership structure of the Anglo-American model. Baums and Fraune (1995, cited in Fiss and Zajar, 2004) posits that German banks typically control significant shareholding interests in most of the big listed companies. German banks directly own 21 blocks of at least five percent of the total shares of the 100 largest German industrial corporations (Roe, 1993). However, Coffee (1991) argues that German banks’ control of the 100 largest German industrial corporations arise not from their direct share-ownership (German banks in fact own under five percent of the industrial firm’s total stock), but rather

because of their status as universal banks, which entitles them to provide both commercial banking and stock broking services. German investors typically deposit their shares with their banks, which can vote the custodial shares unless special instructions to do otherwise are given in advance. The ability to vote large blocks of shares allow the banks to elect their nominees to the supervisory boards of 96 of the 100 largest firms. In addition, in 14 cases, a bank nominee chairs the supervisory board. Roe (1994) posits that the three largest banks (Deutsche Bank, Commerzbank, and Dresdner Bank), acting in unison, can dominate the shareholders portion of the supervisory board.

However, since the banks' control rights over large listed companies are in excess of their cash flow rights, they may effectively benefit themselves at the expense of minority shareholders. Lack of legal protection for minority shareholder rights may explain why Germany has a relatively underdeveloped stock market despite its large industrial economy (Shleifer and Vishny, 1997). The dual roles of banks as financiers as well as investors in industrial corporations may also create conflicts of interest. Despite theoretical propositions that banks can earn rents from their investments by using their information advantage, Gorton and Schmid (1996, cited in Shleifer and Vishny, 1997) discover no evidence to support rent extraction by German banks. The dominance of banks in the ownership and control of German industrial corporations also means that any mergers and acquisitions of firms can only be successful with at least the tacit support of banks. This probably accounts for the almost non-existence of the market for controls in Germany (Jackson and Moerke, 2005).

While the ability of German banks to amass proxy votes well beyond their cash flow rights may prove to be effective to control managers, it may also create a unique agency problem. This is particularly so if the big three banks are facing agency problems that need to be mitigated. In such circumstances, it would be pertinent to ask the classic question: who is monitoring the guardians? This potential conflict of interest situation may well arise as illustrated by Charkham (1994, p.36), noting the virtual self-determination status of the big three banks. "At general meetings in recent years, Deutsche Bank held voting rights for 47.2 percent of its shares, Dresdner for 59.25 percent, and Commerzbank for 30.29 percent".

2.5 Japanese Corporate Governance Model

Like the German corporate governance model, the Japanese model can be characterised as stakeholder-oriented and concentrated ownership structure dominated by banks, as against the shareholder-oriented and dispersed ownership structure of the Anglo-American model. Despite their striking similarities, there are key differences among the German and Japanese corporate governance models. The key differences are in the forms of employee participation, board structure and mechanism for monitoring of managers. These differences are due mainly to the influences of the *keiretsu-bank system* (loose associations of companies centred on a main bank) and culture on corporate governance in Japan (Mallin, 2004).

To understand the Japanese corporate governance system better, it may be useful for us to examine certain aspects of the Japanese culture, which is mainly derived from the teachings of Confucius. The three cultural concepts which greatly influence the Japanese approach to corporate governance are obligation, family, and consensus (Charkham, 1994). Obligation is reflected in the Japanese feeling of obligation to family, company, and country; family is derived from the strong sense and feeling of being part of a 'family' whether this is your own family per se, or a company; and consensus, which emphasises on agreement and values harmony rather than antagonism. The concept of consensus is particularly relevant in understanding in Japanese employee participation in company management.

As has been mentioned earlier, employee participation in Germany is formalised and mandated by laws such as the Works Constitution Act (1972), and the Co-determination Act (1976). In Japan, however, employee participation is through the informal arrangement of joint labour-management consultation, which is characterised by consensus building and group decision-making. Japanese labour unions are organised around enterprise, as against the German system which is organised along industry or occupational lines (Jackson and Moerke, 2005). As such, employees in Germany can be considered to have more influence than their Japanese counterparts in the running of companies, since collective bargaining takes place at a sector level between industrial unions and employers associations in Germany. On the other hand, Japanese employees are perceived, and they consider themselves to be participants in their companies, and not just contracted labour (Learmount, 2002).

Demise (2005), however, argues that the moral benefits of the Japanese employee-oriented labour practice are not that clear cut, due to the problems of death from overwork (*karoshi*) and harassment of employees in the workplace.

Another distinctive feature of the stakeholder-oriented Japanese model is the concept of lifetime employment as practised by most large corporations, notably Toyota and Canon. Toyota believes that lifetime employment enables the firm to accumulate employee skills and strengthens their identification with the destiny of the company. Canon, besides offering lifetime employment, also practices the Tripartite Profit Sharing Scheme, whereby company profits are shared equally between labour, shareholders, and management (Yoshimori, 2005). To counter the pitfall of the lifetime employment system which does not take into account individual differences in job performance (pay and promotion based solely on seniority), Canon embraces meritocracy in its human resource management practices.

Although Germany and Japan both have concentrated ownership structures featuring relational investing that foster long-term inter-dependence relationships, the relationship between banks and industrial corporations in Japan is more complex due to cross-holding of shares and the influence of *keiretsu* system. Historically *keiretsu* was formed out of the demise of *zaibatsu*; a pre-war family owned bank-centred holding companies. During the occupation of Japan, American authorities liquidated the *zaibatsu* conglomerates in order to prevent concentration of economic power in few hands. Banks were also prohibited from engaging in stock broking business. However, because the American authorities did not understand the power and centrality of banks within the *zaibatsu* confederations, they did not insist on the liquidation of these institutions. This omission allowed the re-emergence of a looser grouping of the former *zaibatsu* interests to become *keiretsu* (Coffee, 1991; Roe, 1993). The objective of the American occupation authorities to introduce the US-styled public corporations with dispersed ownership also failed; individual ownership of common stocks in Japanese public corporations declined from 70 percent in 1949 to 22 percent in 1996 (Kaen, 2003 : 200).

Banks are reported to have encouraged the formation and development of the various *keiretsu* business groups as a means of pooling mutual strengths and reciprocal help (Charkham, 1994). It is also suggested that Japanese firms tend to perceive shareholding itself as not so important as the relationship between business partners. Learmount(2002) posits that equity cross-holdings and thus the exchange of shares between business partners is simply an attribute to symbolise the close business relationships, and not share ownership per se. Kaen (2003) also argues that the objective of the *keiretsu* is to maximise the relationship values and financial performance of the *keiretsu* as a ‘family’ entity, as against the usual objective (under the Anglo-American model) of maximising the market value of any individual member company. As such, the grouping of *keiretsu* as a family entity ensures that individual firms are protected from hostile takeovers. Examples of some more prominent *keiretsu* include conglomerates such as Mitsui and Mitsubishi. The *keiretsu* governance system is also characterised by relational contracting (as against legal contracting under the Anglo-American system) among member firms to support each others’ businesses and as a means to reallocate profits within the group. Such practices are usually deemed detrimental to the interests of minority public shareholders in the individual corporation. Despite the absence of laws to protect public shareholders in such situations and a general lack of legal protection for minority shareholders, the presence of substantial minority public (individuals) ownership in Japanese listed firms (almost negligible presence in the case of Germany, which also has relatively weak investors protection laws) represents a research puzzle to Shleifer and Vishny (1997).

The Japanese government also plays a crucial role in the *keiretsu*-bank system of governance. Through its Central Bank, the Ministry of Finance, and other ministries, the government seems to be the monitor of monitors within the *keiretsu* through the creation of *gyosei shido*, an informal system of ‘administrative guidance’ for policy implementation by the *keiretsu*. Governmental influence on *keiretsu* management is indirectly exerted through bureaucrats who retired prematurely at age 55 to join the private sector as managers. As part of the ‘old boy’ network comprising of retired government servants, they contribute directly to the formulation of corporate strategies that are in congruence with government policies (Rubach and Sebor, 1998).

Another key difference between the German and Japanese models is board structure and board composition. As mentioned previously, Germany has a two-tier board structure with legal distinction between the roles of the supervisory board and the management board. Germany also has a long tradition of outside directors that represent the interests of the various stakeholders such as banks, block holders, and employees. On the other hand, Japan has a unitary board of directors dominated by insiders, with no clear roles for outside directors (Jackson and Moerke, 2005). This is also in direct contrast to the composition of the American boards which have majority outside independent directors. Learmount (2002) reports that the appointment of outside directors tends to be chosen from within the partner firms, as most other non-related companies are unwilling to allow their directors to join another board. As such, it is rather difficult to see how the appointment of independent directors and their monitoring role (as per the Anglo- American notion) can be implemented in Japan at least in the foreseeable future. Not surprisingly, the typical Japanese board is usually perceived to be representative of employees rather than shareholders interests; with senior managers (inside directors) apparently finding it hard to reconcile to the Anglo-American notion of ‘accountability to shareholders’. Whether such behaviour is out of step with global best practice and reflects managerial entrenchment is debatable. While the Anglo-American model attribute significant role for BOD to be the link between the shareholders and managers, the important role of Japanese directors seems to be to facilitate and guarantee employee participation in company matters.

The role of the banks in monitoring industrial corporations (in which they have equity stake) is another point of departure between the German and Japanese models. While the monitoring of industrial firms by banks in Germany is considered generally close and intensive, bank monitoring in Japan appears to be relatively lax and acts only when a member company in the *keiretsu* is in financial stress (Coffee, 1991). This latter point is reinforced by Yasui (1999, cited in Monks and Minow, 2004, p.313), who characterises Japanese corporate governance as ‘contingent governance’ in which company insiders retain effective control of managements as long as the firm performs well. Once performance deteriorates, however, the control is taken away and they are made to face severe sanctions. Coffee (1991) also contends that the slack monitoring of industrial corporations by Japanese banks

could perhaps be taken advantage of by insiders as mechanism for managerial entrenchment.

Both Germany and Japan are prime examples of relational banking which foster long term bank-industrial corporation relationships based on interdependence. We note earlier that German banks were able in the 1990s to redefine their investment strategies and relationship with their corporate clients in order to cope with market pressures for change. Japanese banks however, were mired in the aftermath of the burst bubble economy in the early 1990s, struggling to cope with an avalanche of bad loans. It is estimated that US\$700 billion in outstanding non-performing loans are on the books of Japan's main banks (Iskander and Chamlou, 2000, p.93). Iskander and Chamlou (2000) posit that the *keiretsu*-main bank system puts firms in double jeopardy. Firstly, by not following the prudential norms for arm's length lending, the main banks encourage excessive leveraging and investments in highly risky areas including property and stock market speculations. Secondly, although the complex system of equity cross-holding may have shielded member firms from hostile takeovers, it also prevented the development of a healthy market for corporate control that is needed to discipline poor performers and entrenched managers. The result was a wave of corporate bankruptcies and massive banking failures during 1997/1998 in Japan.

On the other hand, Roe (1993) argues that banks do interact with managers of firms at the monthly meeting of *keiretsu* Presidents' Council, which typically consult each other on major decisions such as appointing a successor CEO. Though the main bank holds a dominating position, no single council member has enough shares to control the others. However, in a culture that values consensus, no one member would want to risk the ire of the other members. Social control is therefore exerted indirectly through the informal mechanism of group consultation which emphasises high levels of mutual trust.

Learmount (2002) notes that reciprocal responsibilities, obligations, and trust are important attributes of Japanese firms that are crucial for fostering inter-company relationships. High levels of communication, face-to-face interaction, committed membership of a clearly identified group, and an unambiguous commitment to one's

owned companies are the social and psychological processes that generate and sustain a system of reciprocal responsibilities, obligations, and trust. Accordingly, Learmount (2002) posits that an exacting system of close inter-personal scrutiny and sanctioning on the one hand, and processes that encourage and reward pro-social behaviour on the other, can together produce powerful social accountability that becomes the basis of a form of 'socially endogenous' corporate governance system. This socially endogenous form of corporate governance, in the particular Japanese social-economic context, seems to represent an effective means of directing and controlling corporations. The socially endogenous form of corporate governance seems to fit into the Cadbury Report's (1992) definition of corporate governance as "the system by which business corporations are directed and controlled" (see section 2.1 above), albeit in the peculiar social-economic context of Japan. However, there are also drawbacks to this model that include a tendency to become inward-looking in the absence of regular interaction beyond the boundaries of the firm, accountability or responsibility for bad performance being dispersed across the firm as a whole instead of some identifiable individuals, and dependency on partner firms' commitment for the system to be efficacious. It must be noted that this culturally rooted and social contracting form of corporate governance, suitable and efficient as it may be in the Japanese context, could prove to be very difficult to serve as an exemplary blueprint and model of good corporate governance practices for other countries to follow.

2.6 Theories Underpinning Corporate Governance Systems

It has been mentioned that while the Anglo-American corporate governance model is underpinned by the shareholder value theory perspective, the German and Japanese models seem to be underpinned by the stakeholder theory perspective. However, in view of the tentatively called socially endogenous form of corporate governance system, Learmount (2002) posits that the Japanese model, like its German counterpart, is perhaps also associated with the stewardship theory (Davis, Schoorman, and Donaldson, 1997) and the related trusteeship theory (Kay and Silverton, 1995). While the agency theory perspective of the Anglo-American model (economic approach) assumes that human are basically individualistic, opportunistic, and self-serving, the stewardship theory (sociological and psychological approach) depicts human as collectivists, pro-organisational, and trustworthy. Under the

concept of trusteeship, the BODs are the trustees of both the tangible and intangible assets (including the skills of employees, the expectations of customers and suppliers, and the company's reputation in the community) of the firm, rather than the agents of the shareholders. The duty of the trustees is to sustain and grow the company's assets, as against the maximisation of the value of the company's shares. While the agency model expects managers to place the interest of current shareholders as priority, the trusteeship model expects managers to balance the sometimes conflicting interests of current as well as future stakeholders. Both the stewardship theory and the dominant agency theory (for details, see Section 2.3 above) and their application on the functions of board of directors are to be reviewed further in Chapter Four below.

From the above discussion, one can conclude that although the Japanese corporate governance model shares some strikingly similar characteristics with that of the German model, such as stakeholder-oriented approach, bank-centred concentrated ownership structure, and relational investing, there are also some distinctive differences. While German employee participation is protected and mandated by law, the Japanese employee participation in their firms is governed by social convention and cultural tradition. The Japanese cultural concepts of obligation, family, and consensus (Charkham, 1994) are reflected in the so-called socially endogenous form of corporate governance characterised by reciprocal responsibilities, obligations, and trust (Learmount, 2002). The *keiretsu*-main bank system is characterised by pooling of mutual strengths and reciprocal help (obligation and reciprocal responsibilities), and consultation (consensus). As such, we can say that the Japanese model may perhaps be too embedded or rooted in its socio-economic and cultural contexts, despite some similarities with the German system that also emphasises social contracting and community well-being. The process of globalisation of capital and financial markets and products market competition may necessitate Germany, and to a lesser extent Japan, to move more towards the shareholder-centred Anglo-American model based on agency contracting, albeit in a very gradual and highly selective manner. In this context, it might be worthwhile to examine the extent to which the Japanese and German systems may converge with the Anglo-American system, the next topic of discussion.

2.7 Trends towards Convergence of Systems?

It was briefly mentioned above that the different theoretical perspectives resulted in divergent expectations on public corporations in Germany, Japan and the US, the three largest industrial economies in the world. While the shareholder-centred Anglo-American corporate governance model tend to perceive publicly traded corporations as an economic entity whose purpose is to maximise shareholder value, the German and Japanese models seem to be stakeholder-oriented and to perceive publicly traded corporations as a social institution (Kay and Silberston, 1995, p.86), “with public responsibilities, and a proper public interest in defining the ways in which it is run and governed”. It has also been mentioned that the globalisation of capital and financial markets exerted tremendous pressures on the German and Japanese systems to be more in line with that of the Anglo-American model. However, this does not mean that there would be a *unified* corporate governance system based on the Anglo-American shareholder-centred model happening anytime soon in Germany and Japan. To merge these two opposing agency theory contracting and social contracting models may necessitate nothing less than a paradigm shift in the revolutionary sense as described by Kuhn (1996). Rather, the adoption and adaptation of the perceived global corporate governance best practices and devices might be the basis for future convergence of systems.

Globalisation has led to debates on comparative corporate governance to focus on the issue of whether corporate governance structures among the world’s major economies, especially Germany and Japan, are converging towards the Anglo-American shareholder-oriented model. The issue of convergence of corporate governance systems is also boosted by the response of the IMF and the World Bank to the 1997/98 Asian financial crisis. Nations which accepted financial assistance were required to adopt not only macroeconomics measures such as deficit reduction, but also to commit to fundamental reforms of their corporate governance systems to be patterned after the American model (Iskander and Chamlou, 2000).

Convergence is typically dichotomised by formal convergence of laws from functional convergence of corporate practices. The distinction is important since adoption of similar formal laws in different legal systems might not ensure functional equivalence in the operation of those systems, reflecting the interplay

between functional adaptability and institutional persistence (Gilson, 2001). The debates are fiercely contested by two opposing schools of thought. At one end of the scale is the strong convergence theory forcefully advocated and articulated by scholars such as Hansmann and Kraakman (2001, cited in Fiss and Zajac, 2004). They posit provocatively that ideological convergence based on the supremacy of the shareholder-oriented model is inducing similar rules of corporate law in practice around the world, including similar approaches to mergers and acquisitions. However, whether the adoption of American corporate and securities laws will translate into actual implementation without local functional adaptation is another matter altogether. “Are we expecting a formal emergence of legal rules, as Henry Hansmann and Reinier Kraakman argue has largely been achieved, or merely functional convergence that operates behind a facade of local institutions?” (Gilson, 2001, p.332). In this context, the recent wholesale adoption of Delaware takeover laws might be interpreted on first sight to be the formal convergence of the Japanese and American systems. However, Milhaupt (2005) posits that based on the history of foreign law adoption and adaptation in Japan in particular, and foreign borrowing generally, the more likely outcome would be ‘institution telescoping and stacking’ in which the Delaware law would be telescoped into a convenient and politically palatable package and stacked on top of existing Japanese institutions. This will result eventually in the formation of new Japanese corporate governance institutions, rather than the perceived convergence of systems in form or function. It is also suggested that the adoption of the Delaware takeover laws may turn out to be tools to frustrate hostile bids, rather than the perceived goal of developing a meaningful external mechanism in the form of a market for corporate control patterned after the US model.

At the other end of the scale, there are scholars notably Bebchuk and Roe (1999) who opine that path dependency, which results from a different constellation of rules and institutions designed to solve the problem of organising and monitoring of modern corporations, might impede convergence, and thus ensure diversity of systems. There are two sources of path dependence; structure-driven and rule-driven. Structure-driven path dependence deals with the direct effect of initial ownership structures on subsequent ownership structures. The corporate structures that a nation has at a given point in time are influenced partly by the corporate structures it had

earlier. Rule-driven path dependence arises from the effect that initial ownership structures have on subsequent structures through their effect on rules and regulations governing corporations. Rule-driven path dependence is grounded on efficiency as well as interest group politics. As such, existing corporate structures might have persistent power due to internal rent-seeking even if they have become inefficient. Bebchuk and Roe (1999) conclude that the path dependence theory sheds light on why in the advanced economies, despite pressure to converge, vary in their ownership structures and provides the basis for why some important differences might persist.

Monks and Minow (2004) argue that any convergence of governance systems is more likely to be enforced through market forces rather than to be imposed by law. The most credible and transparent system of corporate governance would attract and obtain the cheapest cost of capital. Based on a 2002 McKinsey study, Monks and Minow (2004) report that investors are willing to pay a premium of up to 18 percent for shares in companies which they perceive to have a superior corporate governance structure.

The main argument for convergence is based on the perceived competitive advantage gained in adopting the shareholder-oriented model, especially in coping with pressures arising out of globalisation of capital markets and product market competition. Globalisation of capital and financial markets enable big corporations to access relatively cheap international funds, compared to the local bank loans. Useem (1998) illustrates the impact of globalisation of finance in which international institutional investors are able to invest in a wider world of higher returns and lower risk while local executives are finding out those foreign institutional funds and other foreign investors are prepared to provide more capital at lower cost. In return, the process of internationalisation of equity market provides incentives for local corporations to restructure their operations to enhance shareholder returns in order to gain a competitive advantage over those non-adopting firms. The perceived emergence of the Anglo-American model as a benchmark for international standards is forcefully articulated by Bradley, Schipani, Sundaram and Walsh (1999, p.14). After examining the purpose of and to whom should public corporations account to, they declare that "... after careful analysis, we conclude that the Anglo-American

governance system, born of the contractarian paradigms, is the most flexible and effective system available. Notwithstanding its idiosyncratic historical origins and its limitations, it is clearly emerging as the world's standard".

Another reason put forward for the growing convergence of governance systems towards the Anglo-American model is product market pressure. Hansmann and Kraakman (2001, cited in Fiss and Zajac, 2004) posit that companies following a shareholder value model seem to have a competitive advantage in product markets since their governance structure allows them to adapt to changing environments more rapidly. The perceived competitive advantage arises out of their management structures which are not constrained by other stakeholder interests, thereby allowing them to enter new product markets aggressively or to rapidly abandon poor investments. On the other hand, Yoshimori (2005), using case studies comparing Toyota with General Motors and Canon with Xerox respectively, show that the two Japanese firms competing in the same product markets as their US counterparts seem to deliver better corporate performance over the last ten years despite their traditional corporate governance system being perceived as ineffective from an agency theory perspective. It is therefore argued that higher firm performance is possible without resorting to the Anglo-American shareholder-oriented model. This lends credence to the path dependence theory that corporate governance systems reflect the unique political, social, legal, economic, as well as cultural conditions in a given nation at a given time. The divergence in corporate governance systems is perpetuated and driven by political, cultural, and philosophical differences rather than on the sole criteria of economic efficiency (Bebchuk and Roe, 1999).

Using European data and settings, Rhodes and Apeldoorn (1998) posit that Europe might not abandon their corporate structures that delivered efficiency and prosperity in the past in order to accommodate globalisation pressures toward the adoption of the Anglo-American model. The external support networks of the Germanic firms would likely be remodelled to accommodate convergence at the margins, since they still gain competitive advantage from their network resources. The complex relationships that underpinned local institutions would also likely prove to be highly resistant to radical change. Even within the European Union, the failure to make any meaningful progress after the introduction of the European Company Statute to meet

certain minimum standards (Charkham, 1994), and the rejection of the European Parliament for a uniform cross-border code for takeovers in July 2001 (Kaen, 2003) remind us that attempts on convergence of corporate governance laws are subject to the lobby of powerful local vested interests and other political considerations even in the face of apparent economic rationality.

Two recent empirical studies also show that there is little support for the strong convergence theory. Khana, Kogan, and Palepu (2006, p. 84) assert “that globalisation is not strong enough to overcome local vested interests. We conclude that globalisation may have induced the adaptation of some common corporate governance standards but that there is little evidence that these standards have been implemented”. In the same vein, Fiss and Zajac (2004) conclude that many German firms engage in symbolic management by publicly embracing a shareholder-value orientation but not implementing it in practice.

While the majority of commentators and academics are talking about the imminent convergence of governance systems toward the Anglo-American model, there are also other dissenting voices such as Roe (1993, 1994) and Charkham (1994) advocating for the reformation of the Anglo-American system to be patterned after the bank-based concentrated ownership structures of Germany and Japan. The theoretical advantages of the bank-based governance system are a reduction in agency and information asymmetry costs and avoidance of conflicts of interest between shareholders and creditors, since they are both the same people. Rubach and Seborra (1998) note that many commentators call for the use of relational investing as a possible remedy for the perceived failure of the various internal and external control mechanisms, introduced under the Anglo-American system.

The debates on divergence or convergence of corporate governance systems reflect the differing shareholder-oriented and stakeholder-oriented perspectives on the role and purpose of public corporations. It is argued that both these two opposing views seem to be based on an unrealistic notion of contracting, as eloquently described by Fort and Noone (1999, p.163): *The agency theory of contracting is ultimately unpersuasive because it fails to take into account adequately the cultural embeddedness of rationality and choice. Agency contractarians concentrate on a*

one-sized dark notion of human nature and do not account adequately for the coercion necessary to sustain the choice that supposedly validates their approach. Similarly, social contractarians provide virtually no account of human nature and also miss the embeddedness problem. By not fully linking contracts to a transcendent reality, social contractarians provide no real reason to choose social contracting over agency contracting.

All this while, the term Anglo-American corporate governance model is used without accounting for differences in local practice. While most aspects of their corporate governance characteristics are similar, there are some subtle differences. Firstly, while it is common to have majority independent outside directors in the US boards, the practice is not too widespread in the UK despite the recommendation of the Combined Code for big listed companies to have at least a majority of outside independent directors (see Chapter Three for details). Secondly, while the positions of chairman and chief executive in the UK are traditionally held by two different directors, the US practice of duality of roles is the exact opposite (see Chapter Three). Thirdly, while the UK non-executive chairman reflect the British set of values of being aloof, wise, unassuming, well connected, and dispassionate, the Americans prefer heroes who are visible, dominant and powerful (Monks and Minow, 2004). Fourthly, the US executive incentive pay scheme rewards executives based on the philosophy that successful people should get rich; such well paid executives in the UK are derided as ‘fat cats’ and widely disparaged in the press. Fifthly, takeover defences such as poison pills (shareholder rights plan) and payment of greenmails that are commonly practised in the US would have been deemed illegal in the UK context. Last but not least, while the UK relies on its long tradition of self-regulation, the US tends to use legislations to regulate corporate governance behaviours. Accordingly, Monks and Minow (2004) argue that if such fundamental differences exist between the US and UK, it will be very difficult for a convergence among markets that are markedly different, such as the German bank-dominated system and the Japanese culturally rooted *keiretsu*-bank system.

From the above analysis, one can deduce that the various claims of the imminent convergence of corporate governance systems towards the Anglo-American model are perhaps a bit over-stated. Nevertheless, the process of globalisation of equity and

financial markets would continue to exert pressures on the German and Japanese corporations intending to tap international funds and to access the American market directly, to update and reform their corporate governance practices to be more in line with that of the American system. The decisions of some big German companies to list on the NYSE and some Japanese firms to opt for the US-styled board structure point us to that direction. Global institutional funds, especially the US public pension funds, would likely to increase their 'voice' by demanding greater transparency and accountability in the conduct of the German and Japanese firms that they have invested. However, whether any of the corporate governance reforms are to be genuinely well accepted by local players and translated into practice is a separate issue. This is particularly so when there is evidence of symbolic and image management, to placate investors rather than to follow perceived best practices in corporate governance. Besides the process of globalisation, local practices, interest groups politics, and the perceived purpose and role of public corporations are important factors to consider when discussing the prospects of convergence of corporate governance systems. The theory of path dependence is appealing, and would continue to provide a basis to explain why some basic differences in governance structures persist to exist among the world's three largest economies. However, nothing is likely to block the process of globalisation that plots the move towards some forms of convergence of the systems to be based on certain perceived common best practices, the topic of our next discussion.

2.8 Convergence of Best Practice Codes and Emergence of Research Questions

While the much debated convergence of corporate governance models is not expected to happen any time soon, the convergence of views on the principles of good corporate governance practices are evidenced from the proliferation of best practice codes across 50 nations (Coombes and Wong, 2004). The common trait of these national codes is that they are all inspired by the principles of the U.K. Cadbury Code of Best Practice, especially the flexible and yet relatively effective "comply or explain" self-regulation approach (see details on the origin and development of the Cadbury Code, and the New Zealand Exchange Best Practice Code in Chapter Three below). Coombes and Wong (2004) suggest that the Cadbury Code has sparked real improvements in the professionalism of many U.K. boards, as reflected in their composition, structure, and processes. In view of the near universal

acceptance and convergence of opinions on what good corporate governance is all about, best practice code seems to be an important and worthwhile topic for further research. The convergence of views on best practice codes also implies that New Zealand companies do not operate in isolation and that the study of corporate governance is a global issue. As shall be seen later on in Chapter Three, even Germany and Japan, which have different corporate governance structures and arrangements compared to that of the Anglo-American model (see Chapter Two above), adopt the principles of the UK Cadbury Code of Best Practice. However, whether the German corporate governance code, and to a lesser extent the Japanese governance code, serve as the benchmark for good governance is a matter of debate, in view of findings that the German and Japanese firms are just reacting to the pressures of globalisation of trade and financial services. Thus, the extent of compliance with the recommendations of the New Zealand Exchange (NZX) Corporate Governance Best Practice Code (NZX Code), and the possible impact of NZX Code compliance on the financial performance of New Zealand listed companies are the two research questions that are to be investigated in this thesis.

2.9 Chapter Summary

The various definitions of corporate governance reflect the differing theoretical perspectives and disciplinary backgrounds of the scholars and practitioners. While the shareholder value theory advocates that the board of directors (BOD) should maximise shareholders value, the stakeholder theorists laments that the BOD should also take care of the legitimate interests of other non-shareholder stakeholders when making strategic decisions. The Anglo-American corporate governance model is developed and designed to suit the special needs of the big publicly traded companies, which are characterised by disperse shareholding and concentrated management. Economics and political factors both contributed to the Anglo-American corporate governance model as it is known today. However, besides big public listed companies, there are many other small and business enterprises, non-profit companies and organizations, and state-owned enterprises that may find the Anglo-American governance system not totally applicable or relevant. The two contrasting approaches to corporate governance reflect the differing theoretical perspectives on the primary roles of the BOD. While the agency theory perspective advocates a control approach to corporate governance, the stewardship theory

perspective prefers a collaborative approach. While the agency theory is closely associated with the shareholder value maximisation perspective of the Anglo-American corporate governance model, the stewardship theory is more akin to the stakeholder orientated Germanic/Japanese models.

Interestingly, the debate between shareholder theory and stakeholder theory is also examined to show and reflect the contrasting approaches and treatment of large public listed companies operating within the Anglo-American and Germanic /Japanese corporate governance systems. The purpose and accountability of large public corporations, which differ accordingly to the two opposing theoretical perspectives, also account for the main differences in corporate governance practices between the Anglo-American system and the Germanic/Japanese system. The differing agency theory and stewardship theory perspectives on corporate governance are also reflected in the two contrasting approaches to board roles between the Anglo-American system and the Germanic /Japanese system.

The shareholder-oriented approach of the Anglo-American model is in stark contrast to the stakeholder-oriented approach of the German and Japanese models. The purpose and accountability of public listed company are also different under the shareholder value and stakeholder value perspectives. While public companies are viewed as economic entities to maximise profits for its shareholders under the Anglo-American model, they are viewed as social institutions to cater to the needs of all stakeholders under the German/Japanese models. Although there are calls for convergence of governance systems on the grounds of competitive advantage, it must be noted that each country has its own form of value systems, be they economic, political, cultural, or social in nature. While the much debated convergence of corporate governance models is not expected to happen any time soon, the convergence of views on the principles of good corporate governance practices are evidenced from the proliferation of best practice codes across both the developed and developing nations, with the common feature of adopting the good principles of the U. K. Cadbury Code of Best Practice. The importance of corporate governance code leads to the emergence of the research questions on compliance with the NZX Code and its possible impact on the financial performance of New Zealand listed companies, assuming all other factors remain constant.

Chapter Three - Literature Review

Introduction

This chapter examines the development of corporate governance best practice code, with special reference to New Zealand. A comparative study of the various codes promulgated in the English speaking countries and the adoption of best practice code in Germany are also to be discussed. The efficacy of the best practice code is also to be studied. Review on the extent of compliance with best practice codes and its impact on the financial performance of listed companies are the focus of this study.

3.1 Development and Reforms of Corporate Governance

The development and reforms of the Anglo-American corporate governance system can perhaps at first sight be described as knee-jerk responses to recurrence of corporate scandals and financial crises. This is understandable, since it is very important to restore confidence in the stock markets, which are not only being used by companies to raise capital but are now being increasingly relied upon to fund the UK/US pension schemes. Clarke (2004) posits that corporate governance crisis and reform is essentially cyclical in nature; complacency during long periods of extension and boom but waves of reform and increased regulations during period of recession and crisis.

3.1.1 UK Corporate Governance Reform

In the UK, one of the earliest governance crises was the collapse of the South Sea Company in 1720/21. The South Sea Company, one of the earliest joint-stock companies permitted by an Act of Parliament, was entrusted to take over the national debt. However, excessive investor speculation led to the ultimate crash that affected almost every segment of the British society. Maltby and Wilkinson (1997, cited in Iskander and Chamlou, 2000) suggest that the collapse of the South Sea Company was more than a financial crisis. The bubble scandal created a general distaste for business in the form of companies, which was perceived to be subjected to abuses and inherently unsound. In response to the scandal, corporate statues were rapidly enacted to protect the investing public. The new measures (reforms) included

shareholder rights to information and the ability to appoint and remove directors as well as auditors (Iskander and Chamlou (2000)).

In the more recent corporate history, concerns about corporate governance in the UK were provoked by the secondary banking crisis of the 1970s. Many of these thrift companies were exposed to excessive risk and became insolvent, which led to official responses by introducing a raft of regulations and a new office to supervise thrift institutions. In the 1980s, the collapse of the Bank of Credit and Commerce International resulted in efforts for international prudential banking regulation and supervision of cross-border operations. The financial scandals of late 1980s and early 1990s involving Maxwell and Poly Peck, among others, lent credence to the perceived general lack of confidence in the financial reporting of many UK companies (Mallin, 2004). This time, however, the response was not from the officialdom but the initiative of the private sector that was concerned about the reputation of London as a world financial centre. The accountancy profession, the Financial Reporting Council, and the London Stock Exchange established the Committee on the Financial Aspects of Corporate Governance in May 1991. The Committee, chaired by Sir Adrian Cadbury, submitted its findings in December 1992, which became widely known as the Cadbury Report (1992). The main recommendations of the Cadbury Report included the operation and structure of the main board; the establishment and composition of key board committees; the role and importance of non-executive directors; and the reporting and control mechanism of public companies. Stiles and Taylor (1993) proclaim that the Cadbury Report, besides putting public pressures on British directors to change their behaviour and to adopt new practices in corporate governance, also “represents a watershed in the development of corporate governance in Britain, a deliberate test of the effectiveness of voluntary regulation and British corporate democracy” (p.61).

3.1.2 Development of Code of Best Practice in the U.K.

The most important recommendation of the Cadbury Report is the introduction of a Code of Best Practice (Cadbury Code), which all listed UK companies are expected to comply with, within the ‘comply or explain’ mechanism. Although the Cadbury Code was meant to be ‘voluntary’, the London Stock Exchange (LSE) made the Code part of the listing requirements, ensuring that a statement in the annual report

of listed companies declaring whether the Code was complied in full or explaining why certain aspects of the Code were not complied with. This 'comply or explain' mechanism serves to ensure that investors are given the full facts of corporate governance standards compliance in listed companies, so that they can make their own judgements as to whether to buy, hold or sell the stocks concerned. In this regard, it might at first sight seem that it is a success for informal self-regulation, as against the usual introduction of knee-jerk regulation. However, Dewing and Russell (2004) argue that since the Code is part of the LSE listing requirements, it might be better to describe the outcome as formal self-regulation. The main recommendations of the Code included the composition and operation of the board of directors; the establishment of remuneration and audit committees of the board; the role and importance of non-executive directors to be "independent of management and free from any business or other relationships which could materially interfere with the exercise of their independent judgement" (Code 2.2); the tenure and pay of executive directors; and the reporting and control mechanisms of listed companies to ensure the integrity of accounting reports and the business as a going concern.

As one shall see later on, the impact of the Cadbury Code goes beyond the shores of the UK. It spurs the development of corporate governance best practice codes not only in the Anglo-Saxon countries (Canada, Australia and New Zealand but not the US, which chose to legislate), but almost throughout the world including groupings and institutions such as OECD, Commonwealth Association, World Bank, and the International Monetary Fund. Meanwhile, it might be timely to follow up on any further reforms of corporate governance system in the UK after the Cadbury Report.

In response to public concerns at both the size of executive directors' pay packages and extent of their disclosures (more correctly the lack of) in the annual reports of companies, the Greenbury Committee reported in 1995 (Greenbury Report, 1995), detailing comprehensive recommendations regarding disclosure of directors' pay packages, strengthening of accountability, and enhancing the performance of directors. These objectives were to be achieved through the establishment of an independent directors dominated remuneration committee which would report annually to shareholders, and adoption of performance measures linking rewards to performances. Mallin (2004) contends that since 1995, the disclosure of UK

directors' remuneration has been quite prolific in annual reports of companies. However, the Greenbury report was assessed as "an unsuccessful attempt to tackle the then heated controversy over executive directors' pay and conditions" (Ingley and van der Walt, 2005, p. 633). Sykes (2002, p. 257) points out that the so-called independent members of most remuneration committees "are effectively chosen by, or only with the full agreement of, senior management". Since most of these remuneration committee members are also serving executives of other companies, their recommendations reflect the philosophy of social comparison rather than linking reward to performance. Sykes (2002) makes the pertinent observation that the now widely criticised executive pay packages were once approved by an 'independent' remuneration committee, contrary to the original intended objective of the Greenbury Report.

The review on the implementation of the Cadbury and Greenbury recommendations was published in the Hampel Report (1998). Besides endorsing the overwhelming majority of the findings of the two earlier committees, the Hampel Report states that the BOD should be accountable only to the shareholders, although to attain the long-term shareholder value successfully, the BOD should be responsible for relations with other stakeholders such as employees, customers, suppliers, credit providers, and the local community. In line with the recommendations of the two earlier committees, the Hampel Report also emphasises the important role of institutional investors in the monitoring of investee companies. The Hampel Report also recommends that the ad hoc nature of inquiry into corporate governance in the UK should be maintained, and that the LSE should in future make minor changes to the governance principles and code (Dewing and Russell, 2004).

The recommendations of the Cadbury, Greenbury, and Hampel reports were incorporated into the Combined Code (1998), which operated on the 'comply or explain' mechanism as described earlier. The Combined Code entrusts the BOD with the responsibility to ensure that the company has a sound system of internal control and to report on its effectiveness in the annual report. The Turnbull Committee, established by the Institute of Chartered Accountants, reported in 1999 and provided guidance on the implementation of the internal control requirements of the Combined Code. Consequently, full compliance with the Combined Code (1998)

was required of all listed companies effective December 23, 2000 (Dewing and Russell, 2004).

The main recommendations of the Higgs Review, 2003 (on the role and effectiveness of non-executive directors) and the Smith Review, 2003 (on the role and effectiveness of audit committee) were incorporated into the updated and revised Combined Code (2003) of the LSE. The Combined Code (2003) requires that “the roles of chairman and chief executive should not be exercised by the same individual” (Paragraph A.2.1). However, the Combined Code did not adopt the recommendations of Higgs Review forbidding any non-executive director serving on all three board committees, and the enhanced role of a senior non-executive director. Keenan (2004) argues that the Higgs Review was well received generally, but contained too many regulation-based box ticking requirements rather than a succinct group of governance principles. The LSE Code provides for a formal and rigorous annual appraisal of the board’s performance, as well as the performance of its committees and its individual members. For larger listed companies, the Code calls for their boards to be constituted of at least half by independent non-executive directors (Mallin, 2004). In line with US practice, the Code calls for all members of the audit committee to be comprised exclusively of independent directors (Chambers, 2005).

Analysing the principles underlying the best practice codes from Cadbury to the Combined Code, one can deduce that they are based primarily on the agency theory perspective despite the absence of unequivocal empirical evidence on the efficiency of governance mechanisms under the agency perspective (see Chapter Four for details). The best practice code emphasises the importance of an independent board and its monitoring role. This is reflected on the requirements for a separated board leadership structure (non-duality of chairman and CEO), composition of board and its committees (majority or all independent directors), independence of external auditors from management, executive remuneration contracts that align the interest of shareholders and managers, the role of the board in the implementation of internal control system, including risk management, and the emphasis on institutional investors as monitors. The introduction of a formal annual evaluation of the performance of the board, its committees and individual members, is also reflective

of the agency theory perspective, except that the BOD and not the usual suspect (management) is now the agent. Although this self-appraisal can be likened to the examiners marking their own exam papers, it nevertheless shortens the agency chain and makes the board more accountable both in spirit and letters. The 'comply or explain' mechanism is complemented by the heavy emphasis on mandatory and timely disclosures of information. Although the absence of empirical evidence to correlate board independence with firm performance renders the rationale of the Combined Code and thus its effectiveness questionable, the impact of the best practice code spreads well beyond the shores of the UK.

3.2 Development of Best Practice Code beyond the UK

The Cadbury Report (1992) inspires and spurs the development and adoption of similar corporate governance best practice codes throughout most parts of the world (Clarke, 2004; Ingley and van der Walt, 2005). Several factors have been put forward to explain the popularity of the Cadbury Code. Firstly, the trend towards globalisation ensures that corporate governance reforms in one country (UK) invariably contributes to debates in other countries, and they learn from each other's worst and best practices (Iskander and Chamlou, 2000). Secondly, the internationalisation of equity market requires that companies in countries wanting to tap the global funds must conform to internationally accepted standards of best practices in financial reporting and internal control. Companies in general also prefer self-regulating codes to bureaucratic regulations. Related to this factor is the dominance and concentration of equity ownership in the hands of institutional investors internationally, which provides investors with the power to put best practice codes and governance guidelines to their use (Cadbury, 1997; 1999). Thirdly, the desire by global organisations such as the OECD and the world bank to promote corporate governance best practices and principles among member countries in order to enhance their long-term economic performance, and the strengthening of international financial system (Ingley and van der Walt, 2005). This is particularly so and significant after the outbreak of the Asian financial crisis in 1997/1998, which pushed corporate governance reforms to the top of the agenda for most nations (Clarke, 2004).

The OECD formed the Business Sector Advisory Group in 1996, tasked with the responsibility to produce a set of code principles of good corporate governance for member states to adopt and adapt, acknowledging that there is no single best corporate governance model applicable to all countries. The OECD in 1999 published its Principles of Corporate Governance, which includes *fairness* (protecting shareholder rights and equitable treatments of all shareholders including minority and foreign shareholders), *inclusiveness* (recognising the legitimate rights of all stakeholders and promoting cooperation between corporations and stakeholders in creating sustainable wealth), *transparency* (requiring timely and accurate disclosure on all material matters including financial situations, performance, ownership, and governance of corporations), *accountability* (clarifying the respective governance roles and responsibilities of management and BOD), *responsibility* (ensuring corporate compliance with laws and regulations and sensitivity to the objectives of the society in which corporations operate), and *strategic leadership* (providing guidance on corporate strategy and effective monitoring of management by the board). The rationales of the OECD Principles are that good corporate governance enables firms to access funds at a relatively lower cost from long term foreign ‘patient’ capital arising out of globalisation of the equity market, and that adherence to good corporate governance practices will improve the confidence of domestic investors in the stock market and thus induce more stable sources of funding (OECD, 1999, updated April 2004)). Kaen (2003) posits that the OECD initiative is partly motivated by its recognition that good corporate governance practices are related to the overall health of a nation’s economy, its prospect for economic growth, and economic efficiency.

The OECD Principles are used by the World Bank to prepare country corporate governance assessments as basis for policy dialogue and technical assistance. This is supplemented by the International Monetary Fund which produces country reports on the observations of internationally recognised corporate governance standards and codes. Other international bodies that produce and promote corporate governance codes and principles include the Global Corporate Governance Forum (OECD/World Bank), International Corporate Governance Network (private sectors initiative), and Commonwealth Association for Corporate Governance (Mallin, 2004).

One can deduce from the OECD Principles of Corporate Governance that they are very much based on the principles embedded in the Cadbury Code and the Combined Code. However, the OECD Principles are more complete in the sense that they also emphasise the importance of corporate strategy as part of overall corporate performance. Although the OECD Principles are more general in order to take into considerations the different corporate structures and cultures of member countries, they are nevertheless based on the Anglo-American corporate governance model. That is to say, the underlying assumption of the OECD Principles is based on agency theory perspective and applicable only to large for-profit publicly listed corporations, although they do qualify that there is no perfect 'one-size fits all' model. As can be seen later on, the development of corporate governance best practices codes in New Zealand and Australia also mirrors that of the UK, both in terms of governing principles as well as the underlying theoretical assumptions.

3.3 Codes Development in New Zealand

Besides the UK, other prominent members of the Commonwealth which adopt the corporate governance best practice codes include Canada, Australia, South Africa, India, Malaysia, Singapore, and New Zealand. It may be useful now to proceed to discuss in detail the development of corporate governance best practice code, principles, and guidelines in New Zealand.

The New Zealand Exchange Limited (NZX, formerly known as NZSE) on May 6, 2003 announced the new proposed corporate governance framework for its listed companies. Upon consultation with listed member firms and the Securities Commission, the Corporate Governance Best Practice Code (NZX Code) of NZX was incorporated into the Listing Rules of NZX effective 29 October 2003. The NZX Code includes the mandatory standards for all listed companies to meet and a more flexible set of principles to enable individual companies to establish their own corporate governance practices, taking into consideration the difference in corporate size and culture. The mandatory standards (minimum of two independent directors or one third of total numbers of directors, whichever is larger; no director duality of CEO/Chairman; establishment of audit committee and rotation of external auditors) are to be enforced through its Listing Rules while the flexible standards are to be monitored through the requirement for all listed companies to disclose in their annual

reports the extent to which their corporate governance processes *materially differ* from the principles set out in the NZX Code [Listing Rule 10.5.3 (i)]. It is to be noted that the requirement to include a corporate governance statement in the annual reports of NZX listed firms (especially to report only if there is *material difference*) is less stringent than the standard ‘comply or explain’ monitoring mechanism of the UK Cadbury Code. The flexible or discretionary standards cover the establishment of nomination committee, remuneration committee, formulation of corporate code of ethics, performance- based director stock compensation plan, provision of timely information to the boards by management, director training, and formal procedure to regularly assess individual director and board performance.

The mandatory standards on board appointments were enforced through amendments to Section 3.3 of the Listing Rule. The mandatory separate board leadership structure and the discretionary standards requirement were incorporated as Appendix 16 of the Listing Rule, effective October 29, 2003. However, listed firms have a grace period of 12 months to comply with. It is, however, not clear whether any non-compliance with Appendix 16 would incur the same penalty (censure, suspension, and delisting) as infringement of Listing Rule 3.3.

The Securities Commission in September 2003 issued its Background Reference Paper on corporate governance in New Zealand and invited public submissions with the aim to prepare a report for the Minister of Commerce in order to establish a benchmark for shaping the behaviour of New Zealand business. On February 18, 2004 the Securities Commission submitted its report entitled Corporate Governance in New Zealand – Principles and Guidelines (the CGNZ Report) to the Minister of Commerce. The nine principles and guidelines are:

1. *Ethical Standards* (directors should observe and foster high ethical standards);
2. *Board Composition and Performance* (there should be a balance of independence, skills, knowledge, experience, and perspectives among directors so that the board works effectively);
3. *Board Committees* (the board should use committees where this would enhance its effectiveness in key areas while retaining board responsibility);
4. *Reporting and Disclosure* (the board should demand integrity both in financial reporting and in the timeliness and balance of disclosures on entity affairs);

5. *Remuneration* (the remuneration of directors and executives should be transparent, fair, and reasonable);
6. *Risk Management* (the board should regularly verify that the entity has appropriate processes that identify and manage potential and relevant risks);
7. *Auditors* (the board should ensure the quality and independence of the external audit process);
8. *Shareholder Relations* (the board should foster constructive relationships with shareholders that encourage them to engage with the entity); and
9. *Stakeholder Interests* (the board should respect the interests of stakeholders within the context of the entity's ownership type and its fundamental purpose).

The problem with the 'one-size-fits-all' approach of the CGNZ Report is that there is no generic or best governance model that is applicable to all the organizations and corporations (with different objectives and cultures) operating in New Zealand (see Section 3.3.1 for a detailed discussion on the relevance of governance model and best practice code and organisational types). Recognising this shortcoming, the CGNZ Report encourages the adoption and adaptation of its principles and guidelines to suit each user's own needs. One particular recommendation of the CGNZ Report, at odds with those consulted, is for the establishment of an oversight body independent of the audit profession to oversee the auditors. As one shall see later, this recommendation is one of the important provisions of the US Sarbanes-Oxley Act, 2002. The CGNZ Report also states that publicly listed companies, which already have their own NZX Code to cope with, are not expected to duplicate their reporting requirements.

It is to be noted that unlike the CGNZ Report's Principles and Guidelines, which carry no legal obligation, the NZX Code has "teeth" to bite, since the implication is that member firms could theoretically be suspended/de-listed for serious infringement of listing rules. However, like the LSE Combined Code, it is debatable whether such a drastic penalty for mere non-compliance would ever be enforced by the NZX. However, a written warning, to be followed by the threat of a public reprimand for repeat NZX Code non-compliance, would usually result in appropriate remedial actions, since listed companies are normally very concerned about any adverse news that may prove to be price-sensitive to their stocks. While the CGNZ Report's Principles and Guidelines are purely advisory, it is to be noted that the NZX Code is to be implemented through the requirement to disclose "material

differences” in governance processes, a less stringent approach than the ‘comply or explain’ mechanism originally recommended in the Cadbury Report.

One can deduce from the NZX Code that the underlying assumptions are based on agency theory perspective, as is in the case of the Cadbury Code. This is reflected in the emphasis on board independence and incentive devices to align shareholder and managerial interests. The incentive aspect is reflected in the introduction of performance-based equity security compensation plan for directors. The board independence aspect is reflected in the requirement for a separated board leadership structure, a majority of independent directors in the audit as well as nomination committees, and a minimum of two independent directors in the board. As such, one might be tempted to conclude that the NZX Code is a mirror duplicate of the Cadbury Code. However, unlike the UK Combined Code (for large firms, at least half of board members must comprise of independent directors) , and the US practice of majority independent directors in the main boards, the NZX Code only requires a minimum of two independent directors, or one-third of the total board members (to be rounded to the nearest number), whichever is greater. The NZX Code is also less specific on the definition of independent directors (leaving it to the board to determine and to disclose in annual reports or through public notification after such appointments), as compared to the definition under the Cadbury Code. The lesser requirement of the number of independent directors in the boards of New Zealand listed companies could perhaps reflect its small jurisdiction and therefore having the difficulty of establishing an adequate pool of independent directors (Farrar, 2005), or it could be because of the relatively small board size of an average NZX listed company. While the UK Combined Code requires boards to consider the legitimate interests of all stakeholders, the NZX Code is silent on this matter. The NZX Code also does not deal with matters concerning shareholder (especially institutional investors) relations and activism, although such provisions are contained in the CGNZ Report, which listed firms are also expected to adopt.

It has been mentioned earlier that the OECD Principles emphasise also the importance for the boards in providing guidance on corporate strategy, besides effective monitoring of management. It is to be noted that the NZX Code, like the UK Combined Code, does not contain this rather important function of the board.

This brings into focus the question of whether the current corporate governance reforms and debates in New Zealand are more about compliance and conformance, rather than on corporate performance (Healy, 2003). On the other hand, Cadbury (1998) maintains that it was accountability for performance, not performance itself, which the Cadbury Committee was asked to review. Chambers (2005) contends that the importance and dominant role of the audit committee in a typical UK board accounts for its focus on the control function at the expense of its strategy guidance function, since audit committee tends to “focus on control and accountability rather than direction and strategy” (p.95).

Cadbury (1998) laments that the Cadbury Committee during the early 1990s was asked to recommend a Code of Best Practice to directors who had no role to play in either establishing the committee or its terms of reference. The Cadbury Committee therefore has to overcome the difficulty of recommending their guidelines to those directors who do not mandate them to do so. The NZX and the New Zealand Securities Commission, although also not mandated directly by the directors, have invited public submissions and held wide consultations with various interest groups, including company directors, before formalising their corporate governance code and principles. It is noted however, that the NZX Code, and the CGNZ Report to a lesser extent, caters mainly to the needs of big for-profit companies, although small and medium enterprises dominate the New Zealand economy. It might therefore be useful to examine the relevance of the Anglo-American corporate governance model in general, and the best practice code in particular to the special needs of the New Zealand setting.

3.3.1 Relevance of Governance Model and NXZ Code to Organisational Types

The Anglo-American model applies and caters only for the special needs of large publicly traded companies which are characterised by dispersed shareholders and concentrated management (Lubatkin, 2005). However, there are many small and medium enterprises, family-owned firms, non-profit organisations and other institutional types that are not covered by, or do not really fit-in with the model. Tracing the origin of corporate governance in the U.S., Lubatkin, Lane, Collins, and Very (2005) opine that the U.S. model may be too institutionalised in American culture and traditions, which makes the model too unique to be totally applicable

even to other English-speaking countries. In this regard, it might be timely to discuss below the feasibility of finding other governance model and best practice code that are able to suit the needs of the various organizational types in New Zealand.

It is said that the Anglo-American corporate governance model focuses almost exclusively on the special relationships between shareholders and managers of large, publicly listed companies (Lubatkin, 2005). However, Forbes and Millikan (1999) contend that besides large and for-profit governance model, there are many other

Table 3.1 Ownership structures and performance requirements			
Ownership type	Ownership structure	Governance culture	Desired return
Private companies	Shareholders are managers	Return	Profit and Value
Publicly-listed companies	A few dominant shareholders <i>Shareholder electees</i>	Value	Growth in share value Dividends
Cooperatives, mutual, employee-owned entities	Equal shareholders <i>Ward elections</i>	Representation	Supply price Rebate
State-owned enterprises	Dominant shareholders <i>Appointees</i>	Monitoring	Profit and value Public good
Crown companies	Single shareholder <i>Appointees/ Representation</i>	Efficiency	Quality service Public good
Charities, trusts, commissions	Nominees <i>Legislative approval</i>	Investment Trust Membership Stakeholder Strategic	Sustainable public good
Local authorities	Representatives <i>Constituent elections</i>	Fairness	Public good today

Source: Van der Walt, Ingley, and Diack (2002)

governance models which are required to cater for the needs of other organisations. Therefore, it is not possible or wise to devise a generic model of governance to fit all types of organisations. The functioning of boards is likely to vary with organisations of different types. They argue that the task and demographics of non-profit boards differs in important respects from for-profit boards. In terms of task, they note the key differences between non-profit and for-profit boards in relation to their respective control, service, and external functions. The control function of non-profit boards must be revised to account for their distinctive legal status and the service

function must be expanded to account for the fact that non-profit boards typically exert more influence over operating functions than do for-profit boards. In terms of demographic differences, they note that non-profit boards typically consist of more woman and minorities, are larger in size and dominated by outsiders. Accordingly, non-profit board processes are likely to be affected by visible diversity as well as job-related diversity.

Van de Walt, Ingley and Diack (2002) propose a framework for the evaluation of the governance requirements of different types of organisation. Using New Zealand corporate and organisational structures, the framework focuses on the evaluation of the governance requirements of the different forms of organisation, as reflected in the differing cultures of the respective shareholders, owners, or primary stakeholders. As proposed by Van de Walk, Ingley and Diack (2002), Table 3.1 above sets out the main types of ownership structures, their respective governance cultures, and performance requirements.

It is to be noted from Table 3.1 above that the natural dichotomy of non-profit and for-profit governance structure may be inadequate in differentiating between organisation types in relation to governance function and practice. Also, it is apparent that a single generic governance model and a single “one size fits all” best practice code may not address the complexity and variation as seen across the widely differing structures and imperatives of the NZ corporate setting. This raises also the differing perspectives of the private and public sectors on the definition of corporate governance. Iskander and Chamlou (2000) contend that there is now an emerging private sector consensus that corporate governance is about maximising shareholders value in the long run, though in the process it requires balancing the interests of shareholders and other stakeholders. This view is in line with the finding of this research on the role of governance and where the responsibility for governance lies in corporations (see Section 2.1 above). On the other hand, from a public policy perspective, corporate governance is about providing firms with the incentives and discipline to minimise the divergence between private and social returns, while ensuring accountability in the exercise of power and patronage by the firms (Iskander and Chamlou, 2000).

Van der Walt, Ingley and Diack (2002) raise the question as to whether or not there should be a distinction between corporate governance and organisation governance, with the former as a sub-set. They propose that governance architectures be specific to the type of ownership, performance measures and desired performance outcome. Accordingly, different organisations are characterised by different governance models.

There is also the issue of “internal” corporate governance, that is, delegation of decision-making powers from the parent company board to the boards of local/overseas subsidiaries. Strikwerda (2003) posits that many parent company boards delegate powers to their subsidiary boards with the ultimate goal of still being in control through their nominee directors, including non-executive outsiders, who might not be considered as “independent” in the real sense.

Fama and Jensen (1983b), while not proposing a generic governance model for all organisations, however, argue that the separation of decision and risk-bearing functions observed in publicly traded companies is common to other organisations such as large professional partnerships, financial mutuals, and nonprofits. They hypothesise that the contract structures of all these organisations separate the rectification and monitoring of decisions (by the board) from initiation and implementation of the decisions (by the management), which contribute to the survival of these organisations through functions specialisation.

From the above, one can deduce that there is not one optimal choice of corporate governance model which applies to all types of organisations, not to mention the natural dichotomy between for-profit and non-profit on one hand, and private and public sectors on the other hand. The present Anglo-American corporate governance model is best suited and applicable only to the large for-profit publicly traded companies with dispersed ownership base and concentrated management. This raises the question of how publicly traded companies manage to maintain, if not actually increase, their popularity despite the inherent problems arising from the separation of ownership and control. The answer could perhaps be partly found in the introduction of the various governance control mechanisms which are supposed to alleviate the

agency problems through minimisation of agency costs, the topic of our discussion in Chapter Four.

3.4 Codes Development in Australia

In March 2003, the Australian Stock Exchange (ASX) Corporate Governance Council (CGC) released its Principles of Good Corporate Governance and Best Practice Recommendations (CGC Code) to its member firms. The CGC Code requires all ASX-listed companies to disclose their extent of adherence to these principles from the 2004 financial reporting year onward. It is to be noted that the *comply or explain* requirement of the CGC Code is similar to that of the NZX Code, which is a mirror image of the UK Combined Code.

The CGC Code contains ten principles for good governance practice, details as follows:

Principle 1: Lay solid foundations for management and oversight

Recommendation 1.1: Formalise and disclose the functions reserved for the board and those delegated to management.

Principle 2: Structure the board to add value

Recommendation 2.1: A majority of the board should be independent directors.

Recommendation 2.2: The chairperson should be an independent director.

Recommendation 2.3: The roles of chairperson and chief executive officer should not be exercised by the same individual.

Recommendation 2.4: The board should establish a nomination committee.

Recommendation 2.5: Provide the information indicated in *Guide to reporting on Principle 2*.

Principle 3: Promote ethical and responsible decision-making

Recommendation 3.1: Establish a code of conduct to guide the directors, the chief executive officer, the chief financial officer and any other key executive as to:

3.1.1 – the practices necessary to maintain confidence in the company's integrity.

3.1.2 – the responsibility and accountability of individuals for reporting and investigating reports of unethical practices.

Recommendation 3.2: Disclose the policy concerning trading in company securities by directors, officer and employees.

Recommendation 3.3: Provide the information indicated in *Guide to reporting on Principle 3*.

Principle 4: Safeguard integrity in financial reporting

Recommendation 4.1: Require the chief executive officer and the chief financial officer to state in writing to the board that the company's financial reports present a true and fair view, in all material respects, of the company's financial condition and operational results and are in accordance with relevant accounting standards.

Recommendation 4.2: The board should establish an audit committee.

Recommendation 4.3: Structure the audit committee so that it consists of (i) only non-executive directors, (ii) a majority of independent directors, (iii) an independent chairperson, who is not chairperson of the board and, (iv) at least three members.

Recommendation 4.4: The audit committee should have a formal charter.

Recommendation 4.5: Provide the information indicated in *Guide to reporting on Principle 4*.

Principle 5: Make timely and balanced disclosure

Recommendation 5.1: Establish written policies and procedures designed to ensure compliance with ASX Listing Rule disclosure requirements and to ensure accountability at a senior management level for that compliance.

Recommendation 5.2: Provide the information indicated in *Guide to reporting on Principle 5*.

Principle 6: Respect the rights of shareholders

Recommendation 6.1: Design and disclose a communications strategy to promote effective communication with shareholders and encourage effective participation at general meetings.

Recommendation 6.2: Request the external auditor to attend the annual general meeting and be available to answer shareholder questions about the conduct of the audit and the preparation and content of the auditor's report.

Principle 7: Recognise and manage risk

Recommendation 7.1: The board or appropriate board committee should establish policies on risk oversight and management.

Recommendation 7.2: The chief executive officer and the chief financial officer should state to the board in writing that:

7.2.1 – the statement given in accordance with best practice recommendation 4.1 (the integrity of financial statements) is founded on the sound system of risk management and internal compliance and control which implements the policies adopted by the board.

7.2.2 – the company’s risk management and internal compliance and control system is operating efficiently and effectively in all material respects.

Recommendation 7.3: Provide the information indicated in *Guide to reporting on Principle 7*.

Principle 8: Encourage enhanced performance

Recommendation 8.1: Disclose the process for performance evaluation of the board, its committees and individual directors, and key executives.

Principle 9: Remunerate fairly and responsibly

Recommendation 9.1: Provide disclosure in relation to the company’s remuneration policies to enable investors to understand (i) the costs and benefits of those policies and (ii) the link between remuneration paid to directors and key executives and corporate performance.

Recommendation 9.2: The board should establish a remuneration committee.

Recommendation 9.3: Clearly distinguish the structure of non-executive directors’ remuneration from that of executives.

Recommendation 9.4: Ensure that payment of equity-based executive remuneration is made in accordance with thresholds set in plans approved by shareholders.

Recommendation 9.5: Provide the information indicated in *Guide to reporting on Principle 9*.

Principle 10: Recognise the legitimate interests of stakeholders

Recommendation 10.1: Establish and disclose a code of conduct to guide compliance with legal and other obligations to legitimate stakeholders.

What then is the difference between Principle and Recommendation, as contained in the ASX CGC? The answer can be found in the report of the review group: “The Principles embody the broad concepts which underpin effective corporate governance. They encapsulate ‘common sense’ ideas with broad relevance. By contrast, the Recommendations given for each Principle suggest one framework for implementing the principles within an organisation (Implementation Review Group Report, March 31, 2004. p. 1ff). The above explanatory note was subsequently contained in the second edition of CGC (2007), which came into effect in 2008 (Farrar, 2008).

An analysis of the CGC Code reveals that they are quite similar with the NZX Code and the Security Commission's Principle and Guidelines. It might be tempting to say that the Australian version is a mirror image of the New Zealand model. However, the timeframe reveals that it is the other way around. Significantly, there are two features in the CGC Code that is not found in the New Zealand model. Firstly, CGC Code requires the companies to disclose and formalise the specific functions of the board and those functions delegated to management (also a requirement of the UK Combined Code). Secondly, it requires the structure of the board to be independent of management. It recommends that the majority of the board should be composed of independent directors, and that the chairperson should be an independent director. In this respect, the CGC Code is more in line with the UK Combined Code, as compared with the NZX Code. Nevertheless, the "delegate, then monitor" provision, together with independent board structures, reflect the agency theory perspective of the CGC Code.

The CGC Code on the composition of the board to be comprised of majority independent directors is even more stringent than the Combined Code, which only recommends that the board be comprised of at least three non-executive directors, although larger listed firms are expected to have half of their board be comprised of independent directors. The NZX Code, on the other hand, provides that at least two independent directors or one-third of the board must comprise of independent directors, whichever is higher. However, as aforementioned, the NZX Code does not specify the definition of an independent director, leaving it to the individual boards to disclose in their annual reports the identity of the independent directors and the basis on which the boards based their criteria on. In this regard, the CGC Code is more comprehensive in terms of outlining disqualifying relationships that would make even a non-executive director to be classed as non-independent director. The disqualifying relationships as outlined in the CGC Code (2003, revised 2007) are as follows:

- i) A substantial shareholder or person associated directly with a substantial shareholder;
- ii) Less than three years from cessation of service with the company or group in an executive capacity;
- iii) Has within the last three years been providing advice/consultancy service to the company or group, on a material basis;

- iv) Is a material supplier or customer of the company or group, or directly associated therewith; and
- v) Has a material contract with the company or group other than as a director.

It has been aforementioned that the Cadbury Code defines independent directors as “independent of management and free from any business or other relationships which could materially interfere with the exercise of their independent judgement” (Code 2.2). A review of the annual reports of New Zealand listed companies (see details in Chapter Five) shows that the New Zealand boards adopt the Cadbury Code and/or the CGC Code or a combination of the two definitions of independent directors. As would be noted later on, the US Securities and Exchange Commission provides specified guidance for determining director independence. In addition, the requirements of the New York Stock Exchange on majority independent directors on the board, and only independent directors on the audit, remuneration, and nomination sub-committees, are more stringent than the provisions and recommendations of the Combined Code, CGC Code and the NZX Code.

There are now two basic approaches that regulators worldwide adopt to promote good governance practices. They are either rule-based that tends to rely more on detailed prescription, or principle-based that establishes guidelines for behaviour with detailed disclosure thereafter. While the UK and most of the members of the Commonwealth and OECD countries typically adopt the latter approach, the US prefers the rule-based approach. While lacking the “teeth” to enforce the recommendations of the principle-based code, the attraction of the code lies in its flexibility ready to be amended quickly to deal with any changing needs. It is therefore timely now for us to review the development and reforms of corporate governance in the US.

3.5 US Corporate Governance Reforms

Corporate governance reforms in the US could be characterised as waves of increased regulation in reaction to corporate scandals and financial crises. The response to corporate governance failure in the US is similar to that of the UK, except that they do not develop a definitive code of best practice, but instead prefer the rule-based approach.

The 1929 US stock market crash resulted in the introduction of the Securities Act of 1933 and the development of the main body of securities law and regulations to fill gaps that led to earlier abuses. Another important milestone in the US corporate governance reform movement was the emergence of an active group of institutional investors, especially pension funds, which began to exercise their fiduciary duties under the Employee Retirement Income Security Act (ERISA) of 1974, which mandated private pension funds to vote their shares. Although public pension funds are not covered by ERISA, in practice they generally exercise their voting right (Mallin, 2004).

The more recent round of reforms began with the 1980s hostile takeover wave which resulted in massive loss of jobs and social upheavals. In response, more than 50 percent of all US states enacted in the late 1980s and early 1990s constituency statutes, which allowed directors when making corporate decisions to consider the interests of non-shareholders, including employees, customers, creditors, suppliers, and local communities. Among all the states, Delaware has built up a reputation for being 'business friendly' to allow legitimate defences against hostile bids and a body of corporate case law that has become the norm in corporate US. Not surprisingly, the majority of the companies listed in the New York Stock Exchange are registered in Delaware (Farrar, 2005). However, whether the generally anti-hostile takeovers legislation and judiciary interventions during the 1980s and early 1990s were good for corporate governance reforms is debatable (see section on external governance mechanism, Chapter Four below).

More recently, the spectacular collapses of Enron, WorldCom, Tyco, Global Crossing and other big American firms resulted in the US Congress rushing through the Accounting Industry Reform Act, widely known as the Sarbanes-Oxley Act, 2002 (Useem, 2003). There was a general public perception that these financial scandals, especially in the case of Enron, were partly caused by acquiescence of external auditors in accounting irregularities and managerial fraud. Serious conflicts of interest arising out of the dual role of Arthur Anderson as both auditors and non-audit services provider to Enron prevented it from carrying out its statutory duties as professionally and objectively as expected of a reputational intermediary. Coffee

(2002) argues that Enron is more about gatekeeper (reputational intermediary) failure rather than board failure.

The Sarbanes-Oxley Act was designed and meant to protect investors by improving the accuracy and reliability of corporate disclosures. This objective was complemented and supplemented by the Securities Exchange Commission (SEC) establishing the Public Company Accounting Oversight Board (PCAOB), as well as the New York Stock Exchange (NYSE) strengthening its corporate governance listing standards and regulations. One of the most publicised provisions of the Act was the requirement for CEOs and chief financial officers (CFOs) to certify the accuracy of quarterly financial reports, with a false certification penalty of up to \$1 million dollars fine, or imprisonment of up to 10 years, or both. The Act also provides protection for employees who assist in investigations or proceedings that involve violations of US federal securities and fraud laws (whistle-blower immunity). However, the Act fails to address the issues of stock-options or executive compensation, except to require CEO and CFO to reimburse the company for any bonus or equity-based compensation gain if the company later restates its earnings (Clarke, 2004).

The SEC administered PCAOB requires all auditors (local or overseas) of companies listed in the NYSE to register with it. To strengthen external auditors' independence, and recognising the significance of conflicts of interest, the SEC prohibits some non-audit services to audit clients, mandatory rotation of audit partners, and auditor's report on the effectiveness of internal control systems. The SEC also requires listed companies to fully disclose off-balance sheet transactions, and to adopt a code of ethics for senior finance officers (Clarke, 2004).

The NYSE requires all listed companies to have boards comprising of majority independent directors, and that audit committee be comprised exclusively of independent directors and mandates it to discuss policies with respect to risk management. It also requires listed companies to establish a compensation committee and a nomination committee made up of only independent directors. Also, listed companies must adopt and disclose corporate governance guidelines which include non-executive directors (NED) qualifications and compensation, NED

access to management, NED orientation and continuing education, NED regular performance evaluation of board, and proper management succession plan. CEOs must certify each year that they are not aware of any shortfalls in their companies' corporate governance standards compliance. Keenan (2004) contends that these corporate governance requirements mirror the principles of the UK Combined Code, although it must be noted that the requirements of majority independent board members, and only independent directors on the audit, remuneration, and nomination committees, are far more stringent conditions than that of the Combined Code. In addition, the SEC also provides specific guidance for determining director independence. Directors meeting any of the following criteria are referred to as affiliated directors and are considered to be characterised by a lack of independence:

- Employment by the firm or a affiliate within the past five years
- Family relationship by blood or marriage with a top manager or other director
- Affiliation with the firm as a supplier, banker or creditor within the past two years
- Affiliation with the firm as an investment banker within the past two years or within the upcoming year
- Association with a law firm engaged by the corporation, and
- Stock ownership resulting in the SEC designation of control person.

The SEC guideline on independent directors seems to be more comprehensive by including familial ties as a disqualifying factor, when compared to the definitions of independent directors under the Cadbury Code, and the CGC Code. Johnson, Daily and Ellstrand (1996) suggest that the SEC guidelines and uniform reporting requirements may provide researchers with a point of convergence to operationalise director independence as unified variable in order to facilitate a more systematic comparison of corporate governance studies.

The far-reaching reform of the Sarbanes-Oxley Act has caused some uproar outside the US especially when the Act does not distinguish between local and foreign companies with a US listing. This is particularly so when some provisions of the Act are in direct conflict with that of other countries. This factor and the high cost of compliance have led to some companies de-listing from the NYSE and deterring non-US firms from listing on the NYSE (Mallin, 2004; Yoshimori, 2005).

In addition to the reforms contained in the Sarbanes-Oxley Act, the Conference Board in 2003 established the Commission on Public Trust and Private Enterprise to examine circumstances that gave rise to corporate scandals which resulted in loss of public confidence in US stock markets. The Commission listed nine corporate governance principles: relationship of the board and management; fulfilling the board's responsibilities; director qualifications; role of the nominating/governance committee; board evaluation; ethics oversight; hiring special investigative counsel; shareowner involvement; and long-term share ownership. The Commission emphasises the importance of boards having majority of independent directors and recommends the separation of the roles of Chairman and CEO (Mallin, 2004). It must be noted that the Commission's corporate governance recommendations are purely advisory, unlike the provisions of the Sarbanes-Oxley Act, which carry penal consequences for non-compliance or breaches thereof.

From the above discussion, one can deduce that like the UK Combined Code, the underlying assumptions of the US corporate governance reforms are based on the agency theory perspective. This is reflected in the emphasis on board independence, the monitoring role of the board through the establishment of audit, nomination, and compensation committees, the use of independent directors to check on managerial discretions, promotion of institutional investors as corporate monitor, timely and accurate disclosures, greater transparency, and accountability through the regular evaluation of board performance. In line with the US tendency to legislate, their corporate governance reform agenda is to be enforced largely through rules and regulations, with penal consequences, although one may be tempted to wonder how effective it would be to regulate governance behaviour. In contrast, the UK Combined Code is to be implemented through the 'comply or explain' mechanism, as described earlier. In this respect, one may also be tempted to ask how effectively the London Stock Exchange can enforce its listing rules relating to corporate governance standards, since the only viable penal sanction is de-listing, which might be out of proportion with mere non-compliance. Thus, it seems that within the Anglo-American corporate governance model, there are different modes of implementation and enforcement of the standards. It could, therefore, be interesting to see how corporate governance code works in Germany and Japan, despite operating under different models of governance.

3.6 German Corporate Governance Reform

In Section 2.4.1 above, it is noted that the German corporate governance system seems to be working well within the constraints of its own setting. If the German corporate governance model seems to be working well, why are there measures to reform it? Traditionally, banks had played a central role in the development of German corporations; being the primary financiers of German industrialisation during the 1870s and reconstruction after World War Two. The German system of universal banking also enhanced the position of banks as financial intermediaries (Fiss and Zajac, 2004). However, German banks are losing and loosening their control over industrial corporations. Several factors are responsible for this changing German scenario.

Internationalisation of capital markets that emerged in the mid 1980s heralded the change in the German corporate governance situation. The development of international equity and bond markets provided the German industrial corporations the opportunities to escape from their traditional bank monitors. The relationship based corporate governance system that worked well previously ultimately could not provide German companies with adequate funds to compete in the fast expanding global marketplace (Monks and Minow, 2004). The activities of US institutional investors in the German stock market (DAX) also induced the emergence of local institutional investors, further eroding the importance and influence of the banks (Coffee, 1991; Fiss and Zajac, 2004).

As the process of internationalisation of capital markets intensified in the 1990s, German banks began to shift away from industrial loans and moved towards the more profitable investment banking services. In order to avoid conflicts of interest with their investment banking activities, German banks (especially the big three) began to voluntarily reduce their supervisory board representation, including withdrawal from chairmanship of the supervisory boards (Jason and Moerke, 2005). Concurrently, the big three banks also began to redefine their investment strategies, perceiving their shareholding in industrial corporations as asset management, rather than just a long term investment. This necessitates a move towards a more shareholder value management approach, especially when the big three banks also

aspire to become international banks in the same league as their big American counterparts (Fiss and Zajac, 2004).

The trends toward more shareholder value orientation are also boosted by the German government policies to promote the growth of stock market and liberalisation of the financial market. The passing of three major laws between 1990 and 1998 (creation of new markets in options and futures, and the establishment of a new securities regulatory body) facilitated German companies to implement stock options and internationally accepted accounting standards. Fiss and Zajac (2004) reports that none of the 112 largest listed German corporations have publicly adopted the shareholder value approach in 1990, but by 2000 more than 60 percent of these companies have done so through statements in their annual reports. However, whether such public embrace of shareholder value orientation by listed firms represent a paradigm shift as originally described by Kuhn (1996) or just a process of symbolic management (Zajac and Westphal, 2004), is another matter to be discussed later on.

Further reform was introduced with the passage of the Control and Transparency Law (Kon TraG, 1998), which free up the German voting system and exposed companies to market takeovers for the first time. Banks' voting powers were reduced and it was mandatory for supervisory board members to disclose their other board positions (Monk and Minow, 2004). Thus, we can say that globalisation has created pressures for Germany to move towards a more shareholder orientated and market-based corporate governance model. The Anglo-American model is considered a market-based system since corporations routinely "raise funds in public capital markets, and their managers are subject to the discipline of capital markets" (Kaen, 2003, p.187). Another key feature of a market-based corporate governance system is more transparency to public investors through managerial accountability and timely disclosures.

In line with international trends, the German Code of Corporate Governance was introduced in 2002 (Cromme Report). The German Code harmonises a wide variety of laws and regulations and makes recommendations for complying with internationally accepted best practice principles. Though voluntary in nature, the

German Code also employs the 'comply or explain' mechanism of the UK Combined Code. Despite moves toward a more shareholder value approach, the German Corporate Governance Commission reaffirms the unique concept of employee co-determination (Jackson and Moerke, 2005; Mallin 2004).

It has been pointed out earlier that corporate governance reforms in Germany partly contribute to some big German listed companies publicly embracing a shareholder value approach. It is to be noted that some large German companies, competing in global markets and facing competition from US companies, have also chosen to list their shares on the NYSE, thus subjecting themselves to US governance standards. These companies include DaimlerChrysler, SGL Carbon, Pfeiffer vacuum, Fresenius Medical Care, Deutsche Telekom, Aventis, VEBA, and SAP (Kaen, 2003). However, whether the reasons offered by these German companies to adopt American governance standards, are based on shareholder value maximisation motive or just rationalisations for paying higher managerial salaries and improving their bargaining position within Germany with respect to unions and social welfare initiatives, are debatable. This is because German firms operating in the US are not obliged to implement the unique practice of employee participation and the more egalitarian compensation packages between the management and ordinary employees.

One can deduce from the above that although the traditional influence of banks and their control over big industrial corporations are eroding, and despite moves toward a more shareholder-orientated approach, the German corporate governance model is still characterised by concentrated ownership structure and the unique concept of employee co-determination. The voluntary withdrawal and reduction of bank representatives on the supervisory boards of big industrial firms would also mean lesser monitoring of corporate management by the banks. It will be interesting to find out whether this gap in monitoring role is to be taken up by the other block holders such as institutional investors (both foreign and local fund managers), or this vacuum could lead to the beginning of the emergence of a powerful German managerial class in the same league as their American counterparts. After reviewing the German corporate governance reform and its adaptation of Cadbury Code

mechanism, it is timely now to proceed to examine the Japanese corporate governance reform.

3.7 Japanese Corporate Governance Reform

Like Germany, globalisation of capital markets and governments induced liberalisation of financial markets have exerted tremendous pressure on Japanese banks and corporations to move toward a shareholder value system of corporate governance. Foreign institutional investors such as CalPERS are more interested in stock market returns rather than about long term business relationships, and are therefore playing a much more active role in corporate governance. Their impact could be potentially substantial, in view of the huge increase in foreign ownership of stocks listed on the Tokyo Stock Exchange, which rose from a mere four percent in 1990 to 18.3 percent in 2002. Shareholder activism by foreign institutional investors also seems to have a rub-on effect on Japanese domestic pension funds. They are also beginning to be more interested and active in exercising voice in corporate governance, as evidence by the surprisingly higher number of ‘no’ votes cast at shareholder meetings (Jackson and Moerke, 2005).

Liberalisation and deregulation of the financial markets in both Germany and Japan also added pressure for change since the 1980s. Like in Germany, financial market reforms in Japan enabled some big Japanese industrial firms to switch from direct bank finance to bond finance, thereby enabling them to escape from their traditional bank monitors. This process affected the banking system, which experienced a stock and land price bubble in the late 1980s. The subsequent collapse of this bubble economy in early 1990s greatly impaired the capacity of Japanese banks to play their proper role in corporate governance. Also, since the mid 1990s, legal reforms relating to corporate governance were also adopted, including the lifting of post war ban on pure holding companies in Japan, and measures to facilitate corporate restructuring. Another set of changes relate to the adoption of international accounting standards which require the valuation of assets (including long term stable shareholdings in industrial corporations) at market price, rather than at cost in order to reflect their true worth. Measures to foster transparency and more disclosure were introduced, and adoption of greater shareholder rights such as removal of

voting rights restrictions and availability of derivative suits (Jackson and Moerke, 2005).

Recognising the importance of good corporate governance practices in a globalised market place, the Corporate Governance Forum of Japan, an initiative of the private sector comprising of executives, academics, lawyers and shareholder representatives, published its guidelines in May 1998. Major recommendations include greater outsider directors (accounted for only four percent of board seats in Japan), establishment of independent board audit, remuneration, and nomination committees (almost non-existence), and requests to the Tokyo Stock Exchange to incorporate the Forum Code into its listing rules. To lend support for corporate governance reforms in Japan, CalPERS adopted the Forum Code as its Japanese voting guidelines (Monks and Minow, 2004). The Forum Code, while recognising the special position of shareholders as providers of equity capital, also urges a holistic approach to corporate governance in which a sense of corporate solidarity with social harmony is included. In 2001, a revised Forum Code was introduced (Mallin, 2004). The Forum Code is purely advisory and voluntary with no monitoring device, as compared to the German Code's 'comply or explain' mechanism adopted from the UK Cadbury Code.

One of the more radical and significant of all corporate governance reforms in Japan is perhaps the revision of its Commercial Code in April 2003, which 'allows' large corporations the option to adopt the US-style board structure based on mandatory establishment of board audit, nomination, and compensation committees. Each of these committees should have majority outside directors. For firms which opt for the US-style board structure, a formal distinction is made between directors with oversight responsibility but without managerial function and directors who are executive officers with day-to-day managerial functions. This is designed to strengthen the supervisory role of the board and to separate the monitoring and decision making functions within the firms. Yoshimori (2005) claims that from a legal perspective, Japanese laws relating to corporate governance are now more in line with that of the US. However, it must be pointed out that while the Sarbanes-Oxley Act (2002) made it compulsory for boards and its committees to have majority outside directors (with penal consequences for non-compliance), the Japanese

Commercial Code only allows the big corporations the option to do so. Since the conventional Japanese boards are dominated by insiders, it is therefore not surprising to find that as of May 2004, 86 percent of member firms in the Japan Corporate Auditors Association expressed no intention to adopt the US-inspired board structure. However, this must be viewed from the perspective of interest group politics, and the importance of local institutions, since under the new US-styled board structure the setting of an audit committee is in lieu of the traditional statutory corporate auditors.

Perhaps the most significant development in corporate governance reforms is the release of the Takeover Guidelines in May 2005 promulgated jointly by the Japanese Ministry of Economy, Trade and Industry and the Ministry of Justice. The Takeover Guidelines was the result of study by a group of experts and business representatives to craft an official governmental response to the rising tide of unsolicited hostile takeover bids. One of the most significant hostile takeover bids involves an internet service provider called Livedoor which announced on February 8, 2005 its intention to acquire the remaining shares of Nippon Broadcasting System, having previously accumulated 38 percent of the latter's shares. The takeover was to be funded by an issuance of convertible bonds underwritten by US investment bank Lehman Brothers. Livedoor eventually managed to obtain a majority stake in Nippon Broadcasting after the Tokyo High Court rejected the issuance of warrants by Nippon Broadcasting to Fuji TV at a discounted price in order to frustrate the Livedoor bid (Milhaupt, 2005).

The Takeover Guidelines are based on the wholesale adoption of the US Delaware takeover law, especially the use of poison pills (also known as shareholder rights plan) as a valid defensive measure. However, whether such adoption of the Delaware jurisprudence represents convergence towards the American corporate governance model (at least in terms of the external mechanism of market for corporate control) is a matter to be discussed later on. Milhaupt (2005) notes the broad parallels between the Japanese experiences of hostile takeover bids in 2005 to the US in the 1980s, citing structural rigidities in both economies which led matured firms to waste free cash flow (see section 1.4.3 above). Interestingly, the recent arrests of the CEO and certain senior executives of Livedoor for alleged insider-dealing and other securities

irregularities (NZ Herald January 25, 2006) also have parallels with some of the scandalous happenings associated with the 1980s US hostile takeovers movement.

3.8 Review of Codes Compliance

Four British cases on compliance with the Cadbury Code/ Combined Code, and one case on compliance with the German Corporate Governance Code are discussed in this review. Stiles and Taylor (1993), using data collected from the annual reports of The Times top 100 U.K. companies, find that 73 per cent of these companies have four or more compliance factors from their list of six used for their research. The six criteria are separation of the CEO/Chairman positions, disclosure on pay packages of directors, appointment of at least three non-executive directors, and the establishment of audit, remuneration, and nomination committees respectively. Only one company is found not to comply with any of the six criteria. Canyon and Mallin (1997) disclose that by 1995, 98.6 per cent of the FTSE 100 and mid-250 listed U.K. companies have established an audit committee. Also, 95 per cent of these same companies have set up a remuneration committee by 1995. However, only 50 per cent of the top 500 U.K. listed companies have established a nomination committee by 1994. Canyon and Mallin (1997) considers the 1994 compliance rate as “disappointingly low adoption rate of Nomination Committees by UK companies, which contrasts with the relatively high incidence reported in US companies, represents a distinct failure in the UK corporate governance system” (p. 32). The above statement seems to be rather harsh, considering that the establishment of a nomination committee is not formally recommended in the Cadbury Code. Gay (2002) contends that although the nomination committee often receives less attention from the academics and practitioners, it should be regarded as the superior committee to the audit and remuneration committees. The nomination committee “is superior in the sense that the human resource activity is always of the greatest importance in the management of a business. Unless effective directors are appointed, boards cannot succeed even if excellent audit and remuneration systems are in place” (Gay, 2002, p. 44).

Commenting on compliance with the Combined Code, Davies (2006), quoting data from the ABI 2004 Report, found that 70 per cent of the FTSE 100 listed companies met all the terms of the Combined Code. This rather high compliance rate with the

Combined Code is in line with the 73 per cent compliance rate with the Cadbury Code as reported earlier from the research of Stiles and Taylor (1993). Thus, there seems to be wide acceptance and compliance with the recommendations of the U.K. Cadbury Code and its successor the Combined Code.

Based on data collected from the compliance declarations of 408 companies that are listed at the Frankfurt Stock Exchange, Werder, Talaulicar, and Kolat (2005) find a high level of compliance with the recommendations of the German Corporate Governance Code, which came into effect in February 2002. They also reveal that company size is positively associated with the extent of compliance with the German Code. There is no known published review on compliance with the Japanese Code.

From the above review, one should be able to generalise the U.K. data and adapt them to the New Zealand setting. This researcher is therefore to be guided accordingly in the review of compliance with the NZX Code in Chapter Six below.

3.9 Code Compliance and Firm Performance

There are only a few empirical studies on the relationship between compliance with corporate governance best practice codes and firm performance, even though it has been more than 16 years after the introduction of the original Cadbury Code. The few empirical studies however, do not produce conclusive evidence to support the above linkage. Nevertheless, the differing provisions and recommendations of the various codes provide opportunity for researchers outside the UK to take into account local requirements when conducting research on code compliance and firm performance. This researcher is attempting to generalise the findings of the U.K. studies so as to adapt them to the New Zealand.

Peasnell, Pope, and Young (2000) examine the possible link between board composition (defined as the ratio of non-executive directors to total board size) and earnings management activity (measured by the use of income-increasing abnormal accruals when unmanaged earnings does not meet target earnings) of UK companies. Empirical results show that during the period 1994 to 1995 (post-Cadbury Code), when the proportion of non-executive directors is high, there is less income-increasing accrual management to avoid earnings losses or earnings decline. In other

words, there is less accounting manipulation or financial engineering activities. They conclude that appropriately structured boards (that is, boards that have higher non-executive director ratio) seem to be more effective in discharging their financial reporting duties after the introduction of the Cadbury Code. In addition, Dahya, McConnell, and Travlos (2002) empirically analyse the relationship between CEO turnover and corporate performance after the introduction of the Cadbury Code. They conclude that CEO turnover increased following the publication of the Cadbury Code. More importantly, they report that the link between CEO turnover and corporate performance became stronger after the introduction of the Cadbury Code. As such, they contend that their findings support the thesis that the Cadbury recommendations have improved the quality of the board's monitoring role in the UK. However, they caveat that their findings of increased management turnover and increased sensitivity of turnover after the Cadbury Code do not necessarily mean that there is an improvement in corporate performance. They acknowledge that their study only analyses the effect of the Cadbury recommendations on a discreet board task, and not on corporate performance. They express their intentions "to investigate whether the Cadbury recommendations have influenced corporate performance more generally" (p. 482). In a follow-up study, Dahya and McConnell (2007) find that U.K. listed companies which comply with the Cadbury Code recommendations of having at least three outside directors show a significant improvement in corporate performance, as measured by return on assets (ROA). Over the period 1989 to 1996, compliant firms financially outperformed their non-compliant peers. They also found a statistically significant increase in stock prices of companies around the period they announce their compliance with the requirement of having at least three outside directors on their boards. Dahya and McConnell (2007), however, find that listed firms that adopt the split roles of CEO and board chairman do not exhibit improvement in their financial performance.

On the other hand, Weir and Laing (2000) report that a direct empirical study between adoption of Cadbury Code board structures and firm performance produces mixed results. Using a constant sample of 200 UK companies for each of the years under study (1992 and 1995 respectively), they analyse the mechanisms of duality, the number of outside directors on the board, and the formation of a remuneration committee. While the empirical result between recommended board structures and

firm performance is inconclusive, the presence of a remuneration committee has a positive effect on company performance. However, the presence of outside directors has a negative impact on firm performance. Also, there is evidence that the relationship between firm performance and outside director representation is endogenous, that is, additional outside directors are appointed after a period of poor performance. Significantly, they reveal that full compliance with Cadbury Code recommendations does not seem to be associated with better firm performance, as compared to companies that have not complied completely. In a follow up study, Weir and Laing (2001) using a sample of 320 UK listed companies, examines the link between Cadbury Code recommended governance structures and corporate performance. Instead of looking at the general relationship between governance structures and firm performance, the 320 UK listed companies are partitioned by performance quartiles, with quartile one representing firms with the lowest 25 percent return on assets to quartile four with companies in the highest 25 percent bracket. Empirical results show that the Cadbury Code recommended governance structures do not produce the desired effect of better firm performance. Instead, they report that “the best performing groups had the lowest incidence of Cadbury preferred governance structures. Equally, the most common occurrence of the preferred internal mechanisms tended to be found in the poorest performing quartiles.” (Weir and Laing, 2001, p. 93)

Nearer to the domestic front, Henry (2008) examines the variation in voluntary adoption of corporate governance frameworks by Australian listed companies during the period from 1992 to 2002. The frameworks under study are representative of the governance codes of practice introduced by the Australian Stock Exchange (ASX) in 2003. ASX companies are required to adhere to the CGC Code requirements from the 2004 financial reporting year onward. The findings of Henry (2008) suggest positive benefits for firms that adopt the overall corporate governance structures that are now in place. Acknowledging that the CGC Code compliance and firm performance is not tested directly, Henry (2008) nevertheless expresses optimism that confirmation of this possibility “would have significant implications for the ‘if not, why not’ disclosure principle that embodies the ASX Corporate Governance Council code of practice, and similar discretionary governance codes in other countries” (p. 938). There is therefore now an opportunity in New Zealand to

conduct an original research on the relationship between compliance of NZX Corporate Governance Best Practice Code and financial performance of New Zealand publicly listed companies. The researcher will be conducting such a study in Chapter Five, and the results, together with policy and practical implication, are to be reported in Chapters Six and Seven of this thesis.

3.10 Chapter Summary

The Cadbury Code of Best Practice is the most important recommendation of the Cadbury Report, 1992. The Cadbury Code, besides putting public pressures on British directors to change their behaviour and to adopt new practices in corporate governance, is also thought to represent a watershed in the development of corporate governance in Britain. The impact of the Cadbury Code goes beyond the shores of the UK. It spurs the development of corporate governance best practice codes not only in the Anglo-Saxon countries (Canada, Australia and New Zealand but not the US, which chose to legislate), but almost throughout the world including groupings and institutions such as OECD, Commonwealth Association, World Bank, and the International Monetary Fund.

Literature review shows that a single generic governance model and a single “one size fits all” best practice code may not address the complexity and variation as seen across the widely differing structures and imperatives of the New Zealand corporate setting. This raises also the differing perspectives of the private and public sectors on the definition of corporate governance. There is now an emerging private sector consensus that corporate governance is about maximising shareholders value in the long run, though in the process it requires balancing the interests of shareholders and other stakeholders. From a public policy perspective, corporate governance is about providing firms with the incentives and discipline to minimise the divergence between private and social returns, while ensuring accountability in the exercise of power and patronage by the firms.

There seems to be a common theoretical underpin in the various corporate governance best practice codes of the UK, Australia, New Zealand, and the New York Stock Exchange recommendations for listed companies. The agency theory perspective and focus on board independence seems to be the underlying theme of

the various best practice codes. The main actor in the various national best practice codes, including the NZX Code, is the board of directors, which is according given a thorough review in Chapter Four below.

A review of literature also shows that there is wide spread support and acceptance of the U.K. Cadbury Code and its successor the Combined Code, as evidenced by the rather high rates of compliance with the two codes (73 per cent and 70 per cent respectively). Although there is no consistent and conclusive empirical evidence to link full compliance with the Cadbury Code and firm financial performance, the relevant U.K. data could be generalised and be adapted to the New Zealand setting to suit local context. There is therefore this opportunity to conduct an original study in New Zealand to address the still open research question on compliance with the NZX Code and its impact on the financial performance of listed companies.

Although the NZX Code was issued in October 2003, so far there is no research study on the extent to which listed firms have complied with the requirements and recommendation of the Code. The absence of empirical data on the adoption and implementation of the NZX Code provides the opportunity for the researcher to conduct such original study in New Zealand. The expected variance in the degree of compliance among listed firms provides a good opportunity to establish whether there is a correlation between code compliance and firm financial performance. There is therefore a good opportunity to conduct an original research on the impacts of compliance with corporate governance best practices code on the financial performance of New Zealand publicly traded firms.

Chapter Four

Introduction

As with the late 1990s/early 2000s financial scandals, the on-going 2007/8 US sub-prime mortgage upheavals have re-ignited the debates on corporate governance in general, and the roles of board of directors in particular. This chapter reviews the roles and tasks of the board of directors (BOD), as seen from the various differing theoretical lenses. It also examines the relationships between BOD and corporate performance. Literature review in Chapter Three reveals that the BOD is the main actor in the NZX Code. There is therefore a need to review the roles of BOD with particular reference to the recommendations of the NZX Code. It must be noted, however, that this chapter is mainly to review the functions and main roles of BOD, leaving the study of individual board variables to be under Chapter Five below.

Overview

The spectacular collapses of Enron, WorldCom, and Arthur Anderson, the excessive payoffs to under-performing chief executive officers (CEO), the perceived failures of BOD in performing their duties, the build-up of excess capacities, the increased activism of minority shareholders and institutional investors, the apparent sensationalism of the financial press and the knee-jerk reactions of the regulators together have led to the renewed interest in corporate governance as a topic for research. The current world-wide credit crunch crisis arising out of the August 2007 US sub-prime mortgage scandals once again shines the spotlight on the importance of good (or lack of) corporate governance mechanisms to safe-guard the interests of shareholders and investors.

The BOD, widely perceived as the apex of corporate power, is perhaps the most central of internal governance mechanisms (Walsh and Seward, 1990). But, what are the primary roles of the Boards? Our knowledge of the Boards' functions and roles would enable us to further understand their effectiveness and limitations, and the possible linkages between BOD and corporate performance. However, a review of the academic literature reveals widely diverse perspectives, depending on which theoretical approach one takes. We have the agency theorists (e.g., Berle and Means,

1932; Jensen and Meckling, 1976) focus only on the board's primary role as monitors of management behaviour and performance. The resource dependence theorists (e.g., Pfeffer and Salancik, 1978; Boyd, 1990) view the board as a means for facilitating the acquisition of critical resources such as capital and business partners through directors' networks with outside firms. The legal theorists (e.g., Farrar, 2001; Walsh, 2002) focus their attention on the legal responsibilities boards must fulfil as overseers of corporations, especially their fiduciary duties to the shareholders. The management academics and practitioners (e.g., Tricker, 1984; Lorch and MacIver, 1989) stress the crucial service role of the boards in providing strategic advice to CEO and top management, as well as more actively initiating and reviewing corporate strategy. However, the managerial hegemony theorists (e.g., Mace, 1971; Kosnik, 1987) argue that the perceived governing power of the board over the management is but a legal fiction; the BOD is actually being controlled by the management!

From the above analysis, it is clear that there is no agreement on the functions of the BOD. It differs according to the specific theoretical perspective and approach. In order to obtain a more comprehensive picture of the boards, Zahra and Pearce (1989) synthesise empirical research findings on the impact of boards on corporate financial performance and recommend an integrative model of board attributes and roles. They identify the critical functions of the BOD and grouped them under service, strategy, and control roles respectively. In a related review, Johnson, Daily, & Ellstrand (1996) classify board responsibilities into three broadly defined roles of control, service and resource dependence. Hillman and Dalziel (2003) opine that the important functions of the board can be classified into two broad roles of monitoring and resource dependency, with the latter to include all the services functions. They also argue for the integration of the agency and resource dependence perspectives to better understand the relationship between board functions and firm performance.

This researcher is reviewing the control, resource dependence, and service roles of the board respectively from the various theoretical perspectives as described above, together with other related board theories. The efficiency of each board role under a specific theory is also to be examined as follows.

4.1 The Control Role of the Board of Directors

The control role of the BOD refers to the fiduciary duty and responsibility of directors to monitor managers on behalf of shareholders in order to improve firm performance (Johnson, Daily, & Ellstrand, 1996; Zahra and Pearce, 1989; Conger, Lawler, and Finegold, 2001). The monitoring functions of the BOD can be analysed from the agency and legal theoretical perspectives, together with the opposing managerial hegemony theory. Each of these differing perspectives is to be reviewed as follow.

4.1.1 Agency Theory Perspective

I have in Chapter One reviewed the agency theory in details (please refer to Section 1.4.1 above). Suffice here to state that the crux of the agency theory is that given the divergence of interests between the stockholders and management due to the separation of ownership and control (Berle and Means, 1932), the shareholders, through the board of directors (BOD), delegate the responsibility of managing the firms to the top managers, who are supposed to use their inherent information advantage, specialised industry knowledge and expertise, and the firms' resources to maximise returns for the shareholders. It is this delegated authority which potentially enables the managers (agents) to act in a self-interested and opportunistic manner to build their own wealth at the expense of the shareholders (principals). This agency problem, in turn, induces the shareholders (principals) to invest in formal governance mechanisms which incur the minimum agency costs in order to align the diverse interests of the principals and agents (Jensen and Meckling, 1976; Fama, 1980; Eisenhardt, 1989). The BODs are thus seen as monitoring devices that help align management and shareholders' interests (Fama and Jensen, 1983). The BODs are entrusted to protect the interests of the shareholders through effective control and monitoring of managerial actions and decisions, and to act as a bridge between the owners and managers.

Governance mechanisms can typically be classified as internal (organisationally-based) or external (market-based) control mechanisms that can be employed to help align the diverse interests of shareholders and managers (Walsh and Seward, 1990). Internal control mechanisms include an effectively constituted board, compensation contracts that encourage convergence of shareholder's-manager's interests, and

concentrated ownership structures that motivate effective monitoring, thus leading to improved performance. External control mechanism in the form of the market for corporate control is the discipline of last resort (Fama, 1980). Each of these monitoring mechanisms and their efficiencies are to be reviewed respectively.

The board of directors (BOD) of a publicly traded company is responsible for developing and implementing internal control mechanisms that are designed to align the interest of managers and shareholders. With this agency theory perspective, the primary role of the BOD is to monitor the behaviour and performance of managers (Jensen and Meckling, 1976; Fama and Jensen, 1983; Eisenhart, 1989). The BOD is the ultimate internal monitor and is perhaps the most central internal governance mechanism (Fama, 1980; Daily, Dalton and Cannella, 2003). Thus, the control role stresses discipline. In addition, outside directors who are detached from management facilitate objectivity (Kosnik, 1987), while separate CEO/Chairman positions provide further checks and balances (Rechner and Dalton, 1991).

Board Leadership Structure

One of the devices that a BOD can implement to monitor the senior managers, especially the chief executive officer (CEO), is the constitution of board leadership structure. Jensen (1993) criticises the combined structure (where one director holds both the titles of CEO and chairman of BOD) as an inappropriate way to design one of the most important power relationships in a public corporation. This is because such concentration of power in an individual would allow the CEO/chairman to make decisions in his/her self interest at the expense of the shareholders. Millstein and McAvoy (2003) advocate that a separated board leadership structure with an independent director as chairman is crucial to positioning the board as an objective authority distinct from management. This agency theory perspective supports the separation of the positions of CEO and board chairman in order to enable the BOD to more effectively perform its fiduciary duties.

It must be noted that, however, between 70% and 80% of large US publicly traded companies still maintain the combined board leadership structure (Rechner and Dalton, 1991; Coles, McWilliams and Sen, 2001). It is also to be noted that the separated board leadership structures did not prevent the spectacular collapses of

Enron, WorldCom, Global Crossing, Qwest and Tyco (Finkelstein and Moony, 2003). The extant empirical studies reveal that the difference in financial performance between firms with combined board leadership structure and firms with separated structure is at best minimal. On one hand, Rechner and Dalton (1991) conclude from a longitudinal analysis that firms with separated board leadership structure outperform firms with combined structure in terms of accounting measures of returns on equity, returns on investment, and profit margin. On the other hand, Baliga, Moyer and Rao (1996) and Daily and Dalton (1997) conclude that there is no difference in the financial performance between firms with and without the combined structures, captioning them as either “fussing about nothing” or “much ado about nothing”. However, Finkelstein and D’Aveni (1994) find that both CEO duality (combined structure) and non-duality (separated structure) may be dysfunctional in different circumstances. This view is to a certain extent supported by the findings of Kang and Zardkoohi (2005) that duality could be a determinant of higher or lower corporate performance, depending on its fit with a company’s internal and external conditions.

This question of board leadership structure is a moot point in so far as New Zealand is concerned, since The New Zealand Exchange (NZX) has disallowed a director to hold the position of CEO and Chairman simultaneously (see Chapter Four on the development and principles of corporate governance best practice code in New Zealand). This NZX ruling is in line with calls by institutional funds, block-holders, minority shareholders and other activists for non-duality to enhance management accountability and transparency and to avoid any potential conflict of interest situations. The amendment to its Listing Rule on this matter perhaps reflects NZX’s self-preservation strategy, in view of the very high percentage of foreign and institutional ownership (54% and 46% respectively – Healy, 2003) in the local stock market! However, this has the unfortunate effect of forcing otherwise well managed and profitable companies such as The Warehouse and Michael Hill International to decide whether Stephen Tindall and Michael Hill respectively should serve as either their CEO or Chairman, but not in the otherwise time-tested combined roles.

Independent Directors

Another device that the BOD employs to strengthen its monitoring role is the use of outside independent directors. The rationale for this monitoring mechanism is to limit managerial opportunism, and to check on the power of the CEO while retaining the benefits of a unity of command in a combined board leadership structure (Finkelstein and D' Aveni, 1994). However, the efficiency of this device is questionable. On one hand, we have empirical studies which support the position that outside director act as effective monitors of top managers to protect shareholder interests. For examples, a larger number of outside directors have been associated with a higher CEO turnover in firms with poor performance (Weisbach, 1988), a lower probability that BOD pays greenmail, that is, repurchase of own stock at a premium over the market price in private transactions (Kosnik, 1987;1990), or adopts a poison pill, that is, shareholder rights plan which entitles its holder to purchase shares in the firm at a deeply discounted rate should a takeover attempt occur (Mallette and Fowler, 1992) during a takeover contest. Thus, the presence of outside directors enables the boards to perform their proper monitoring role (Coles and Hesterly, 2000).

Also, conceptually an effective monitoring board is associated with a greater number of outside directors (Mizruchi, 1983; Lorsch and MacIver, 1989; Zahra and Pearce, 1989). This is because directors who have personal, professional, and economic interests with the CEO and/or the corporation (so-called outside but non-independent, or affiliated directors) are less incline to be the effective monitors of corporate management due to self-interest. In addition, it may be unrealistic to expect inside directors, who are also executives, to also monitor or control the actions and decisions of their CEO!

Although in the minority, there are US studies which tie higher ratio of outside directors to better firm performance (for examples, Baysinger and Butler, 1985; Byrd and Hickman, 1992). After adjusting for stricter definitions of outside directors, a meta-analysis study by Rhoades, Rechner, and Sundaramurthy (2000) indicates a slight positive relationship between higher ratio of independent directors and firm performance. Using data collected from a majority sample of listed New Zealand companies for the years 1991 to 1997, Hossain, Prevost, and Rao (2001) find a

statistically significant positive link between outside directors and firm performance. Similarly, Dahya and McConnell (2007) find U.K. listed companies which comply with the Cadbury Code recommendation of having at least three outside directors in their boards seem to outperform their non-compliant peers, both in terms of firm financial performance as well as share price increases.

On the other hand, however, longitudinal studies and meta-analyses reveal that a greater number of outside independent directors do not lead to higher firm financial performance. For examples, longitudinal studies by Bhagat and Black (1999; 2002) found that firms with more independent boards do not perform better than other firms, despite the trend towards greater board independence in US firms. Instead, using the 1991 data of 934 large US listed corporations, they contend that their evidence hints toward companies with higher proportion of outside directors performing worse than other firms. Meta analyses by Dalton et al. (1998) and Dalton et al. (1999) also do not reveal correlation between board independence and firm's financial performance. In addition, there are studies which indicate negative correlation between outside directors and firm performance (e.g. Beatty and Zajac, 1994; Zahra and Stanton, 1988). Using data from a sample of 145 companies listed on the Australian Stock Exchange in 1994, Muth and Donaldson (1998) conclude that board independence factor, contrary to agency theory prediction, "affected shareholder wealth and sales growth negatively" (p.26). But Lawrence and Stapledon (1999), using data from top100 Australian companies, find that there is a slight positive correlation between the proportion of independent directors and firm financial performance. Their empirical findings also do not support the contention of Bhagat and Black (1999) that the proportion of independent directors is negatively related to the growth variables.

From the above analysis, it seems that empirical results do not appear to be able to produce unequivocal evidence to support any of the three positions. The three outcomes are: first, there seems to be no direct correlation between the proportion of outside independent directors and firm performance. Second, there are some negative correlations, and; third, there is a slight positive correlation between the ratio of independent directors and firm performance.

CEO Compensation

The second broad type of internal governance mechanism is CEO compensation contracts which align the interests of shareholders and managers. CEO incentive compensation contracts can take the form of share ownership and stock options (Jensen and Meckling, 1976), or the threat of dismissal (Fama, 1980). However, the efficiency of this internal control device is also questionable. On one hand, we have empirical studies which conclude that incentive executive compensation contracts are associated with increased shareholder wealth. For example, consistent with agency theory logic, Himmelberg, Hubbard, & Palia (1999) posit that managerial interest can be aligned with those of shareholders through equity ownership. This is also the rationale behind the actions of most BODs to compensate executives, especially CEOs, with stock and stock options. Jensen and Murphy (1990) opine that the use of executive compensation devices such as stock option give managers an incentive to maximise value for shareholders. Also, incentive executive compensation contracts motivated US managers to initiate their own value-added restructurings in the 1990s (especially mergers and acquisitions, and divestment of excess capacity), thereby contributing to corporate value creation (Holmstrom and Kaplan, 2005).

On the other hand, Tosi and Gomez – Mejia (1994) comment that much research on the use of executive compensation schemes to align the interests of principals and agents has failed to provide strong confirming evidence for agency theory predictions. They cite the meta-analysis of Jensen and Murphy (1990) that examine the compensation – performance histories of several thousand CEOs over five decades using an agency framework. The results show that there is little support for implications of formal agency models of optimal contracting. Also, there are no demonstrated consistent relationships whether corporate performance is measured as an antecedent or as a consequence of CEO compensation (Rajagopalan, 1997). In another related study, Core, Holthausen and Larker (1999) suggests that overall, corporations with weaker governance structures have greater agency problems; that CEOs at corporations with greater agency problems received greater compensation; and that corporations with greater agency problems perform more poorly. Mcquire and Matta (2003) examine the ownership and performance implications of the exercise of CEO stock options. They find that the exercise of stock options has no

relationship with subsequent corporate performance. They conclude that the decision by the CEOs to exercise stock options appears to reflect risk-balancing concerns rather than the expectation for future performance. Another serious problem of stock options is that they are often used as covert mechanisms of managerial self-dealing; negotiating especially with weak BODs for options when they expect earnings or stock price to rise by manipulating accounting figures and timing of financial disclosure. Yermack (1997) concludes that managers often receive stock options shortly before good news announcements or delay such awards until after bad news announcements. The symbolic action of management to announce the adoption of long-term incentive plans to engender positive stock market reactions, even if such plans are not actually implemented later on, lends further credence to the alleged managerial abuse of the executive compensation schemes (Westphal and Zajac, 1998).

In view of the above, the widespread reliance of the BODs on the use of stock option programme as a means to align CEOs – shareholders interests is now questionable. This is particular so when we find that firm size accounts for almost nine times the amount of variance in total CEO pay than did firm performance (Tosi, Werner, Katz, & Gomez-Mejia, 2000). Also, O' Reilly, Main and Crystal (1988) found that CEO compensation level is determined more by the psychology of social comparison, rather than by the economics of corporate performance. A recent U.S. study, however, concludes that a great deal of evidence supports the proposition that CEO pay is determined largely by market forces. Kaplan (2008) argues that CEOs have been affected by the same market forces that create income inequality, and that average CEO pay actually declined in real terms during the period 2000 to 2006. In addition, CEO tenures are getting shorter and CEO turnover is more closely tied to stock performance. Kaplan (2008) contends that CEOs are paid for their performance accordingly. Be that as it may, the validity of performance measures and the robustness of the CEO evaluation process are matters that could be better studied before a final conclusion could be reached.

Ownership Structure

The third broad category of internal governance mechanism is concentrated ownership structures, such as large block holders and institutional shareholding,

which provide incentive to actively monitor managers, and so improve firm performance. Jensen and Meckling (1976) characterise agency theory as a theory of ownership structure of the firm. Demsetz and Lehn (1985) characterise a firm's ownership structure as being cooperatively decided by shareholders, and so lead to firm value maximisation. However, Agrawal and Knoebar (1996) characterise the concentration of shareholdings by large block holders and institutions as chosen externally by outsiders. In this regard, therefore, they are not necessarily consistent with firm value maximisation.

Despite near consensus interpretation in the literature that the allocation of equity ownership matters (e.g. McConnell and Servaes, 1995), there is no empirical evidence to associate it with firm financial performance. In a meta-analysis of financial performance and equity ownership, Dalton, Daily, Certo and Roengpitya (2003) conclude that extant studies provide no consensus about the direction and magnitude of the relationships between equity holding and firm performance. There are also no consistent linkages between firm performance and equity ownership that are categorised separately as CEOs, officers, directors, institutional or block holders respectively. Thus, the various equity categories and their relationship to firm performance as a function of the alignment or control perspective have been disappointingly inconclusive. However, it is to be noted that in the case of Germany and Japan, concentrated ownership structures dominated by the banks are the norm and their big corporations and economies seem to be performing well (see Section 2 above).

In a review of corporate ownership around the world, La Porta and colleagues (1999) challenged the standard agency theory argument and point out that in most countries, the separation of ownership and management has yet to take place even in publicly traded companies due to the presence of controlling shareholders who are also managers. The fundamental agency problem in such companies is not the usual conflict between outside investors and managers, but rather that between outside investors and controlling shareholders who nearly always have full control over managers through their nominee directors. S.J. Chang (2003) points to the agency problems created by Korean family-based conglomerates (chaebol) when chaebol families capitalise on inside information by taking direct and indirect equity stakes in

profitable or promising firms and transfer profits to affiliates through inter-group trade, thereby expropriating value from minority shareholders. Chaebols' cross-shareholding structures, with disproportionate voting power in relation to percentage of actual stock ownership, enable the chaebol chairmen to make decisions that are detrimental to the interests of minority shareholders. Therefore, agency theorists should be more cautious about positing and testing causal relationships between ownership and performance. In New Zealand, it is observed that less than 5% of its publicly traded companies are classified as management-controlled. Management-controlled companies are defined as those whose shareholding base is diverse and none of the major shareholders own more than 20% of the equity stock (Fox, 1995).

Institutional Investors As Corporate Monitor

Another aspect of the relationship between equity ownership and corporate performance is the emergence of institutional investors, especially large public pension funds such as the California Public Employees Retirement System (CalPERS), assuming a more pro-active role in corporate governance. This new activism by the institutional investors was first observed by Drucker (1991). Many academics and practitioners have assumed that institutional investors are on the verge of becoming active monitors of corporate governance standards. Jensen (1993) opines that institutional investors (such as banks, insurance companies, pension funds, mutual funds, and money managers) are instrumental to an effective governance system because they have the financial interests and an objective view on firm management and policies. He cited Warren Buffet's involvement through Berkshire Hathaway as a good example of an active institutional investor. Monks (2002) urges shareholders, especially institutional investors, to exercise their democratic rights by voting their proxies in order to hold management and directors more accountable for corporate performance.

However, since the fund managers or trustees are themselves not the direct equity owners, there arises a unique agency problem of one type of agent monitoring another type of agent. The question of who holds institutional money managers accountable is significant in view of the inherent problems of conflicts of interest. As noted by Ingley and van der Walt (2004), the dual role of institutional investor as both principals and agents creates problems of conflicts of interest for fiduciary

shareholders in respect to their share portfolios. They face conflicts of interests since they live off mandates from companies to manage corporate pension funds, or to provide insurance services. Coffee (1991) notes that an investment manager who acquires a reputation as an active corporate monitor may indeed cease to be given pension fund accounts. He argues that the usual governance mechanisms of corporate accountability are either not available or manifestly compromised at the institutional level, and that many institutional investors are less accountable to their principals than are corporate management to their shareholders. Not all institutional investors are inclined to challenge executive decisions. David, Kochhar and Levitas (1998) classify institutional investors as pressure-resistant, pressure-sensitive, and pressure-indeterminate investors. As their labels imply, each of them suggests differing objective functions and differing predispositions towards activism, depending on their involvement in conflict of interest situations. Another factor affecting institutional shareholder activism is the managerial 'comradeship'. In exercising their proxy votes (reclaiming voting discretion over the portfolio's asset), most corporate managements tend to "support each other in the expectation that a Golden Rule of Deference may someday benefit them" (Coffee, 1991, p. 1322).

Besides having to contend with the inherent conflicts of interest problem, fund managers also need to deal with the trade-off between stock liquidity and control of companies. Investors who prefer liquidity may hesitate to accept control, or risk becoming poor monitors (Coffee, 1991). This is in line with the so-called 'Wall Street Rule': dissatisfied investors could sell, but they could not effectively challenge management. The trade-off between liquidity and control is similar to a choice between 'exit' and 'voice'. If 'exit' is easy and low-cost in near- perfect liquid stock markets, institutional investors have little interest in exercising a more costly 'voice'. Bhide (1993) posits that liquidity discourages internal monitoring since it reduces the cost of 'exit'. Therefore, public policymakers need to weigh the benefits of stock liquidity against the cost of impaired corporate governance. However, if 'exit' is difficult and costly, institutional investor will be more inclined to exercise their 'voice' in governance matters. Coffee (1991) notes the trends toward greater 'voice'. The fast growth in institutional ownership of securities that resulted in increased capacity for collective action has made 'voice' become less costly. At the same time, 'exit' has become more difficult and costly, since institutional investors would have

to accept a substantial price discount if they want to liquidate their increasingly larger blocks of shares.

On the other hand, Romano (1993) argues that the often mentioned hopes of US institutional investor becoming active and value-maximising shareholders are overstated. Although public pension funds such as CalPERS are found to be more active than other institutional investors in corporate governance engagements, they face political pressure to temper investment policies with local geographical consideration that are not aimed at maximising the value of their investments. Unless workable mechanisms can be devised to insulate them from political interventions, there are limits to what can be expected of shareholder activism by public pension funds. In this context, we shall see later that when US public institutional funds such as CalPERS operating overseas and thus outside the political interference of state governments, they become shareholder activists and play a more prominent role in monitoring their investments in Germany and Japan.

The relatively high cost of monitoring, problem of 'free riders', and doubtful effectiveness have led some institutional investors to adopt indexing (buying of every stock in accordance to its percentage weight as comprised in a basket of stocks forming an index, such as the S&P 500) as an investment strategy, which renders activism unnecessary. Nevertheless, together with other shareholder activists such as minority shareholder associations and the financial press, they can be a potent force as pressure groups to counter any perceived excesses of management and boards of publicly traded companies, in view of the finding that on an aggregate basis, institutional investors own more than 50% of total US corporate equity (Conference Board, 2000). In New Zealand, institutional shareholders own 46% of the total New Zealand Stock Exchange equity (Healy, 2003: 197).

I have so far reviewed the three broad categories of internal governance mechanisms and their respective efficiencies. Agrawal and Knoeber (1996) expand the list to include the market for directors which serves to motivate outside directors, the market for managers which serves to voluntarily curb managerial excesses since it is in their own interest to uphold their professional reputations, and the use of debt which relies on the capital market for monitoring. These three additional devices are

classified as internal mechanisms since they are decided by insiders, although they are also influenced by external forces. Typically, when all these internal mechanisms fail to perform their monitoring and control role effectively, the external governance mechanism in the form of the market for corporate control is activated and becomes more relevant (Walsh and Seward, 1990; Daily, Dalton and Cannella, 2003).

Market for Corporate Control

The market for corporate control is also the discipline of last resort when internal control devices fail to curb managerial opportunism (Fama, 1980). The takeover market provides an external court of last resort to protect shareholders from boards that fail in their monitoring role. But how does one know that internal control devices have failed to do their jobs? Morch, Shleifer and Vishny (1989) rank non-takeover related complete turnover of the top management team (TMT) as the best measure of forced internally precipitated change, and associate it with successful monitoring by the BOD. Orderly internal succession is not treated as a control change, since it does not usually represent a response to poor management performance. Conversely, hostile takeovers are associated with the failure of the BOD to discipline TMT. Successful hostile takeovers usually result in the replacement of the TMT whom the BOD is unable or unwilling to discipline. Friendly acquisitions or mergers, to the extent that they are disciplinary in nature, seem to be encouraged by boards which are confronted with poor corporate performance relative to a healthy industry.

The theory of the market for corporate control was first suggested by Manne (1965) and subsequently developed further by Jensen and Meckling (1976), Fama (1980), and Fama and Jensen (1983a, 1983b). The essence of the theory is that when top managers engage in self-interested behaviour, their company's performance is not likely to reach its maximum potential. When this under-performance is reflected in the lower value of the company's stock, other management teams are induced to offer their services to the shareholders as alternatives to the incumbent TMT, either through negotiated mergers or outright hostile bids.

Both theory and empirical evidence seem to support the contention that the market for corporate control in the form of takeovers addresses governance problems

(Manne, 1965; Jensen, 1988). There are broadly three main ways in which takeover alleviates governance problems. Firstly, Jensen and Ruback (1983) posit that takeovers typically increase the combined value of the target and acquiring firms (synergies), leading to expected increase in total profits. Secondly, takeover targets are usually poorly performing firms and their top managers are likely to be replaced once the takeover bids succeed (Morck, Shleifer and Vishny, 1989; Martin and McConnell, 1991). Thirdly, takeovers can solve the free cash flow agency problem. Free cash flow (that is, cash flow in excess of that required to fund all projects with positive net present values) problem arises when top management invests in over-diversification and organisational inefficiencies. This agency problem is typically overcome by successful takeovers which usually lead to distribution of profits to shareholders over time (Jensen, 1986; 1988).

On the other hand, the efficiency of takeover as an external corporate governance mechanism is also questionable. Walsh and Seward (1990) conclude that empirical evidence regarding synergy as a source of takeover gain is inconclusive. Betties (1981) and Rumelt (1974, cited in Walsh and Seward, 1990) found that related diversification strategies performed better than unrelated ones, when firm performance is assessed through accounting-based measures. However, when firm performance is assessed through market-based measures, the research findings are not unequivocal. While Shelton (1988), and Singh and Montgomery (1987) found that related mergers create more shareholder value, Chatterjee (1986), Lubatkin (1987), and Stillman (1983) found unrelated mergers to perform at least as well. Moreover, takeover as a disciplinary device to solve the problem of inefficient management is also questionable. Manne (1965) posits that the proof of the effectiveness of this disciplinary device is to determine if actual changes in the TMT ultimately follow the merger. Walsh and Ellwood (1989, cited in Walsh and Seward, 1990) found that the predicted relationship between previous target company performance and its subsequent top management turnover rate was non-existent. They posited that much of the post-acquisition top management turnover may be voluntary, since talented top managers do not want to be associated with poorly performing firm, and therefore seek employment elsewhere when opportunities arise. Thus, successful hostile takeovers do not necessarily result in the complete replacement of top managers in the target firms.

The success of any hostile bid depends to a great extent also on the effectiveness of the anti-takeover devices of the target firm. Typically, takeover defences include the payment of greenmail (Kosnik, 1987; 1990) and the adoption of poison pill (Mallette and Fowler, 1992). Greenmail refers to premium payments made to bidders to induce them to terminate their attempt to gain control of the corporation, while poison pills refer to corporate charter provisions, financial security issues, or other contractual provisions that either transfer wealth or ownership from the takeover group to the target company's shareholders or force the takeover group to pay off a huge debt if the takeover succeeds. Poison pills are also referred to as shareholder rights plans, although they are called management rights plans by critics (Kaen, 2003). We had earlier discussed the relationship between these takeover defences and outside/independent directors. However, Bhagat and Jefferis (2002) found that takeover defences are not completely effective in insulating managers from the consequences of poor performance.

On balance, takeovers are widely interpreted as the crucial external corporate governance mechanism during the 1980s in the US to curb managerial discretion and to squeeze out excess capital and capacity (Jensen, 1993; Shleifer and Vishny, 1997). Donaldson (2005) posits that the primary thrust of the US corporate restructuring in the 1980s was to expose business units once protected by conglomerate structure to direct product market competition, thereby forcing improvement in efficiency.

On the other hand, the waves of hostile takeovers in the 1980s had also proven to be quite costly not only in terms of dollars and cents but also their impacts on human and social capital (Rubach and Sebor, 1998). The 1980s saw the emergence of the corporate raiders (asset strippers) and hostile takeovers which were funded by aggressive financial schemes such as leveraged buyouts (LBOs) and junk bonds. Corporate raiders often sold off assets of their targets and closed plants in order to recoup their investment, but the process also hurt the interests of employees and communities through the breaking of long-term contracts with employees and other stakeholders. Whatever gains the corporate raiders may wring from assets sale of targets companies would need to be offset by payments of unemployment and other welfare benefits that are ultimately funded by the tax payers. As we shall see later on, the resultant social and political upheavals led to many states in the US to enact

constituency statutes that permit companies directors to take into considerations the interests of employees and other stakeholders in their decisions making process.

Besides charges of widespread abuses, fraud, illegal insider trading, and increase in default and bankruptcy rates, opponents of hostile bids alleged that the threat of takeover by corporate raiders was forcing companies to lay off productive employees and postpone promising investment in order to meet short-term earnings targets. More tellingly, the managerial lobbies and enlistment of political and popular support against corporate raiders resulted in legislative, regulatory and judiciary interventions that contributed to the end of the takeover wave in late 1989/1990 (Jensen, 1993). By contrast, the wave of corporate restructurings in the US in the 1990s was largely characterised by friendly mergers and the use of equity stock, instead of debt instruments. Holmstrom and Kaplan (2005) posit that the increased use of stock option plans encouraged managers to restructure their own companies in order to reap the benefits of enhanced value that is to be created.

So far the review of the efficiencies of the various internal and external governance mechanisms assumes that they are independent of each other. However, Rediker and Seth (1995) and Agrawal and Knoeber (1996) argue that while governance mechanisms can substitute for each other, they are not independent of each other. Bhagat and Jefferis (2002) found that corporate ownership structure, capital structure, takeover defences, takeovers, management turnover, and corporate performance are interrelated. They opine that most of the research studies in corporate governance are econometrically flawed since they generally look only at the relationship between two given variables at a time, using econometric methods that ignore interrelationships among corporate governance mechanisms and the endogeneity of many of these mechanisms. As a result, the making of a corporate governance decision may involve a variety of possible effective governance mechanisms. This may partially explain why the empirical evidence on the efficiencies of each of the respective governance mechanisms discussed above has largely proven to be inconclusive. Also, Hermalin and Weisbach (2003) argue that almost all the governance variables are endogenous, citing the example that “firm performance is both a result of the actions of previous directors and itself a factor

that potentially influences the choice of subsequent directors” (p.8).

Concluding Remark

The almost non-existent and sometimes negative correlation between independent directors and corporate performance is a research puzzle. This is particularly so when the use of independent directors to enhance the monitoring role of the BOD has been the main thrust and rationale in the recent reforms of the Anglo-American corporate governance systems, especially in the introduction of best practice code, as seen from Chapter Three above.

If the agency theory perspective of the monitoring role of BOD has not been proven empirically to be conclusive in term of its efficacy to firm performance, what then explain its wide adoption as the basis and main rationale of the principles and recommendations of the various national corporate governance best practice codes? The reason could perhaps be found in the knee-jerk like reaction when some big corporate faults resulted in bankruptcies and public outcry for remedial measures, irrespective of their actual effectiveness. Kaufman and Englander (2005) argue that a post-Enron consensus on corporate governance has emerged that the BOD should primarily function as a shareholder oversight body. This consensus is perpetrated by the investor groups, government regulators, and the various stock exchanges. The danger here is that compliance with corporate governance code could be reduced to the “tick the boxes” approach, detaching from it from firm performance.

4.1.2 Legalistic Theory Perspective

From the above analysis, one could perhaps suggest that the agency theorists view the control function of the board as mandated by the shareholders. On the other hand, the control function of the board under the legal theory perspective is empowered by corporate laws (Farrar, 2001). For example, in New Zealand, Section 128(1) of the Companies Act, 1993, provides that the business and affairs of a company must be managed by, or under the direction or supervision of the board of the company. In reality, the board delegates most of the management functions of the company to the executives, as provided by Section 130 of the Act.

Although the board may not necessarily need to have the technical expertise, or time to manage all the business affairs of the company, it has legal powers to ensure that the company reaches a certain acceptable level of firm performance by controlling the key decisions and setting limits within which the management could act (Mizruchi, 1983). Thus, it could perhaps be said that the essential element in discharging the board's control function is the fine balancing act of delegation of responsibilities. However, it must be noted that the company laws do not specifically define the functions and responsibilities of the board of directors (Jones, 1993), leaving them for the boards to decide.

What then constitutes the control function of the board and its relationship with firm performance? Kosnik (1987) argues that the board of directors is the formal and legal representative of the shareholders, and its primary task is to supervise the performance of the management and ultimately is responsible for firm performance. Zahra and Pearce (1989) lists the control function of the board under the legalistic perspective to include the duties of selecting and replacing CEO, monitoring the performance of management, and evaluating the performance of company to ensure corporate growth and protection of shareholder interests. The emphasis on corporate survival and growth necessitates the formulation and monitoring of systematic performance criteria, and this orientation is evidenced from the study by Chaganti, Magajan and Sharma (1985) of the relationship between board composition, board structure, and firm bankruptcy. On the local front, almost all the public companies listed on the New Zealand Stock Exchange state in their respective annual reports that the responsibilities of their boards include the legally mandated duties to protect shareholder interests through complying with all laws and regulations, and monitoring management to ensure firm performance (see Chapter Five for details of studies on New Zealand listed companies). This legalistic perspective of board roles is also recommended by the Institute of Directors New Zealand (IOD, 2003).

Since the focus of the legalistic theory on the role of the board is the safeguarding of shareholder's interest, it follows that corporate directors are deemed as fiduciaries. As fiduciaries, directors bear the embedded duty of loyalty, duty of care, and duty of disclosure to the company and its shareholders (Walsh, 2002). The duty of loyalty requires the directors to act bona fide in the interest of the company; to act within the

director's power and not to allow personal interests to conflict with company interest. Walsh (2002), in tracing the fiduciary foundation of corporate laws, cited the following quote from a 1939 Delaware judgment as a bedrock duty of loyalty:

Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers (p. 334).

The duty of loyalty as described above and the duty of care are the two specific elements used by the courts to evaluate corporate director's fiduciary responsibility when applying the business judgment rule (Farrar, 2005). The duty of care requires directors to exercise the degree of care that a reasonably diligent person would exercise under the same or similar circumstances (Jones, 1993). The business judgment rule requires directors to make decisions on an informed basis, in good faith, with no conflicts of interests, independent of management influence, and with the best interest of the company in mind. While acknowledging the directors' fiduciary duty to corporation, the business judgment rule protects individual directors from liability when acting under good faith, even when such decisions have been deemed financially detrimental to the company (Farrar, 2005).

The director's fiduciary duty of disclosure, traditionally applicable to corporations seeking shareholder approval for the issuance of securities or a merger proposal, requires the board to disclose all information that a reasonable shareholder would deem necessary to form a judgment on the merits or otherwise of such proposed transactions. However, the focus of the duty of disclosure has shifted to directors who allow the release of financial information that is allegedly misleading or

intended to hide the true state of the financial status of the company (Walsh, 2002). The litigation by shareholders against Enron directors is the case in point, illustrating that while the board may delegate the auditing function to an external auditing firm, the duty of disclosure still requires the directors to ensure the accuracy of the resulting financial statements.

Despite the legalistic theory perspective's claim of boards enhancing corporate performance through carrying out their legal responsibilities, empirical studies do not seem to support such propositions. Not only is their impact on firm performance indirect, boards have been found to have failed to fulfil their legally mandated duties (Ong and Lee, 2000). Mace (1971) opines that the board's participation in directing the company is minimal. Similarly, Boulton (1978) finds that the board's review of corporate performance in most cases is minimal, and is meant to meet the minimum requirement of the law. Such empirical findings reinforce the common perception of managerial domination of boards, resulting in calls for corporate governance reforms, such as board with majority independent directors, and a greater monitoring role for institutional shareholders (Useem, 2003; Clarke, 2004).

4.1.3 Managerial Hegemony Perspective

Contrary to the legal theorists' prescription that the board controls the company, the managerial hegemony theory posits that the actual governing and running of the company is in the hands of the corporate management. The general decline of the power of the shareholders (and its representatives, the board) to corporate management could be traced to the seminal work of Berle and Means (1932) whose thesis on the separation of ownership and control lay the foundation of the theory of managerial hegemony (see Chapter One for details, which include works of Chandler, 1977, and Roe, 1996, tracing the dispersion of shareholdings in large public companies, and the emergence of strong managers and its accompanying problems of managerial accountability).

Proponents of the managerial hegemony theory argue that effective control of corporate resources, board appointment process, and proxy mechanisms enable top managers to entrench their interests (Mace, 1971, Herman, 1981). Using data from interviews of 50 directors of some medium and large US corporations, Mace

concludes that typically boards are under management control, and famously remarks that “boards are the creatures of CEO” (1971, p. 3). Mace (1971) also reveals that boards mostly fail in their control role by not asking the discerning questions expected of a monitor, and generally do not supervise the performance of the management and the company. Similarly, Herman (1981) argues that boards, especially large ones, that make in-depth discussion unlikely, are basically weak and powerless. Instead of carrying out their control functions, the boards are reduced to rubber stamping the decisions of management. As such, outside directors are ornaments in the corporate Christmas tree instead of being the agents of shareholders acting as effective monitors of management performance under the agency theory perspective (Herman, 1981). Also, Drucker (1974), one of the earliest and most famous management gurus, laments that boards “do not function” (p. 628).

Lorsch and MacIver (1989) confirm the control thesis of the managerial hegemony theory that real corporate power lies with the top management team. However, during crisis situations, such as the sudden death of the CEO, and takeover bids, outside directors could and should translate their mandate into effective power over the top management team, thereby fulfilling their control functions (Lorsch and MacIver, 1989; Pettigrew and McNulty, 1995). The managerial hegemony theorists’ view of the board is best summarised as “...a legal fiction; a co-opted appendage institution that, despite its formal governing power over management, is in fact dominated by corporate management and, hence, ineffective in alleviating conflicts of interest between management and stockholders” (Kosnik, 1987, p. 166).

On the other hand, Mizruchi (1983) argues that the almost consensus assumption of CEOs domination of their boards could be due to confusion over the nature of corporate control, and that this central thesis of managerial hegemony theory has not been studied in a systematic manner. Interpreting of extant literature convinces Mizruchi (1983) that board controls CEOs and not vice versa as claimed. Also, using data from interviews of 42 directors from 11 large UK companies, Hill (1995) concludes that large shareholders could exert great influence on managerial actions through their representatives in the boards.

Empirically, the efficacy of the managerial hegemony theory is inconclusive. Herman (1981), in analysing the corporate power and control of firms, reveals that there is no difference in terms of company financial performance between owner-controlled and management-controlled firms. In addition, Kosnik (1987) opines that evidence supporting the managerial hegemony theory tends to be found only in single-case studies, which are mostly anecdotes. It must be noted that executive directors responding to questions during interviews are unlikely to admit openly that they dominate the board.

Interestingly, Davis (1991), in studying the adoption of the poison pill (a takeover defense used by a firm's board of directors to substantially increase the cost of a hostile takeover bid) of Fortune 500 companies between July 1984 and August 1989, found that 60 percent of the firms opted for the poison pill approach by the end of 1989. This partially confirms that managerial discretion is still widespread. However, it must be noted that self preservation could be the main factor for the apparent convergence of interests between the directors and top managers on the issue of poison pill. This is because in a successful post hostile take-over scenario, it is almost standard practice to replace most of the board members and top managers.

4.1.4 Concluding remarks

The board of directors, in carrying out its control role, is challenged basically to keep the balance between managerial discretion and accountability to the shareholders. While acting as fiduciaries to serve the best interest of shareholders who provide the capital, the directors are equally aware of the value creating and enhancing activities of top managers, who are responsible for the day to day operation of the firm. This implies an oversight function that to a certain extent, involves an element of confrontation between the executive and non-executive directors, in this rather adversarial model of board governance, especially under the agency theory perspective.

The agency theory perspective of the board's control role, as reflected in the focus given by the respective corporate governance best practice codes of the UK, Australia, and New Zealand (see Chapter Three above), mandates that non-executive directors act as independent monitors of the company. The problem here is that such

policy recommendation makes it hard for non-executive directors to carry out their service and resource dependence roles. This is because the board of directors is not just only a legal entity with mandated powers, but it also operates in the contexts of overlapping and inter-dependent governance structures and processes that are embedded with social norms and power politics. The importance of collaboration and cooperation between the executive and non-executive directors in order to function as an effective board cannot be more than over-emphasised. This is particularly so when one considers that the BOD is seen as a strategic decision making body critical to the performance of a corporation. The BOD is also expected to manage the company's external environmental dependency and uncertainty, the topic of the next section.

4.2 The Resource Dependence Role of the Board of Directors

Besides its control role, the BOD also serves another distinct and important role, that is, the provision of essential resources to the firm in ensuring its successful operation. Using the language of the resource-based view of the firm, in the context of strategic management, resources mean “ anything that could be thought of as a strength or weakness of given firm” (Wernerfelt, 1984, p.172). Thus, under the resource dependence theory perspective, the BOD is “one of a number of instruments that management may use to facilitate access to resources critical to the firm's success” (Johnson, Daily, and Ellstrand, 1996, p.427). The board may also be used “as important boundary spanners that make timely information available to executives” (Zahra and Pearce, 1989, p. 297). It is interesting to note later on that while the board may be able to provide the essential resources, it is the top managers who decide whether to access such resources, especially in the context of the inter-relationship between executive and non-executive directors.

Proponents of the resource dependence theory posit that the BOD is a mechanism for managing external dependencies (Pfeffer and Salancik, 1978), for reducing environmental uncertainty (Pfeffer, 1972 and 1973), for reducing the transaction cost arising from environmental inter-dependency (Williamson, 1984), and for ensuring the ultimate survival of the firm (Singh, House, and Tucker, 1986). Also, the BOD is able to secure essential resources through linkages to the external environment

(Zahra and Pearce, 1989; Boyd, 1990; Pearce and Zahra, 1992; Gales and Kesner, 1994; Johnson, Daily, and Ellstrand, 1996).

Pfeffer and Salancik (1978), widely credited with the theoretical underpin of the resource dependence role of the board, argue that board can provide four primary benefits to the firm. They are, firstly, advice and counsel; secondly, legitimacy; thirdly, channels for communicating information between external organizations and the firm; and fourthly, preferential access to commitments or support from important constituents outside the firm. In this resource dependence role, directors serve to link the firm with its external environment, and to effectively deal with uncertainty (Pfeffer and Salancik, 1978).

Researchers use the proxies of board composition (proportion of inside and outside directors and other variations), board size, and board interlocks to establish the relationship between resources dependencies and firm performance in order to test the efficacy of this theory (Pfeffer, 1972; Pearce and Zahra, 1992; Gales and Kesner, 1994; Boyd, 1990; Boeker and Goodstein, 1991). For example, resource dependence theory predicts a relationship between the degree of uncertainty (or dependency) and the composition and size of the board. Gales and Kesner (1994), using a sample of 127 bankrupt firms and a similar number of non-bankrupt firms, find that the former group has smaller board size than the latter group before and after bankruptcy. They also reveal that bankrupt firms' board size decline during the two years prior to bankruptcy, and that more outside directors are appointed after the firms filed for Chapter 11 re-organization.

Empirically, researchers use change measures of organizational performance to capture the effect of board composition on firm performance. This is designed to support the thesis "that boards which fit the firm's external environment or aid in absorbing uncertainty enhance company performance" (Zahra and Pearce, 1989, p. 299). One of the earliest researchers who tested this proposal by using cross-sectional analysis to examine firms in different environmental context is Pfeffer (1972). Using data from 80 non-financial institutions, Pfeffer (1972) shows that both board size and board composition are co-related positively with firms' dependence to co-opt external environmental constituents. In addition, Pearce and Zahra (1992)

confirm that board composition (proportion of affiliated and unaffiliated outside directors) and board size are positively related to future financial performance. A recent study by Hillman, Cannella, and Paetzold (2000) conclude that US airline companies under-going de-regulation pressures respond to changes in their external environment by altering their board composition.

Johnson, Daily, Ellstrand (1996) contend that board interlocks provide an example of direct application of board's resource dependency. A direct interlock happens when one or more directors of the same firm serve on the board of another company, where else an indirect interlock occurs only when directors of two different companies serve on the board of a third company (Zahra and Pearce, 1989). Lang and Lockhart (1990), in a longitudinal study of interlocking among eight airline companies which are direct competitors, reveal that de-regulation in the industry creates pressures for competitors to form direct board interlocks. They also find evidence of direct interlocks between competitors after de-regulation. More importantly, they find that company interlocking with financial institutions is positively related to the company's financial dependence.

Research results generally support the thesis that board interlocks with financial institution facilitate the firms' access to financial credit. Pfeffer (1972), Stearns and Mizruchi (1993), and Mizruchi and Stearns (1994) have all established the linkage between board interlocks with financial institutions and the firms' subsequent acquisition of credit funds. These results support the exertion of Mizruchi and Stearns (1988) that directors facilitate access to capital.

On the other hand, Burt (1983) proves empirically that there is no link between corporate profits and co-optation through interlocking directorates. Additionally, Zajac (1988) questions the claims of direct interlocks between competitors and concludes that companies do not co-opt their competitors through board interlocks. By examining more specific industry definitions (instead of the early broad industry classifications used by previous researchers), Zajac (1988) shows that the extent of competitors interlocking is much less prevalent than previously thought to be. Nevertheless, while interlock is almost always between competing firms under board interlock theory, the resource dependence theory focuses on director's linkage to

both competitors and other external environmental constituents (Zahra and Pearce, 1989).

Researchers also study the roles played by individual directors as environmental links. Inside directors are designated to serve on boards primarily to provide firm-specific information (Fama and Jensen, 1983a), even if they have linkage with environmental constituents. On the other hand, outside directors are largely needed to cope with external factors. Kesner (1988) and Kosnik (1990) both opine that each director brings to the firm unique attributes that can be used to determine the kind of resources a particular director is likely to provide to the board. Baysinger and Butler (1985) conclude that differences in directors attributes are perhaps more visible in terms of their respective experience and occupational backgrounds, reflecting the heterogeneity of resources such as expertise, skills, information, and linkages to external constituencies, that could be provided to the board. The contribution of directors in providing resource is confirmed by the findings of Gales and Kesner (1994) that directors bring resources such as skills, information, legitimacy, and linkage to key outside constituents and non-shareholding stakeholders to the firm. Furthermore, empirical support has been found to the notion that directors enhance the reputation and credibility of their companies (Daily and Schwenk, 1996; Hambrick and D'Aveni, 1992). In addition, corporations with prestigious board members also experience better pricing performance at their initial public offering (Certo, Daily, and Dalton, 2001).

Individual directors perceived to have connections and influence with US government have been found positively linked to higher shareholder value (Hillman, Zardkoohi, and Bierman, 1999). The above empirical example could perhaps be used to provide support to the perceived potential of reducing transaction cost associated with the interdependencies between the firm and the various institutions in the environment, as originally posited by Williamson (1984). Other research results also show that individual directors' connections enable companies to secure essential resources mostly on more favourable terms (Boeker and Goodstein, 1991; D'Aveni, 1992; Zald, 1969). For non-profit agencies on the other hand, their ability to raise fund is greatly enhanced when prominent and influential community members serve on their board (Provan, 1980). Zald (1967), using data from study on

the Chicago area YMCA fundraising efforts, reports that the percentage of business leaders on the boards is positively associated with financial contributions.

Despite its strong theoretical grounding (sociology and organisational theory), the resource dependence perspective is not free from criticism. Zahra and Pearce (1989) contend that the theory fails to articulate the processes by which directors link the company and its environment. This is particularly so since boards need to strategize to achieve the fit. The substantive context of board interlock appointments also needs to be examined if their consequences are to be understood (Pettigrew, 1992). It is to be noted that such concerns have been partly addressed by the findings of Carpenter and Westphal (2001) that boards consisting of directors having ties to strategically related firms are able to provide better advice and counsel to their focal firms, by using a socio-cognitive perspective to account for the substantive context of how board interlock could enhance the strategic role of the directors (see Section 4.3.1 below).

Hillman, Cannella, and Paetzold (2000) assert that the common outsiders and insiders (and other board composition variations) definitions are less appropriate for resource dependence role, and recommend taxonomy for directors classification which separates resource dependence role from the agency control role. It must be noted that in reality the boards carry out both the control and resource provision functions, in line with calls by corporate governance scholars for multi- theoretical perspectives to present a more complete picture of board composition and firm performance (Daily, Dalton and Cannella, 2003; Hillman and Dalziel, 2003).

4.2.1 Concluding Remarks

Despite its limitations, the ability of board members to source resources from external constituents and providing essential resources to the firm have in general been proven empirically. Nevertheless, in order to carry out its resource dependence role more effectively, an individual board will need to determine what types of resources and linkages are the most salient in a given environment. In order to do so, the board must conduct an audit of its own strength and weaknesses, in relation to its external environmental constituents. This has policy implication when recommending the nomination and selection of new directors. This is especially so in

the context of evaluation of board and individual director performance, a recommendation of the NZX Corporate Governance Best Practice Code (see Chapter Four below). The result of a BOD performance evaluation could be used to determine whether the board is properly staffed to manage its external environmental dependency and uncertainty. Any remedial measure could then be used to strengthen the follow-up individual director performance evaluation process.

4.3 The Service Role of the Board

The service role of the board is defined as “enhancing company reputation, establishing contacts with the external environment, and giving advice and counsel to executives” (Zahra and Pearce, 1989, p. 292). It is also characterised as “directors advising the CEO and top managers on administrative and other managerial issues as well as more actively initiating and formulating strategy” (Johnson, Daily, and Ellstrand, 1996, p. 411). It is interesting to note that some of the functions described under the service role seem to overlap with those of the resource dependence role, including the part regarding corporate strategy. The researcher is therefore going to analyse the service role under the strategic decision-making perspective as well as the stewardship theory perspective.

4.3.1 Strategic Decision-making Perspective

The strategic decision making perspective of board’s service role envisages that the board serves as a strategic consultant to top managers, in addition to its independent control functions. This dual role of the board is in line with the original prescription of Pfeffer and Salancik (1978). The strategic role of the board separates it from the work of the management, making it the defining characteristic of board endeavours (Tricker, 1984; Lorsch and MacIver, 1989; Hilmer, 1993). Based on the empirical data collected from the McKinsey Global Survey of more than 1,000 directors, Felton and Fritz (2005) reveal that the directors, having focussed for a long time on accounting-compliance issues, are now determined to play an active role in setting the strategy, assessing the risks, developing the leaders, and monitoring the long-term health of their companies.

However, the extent of the board’s involvement in strategic activities is blurred by the definitions of corporate strategy. Strategy has been traditionally thought of as the

result of formal planning, usually initiated by top managers and undertaken by corporate planners at the head office to establish long term objectives (Chandler, 1962; Ansoff, 1965). However, the problems of environmental uncertainty and bounded rationality of managers make planning more complex and less valuable. As a result, research on the process of strategy shifts its focus from prescription towards a descriptive understanding of the complexity of strategy “as a pattern in a stream of decisions” (Mintzberg, 1978; Mintzberg and Waters, 1985). Strategy in this perspective is viewed as emergent, rather than as planned or deliberate (Burgelman, 1983, 1991). Acknowledging that no strategy could be perfectly emergent without some elements of planning, then deliberate and emergent strategies would “form the poles of a continuum along which we would expect real-world strategies to fall” (Mintzberg and Waters, 1985, p. 3). In addition, the strategic process ranges from articulation of the mission statement to implementation, control, and review that involve some 26 potential roles for the directors (Zahra, 1990).

Extant governance literature suggests a considerable variance of board involvement in strategic decision making, ranging from minimal to formulation of strategy. Using data from interviews with 50 directors of medium and large US companies, Mace (1971) concludes that board involvement in strategic decision-making is minimal, unless the organisation is in crisis. This picture of board passivity during normal times is confirmed by the study of Losch and MacIver (1989), although they report that boards act as strategy advisors to the CEO.

The limited board involvement in the strategic decision making activities is often blamed on management entrenchment. Boards are less likely to exert control over strategic decision-making when members lack formal or social independence from management. Such perceived lack of power or independence could be reflected in the percentage of non-executive directors, or the presence of friendship, family and other social ties, and connection between directors and top management (Baliga, Moyer, and Rao, 1966; Boeker and Goodstein, 1993; Hill and Snell, 1988; Mallette and Fowler, 1992). However, Westphal (1998) shows that there is little consistent evidence to support the proposition that increases in structural board independence raises the level of board involvement in strategic decision-making.

The level of managerial influence in strategic decision-making can be shown in the study of Ferlie, Ashburner, and Fitzgerald (1994). In a longitudinal and comparative case study of 11 National Health Service sites in the UK, and using data collected from interviews, archival analysis, and attendance at board meetings, they suggest that there are three levels of board involvement in strategic decision-making. First, rubber stamp, second, probing and questioning of strategic options, and third, active involvement in deciding between options, including shaping the vision of the agencies. Factors that are cited to influence progression through levels include experience, expertise, and confidence of the non-executive director, and significantly, whether the managers want them to make the transition. Hill (1995) also reports that the influence of the executives, especially the CEO and established board culture can limit the effectiveness of non-executive directors. However, the recent corporate governance reforms, including the introduction of best practice codes (see chapter Three above), have shifted the balance of powers increasingly to the advantage of the directors, and there seems to be a higher awareness among senior executives that they serve at the pleasures of the BOD. Managers are also increasingly more prepared to provide relevant information to directors in order to enable the latter to be involved and in determining top company decisions (Useem and Zelleke, 2006).

The reasons for the inability of non-executive directors to contribute effectively in the focal firm's strategic decision-making process could be due to extreme constraints on their available time, considering that most of them hold full-time jobs. In addition, the avalanche of materials and information (or lack of) makes it harder for directors to sufficiently learn enough about the company and the industry to be significant contributors in the strategic decision-making processes (O'Neal and Thomas, 1996). However, Tashakori and Boulton (1983), from data gathered through a survey of CEOs, reveal that increasingly, boards are involving themselves in all phases of the strategic planning process. Nevertheless, they note that most directors do not directly engage in strategy formulation. This finding is supported by an important UK study; based on data collected from interviews with 51 directors of large UK corporations and case study into four large UK firms, Stiles and Taylor (2001) conclude that "boards are not involved to any great extent in the strategy formulation process, but rather set the parameters within which strategic discussion

take place” (p. 119). They contend that the board’s gate keeping role induces strong incentives for executives to perform to their best efforts, confirming the findings of Mace (1971) that the obligation to appear or submit reports to a formal authority acts as a driver to efficiency. They also suggest that the strategy making process in large UK companies does not occur in a purely top-down fashion. Rather, strategy is typically developed at both executive committee and business unit level, confirming the findings of Burgelman (1983, 1991) and Mintzberg and Waters (1985).

In contrast, Judge and Zeithaml (1992) provide evidence to support directors’ involvement in strategy formulation. Using data from interviews with 104 CEOs and directors of Fortune 500 companies, and relying on institutional and strategic choice theories, they argue that board size, number of inside directors, firm diversification, and company age are related to board involvement in strategy formulation. In addition, the findings of Palmer, Jennings, and Zhou (1993) on the adoptions of multi-divisional corporate structure, as well as the finding of Haunschild (1993) on acquisition strategies, offer evidence that directors not only provide strategic advice, but also initiate significant changes in corporate strategy.

The strategy-performance linkage finds support in the study of Judge and Zeithaml (1992), who report that board involvement in the strategic decision-making process is positively associated with firm financial performance. The findings of Pearce and Zahra (1991) also confirm the positive relationship between board involvement in strategic decision-making and firm performance. Their research on 139 companies from the Fortune 500 list reveals that participative boards, where both the CEOs and directors are equally powerful, work synergistically to develop explicit strategies that enhance the earnings per share of the companies. Also, Conger, Lawler, and Finegold (2001), using data from Korn/Ferry International Surveys, proved empirically that boards which actively participate in corporate strategy formulation associate positively with better firm performance.

Using a socio-cognitive perspective, Carpenter and Westphal (2001) exert that boards consisting of directors having ties to strategically related firms are able to provide better advice and counsel to their focal firms. Importantly, such strategic advice has been linked positively to firm performance (Westphal, 1999). The

external strategic connections of executive directors have also been found to play a critical role in the future strategy formulation of focal firms, and subsequent firm performance, as shown in the empirical studies of Eisenhardt and Schoonhoven (1996), and Geletkanycz and Hambrick (1997).

The extent of board involvement in the formulation of corporate strategy during normal corporate environment could prove to be controversial. This is because initiation and implementation of corporate strategy is commonly perceived to be the domain of the executives, who may feel resentful to have their turfs invaded. Fama and Jensen (1983b) posit that the contract structures of a corporation separate the rectification and monitoring of corporate strategy (by the board) from initiation and implementation of such strategy (by the management). They claim that such functions specialisation ensures the survival of the firm. On the part of the non-executive directors, there is also the question of legal liability, which may impede their willingness to be too deeply involved in the formulation of corporate strategies (Zahra and Pearce, 1989), although it is noted that the business judgment rule of the court is based more on duty of care than the degree of involvement.

Zahra and Pearce (1989) contend that agency theory also places great importance on board involvement in initiating and monitoring of the implementation of corporate strategies. Kang, Cheng, and Gray (2007) opine that a BOD's lack of independence from management could hamper its contribution to strategic decision making. It must be noted, however, that outside directors may not have the time and the expertise to contribute meaningfully, besides being involved in the normal annual budgetary planning sessions. Using data from surveys of New Zealand directors, Van de Walt and Ingley (2001) reveal that the contribution of outside directors in terms of their ability to provide strategic vision is perceived to be low.

4.3.2 The Stewardship Theory Perspective

Meanwhile, it may be useful to examine another theoretical perspective which challenges the agency theory assumptions of inherent conflict of interests between managers and owners and the depictions of managers as self-interested and opportunistic agents rationally maximising their own economic gains at the expense

of the shareholders. This is the stewardship theory perspective of board role.

It may be recalled that stewardship theory is used to compare with agency theory to reflect the two contrasting approaches to corporate governance (see Section 1.4.2, Chapter One for details on the stewardship theory). It can be said that in essence, stewardship theory proposes that managers are essentially trustworthy individuals or good stewards of the resources entrusted to them. Top managers as stewards are motivated to act in the best interest of their principals, since they are assumed to be collectivists and pro-organisational (Donaldson and Davies, 1991). Many managers are stewards whose motives are largely aligned with the objectives of their principals (Donaldson, 1990).

Stewardship theory emphasizes the service role of the board (Davis, Schoorman, and Donaldson, 1997). Stewardship theorists advocate a collaborative approach to corporate governance, calling for boards to advise and enhance corporate strategy formulation. However, what is the efficacy of the service role of the board under the stewardship theory perspective? To empirically prove the exertions of the theory, supporters point to the superior amount and quality of information possessed by inside directors (Baysinger and Hoskisson, 1990), the positive relationship noted between research and development spending, and the presence of inside directors (Baysinger, Kosnik, and Turk, 1991), and a more balanced approach to CEO compensation (Boyd, 1994).

Stewardship theorists also focus on the needs of the BOD to design enabling corporate governance structure which empower top managers, especially the CEO. As such, stewardship theory supports the CEO-Chairman duality of board leadership structure (Donaldson and Davis, 1991, 1994; Fox and Hamilton, 1994). However, empirical results has been mixed (for details, see Section 3.1.1 above). While some research results reveal that independent board leadership structure is associated with higher firm performance (Daily and Dalton, 1994; Rechner and Dalton, 1991), others show that CEO-Chairman duality structure produces significantly higher firm performance (Donaldson and Davis, 1991; Frinklerstein and D'Aveni, 1994). Yet other researchers have found no difference in firm performance between independent

board leadership and CEO/Chairman structures (Chaganti, Mahajan and Sharma, 1985; Molz, 1988).

4.3.3 Concluding Remarks

So far, the discussion here assumed that the BOD only performs its service role, with no consideration of the resources dependence role and the control role. In reality, the BOD performs all three roles, not always at the same time, but may be at different stages of the company's life circle and the CEO's tenure.

Shen (2003), using an evolutionary perspective, argues that during the CEO's early tenure, the risk of managerial opportunism is low. As such, the board should concentrate on its service role by providing advice and counsel in order to maximise the potential performance of the CEO. However, once the CEO has proven his or her leadership on the job, and as CEO tenure progresses, the board should shift its focus to control managerial opportunism. Shen (2003) opines that it is unrealistic and over simplified to adhere to standard managerial behaviours to assume that the CEO is either an opportunistic agent or a dutiful steward. However, the increased risk of managerial opportunism as the CEO tenure progresses should not be ignored by the board.

The resource dependence role and service role, though not ranked as important as the control role of the board, are also vital for an effective board. The main challenge to the board, in carrying out its service and resource dependence roles, is to manage the working relationship between the non-executive directors, especially the independent directors, and executive directors. This is particularly so when one considers that while the board may be willing or in a position to provide strategic advice and counsel, it is often up to the management whether they will like to take the opinions of outside directors into consideration when making decisions, as reflected in the various research findings.

4.4 Chapter Summary

The roles and functions of the BOD are defined differently in accordance with differing and sometimes contrasting theoretical perspectives. While the agency theory, and to a lesser extent, the legalistic theory, promote the primary role of the

BOD as controlling and monitoring of managerial opportunism, the managerial hegemony theory laments that the board is a creation of the CEO and a legal fiction. Such contrasting perspectives, however, do not seem to take into account the changes taking place in the 21st century boardrooms arising out of the recent corporate governance reforms, especially the adoption of best practice codes, and the implementation of the Sarbanes-Oxley Act, 2002 (see Chapter Three). The establishment of the audit, remuneration, and nomination committees with majority independent director membership should theoretically shift the power balance to the advantage of the BOD.

The resource dependence role and the service role of the BOD, on the other hand, are very much contingent on the management of the working relationship between the executive and non-executive directors. Herein underscores the dilemma for outside directors, as research shows that good social ties between directors and management foster trust, which encourages managers to seek greater input from directors and reduce the need for impression management (Westphal, 1999). However, outside directors who are supposed to be independent (especially so stated under the various best practice codes) are expected to focus on their control role. This only makes it hard for the non-executive directors to carry out their service role, since their views may not be considered by the management seriously. The choice between the control approach and the collaborative approach is a fine balance that the BOD must learn to pursue and live with. Perhaps, it might be useful to examine further the argument of Shen (2003) that during the early stage of the CEO tenure the BOD concentrates on its service role to maximise the potential of the CEO. Once the CEO has proven his or her leadership on the job, and as the tenure progresses, the BOD shifts its focus to control role to monitor managerial opportunism.

The recommendations for BOD and individual director performance evaluations, and the setting up of nomination committee (see Chapter Three above) should together provide extra space for the application of the resource dependence theory in the implementation of the best practice code. Board and director performance evaluations necessitate a re-examination of a company's external environment in relation to its internal capacity and capability, and the nomination committee should

be tasked to select the most suitable candidates with external networking in order for the BOD to adequately provide the necessary resources to the company.

Despite management scholars' enthusiasm for board involvement in strategy formulation, and directors' opinionated desires in setting corporate strategy, empirical results are inconclusive. Besides, the involvement of the BOD in strategy formulation may prove to be controversial, with the tensions that it is likely to create with the management. Monitoring long-term strategic directions and providing strategic leadership are different from active involvement in corporate strategy formulation, given the time constraints and other agenda during board meetings. Strategy is also now considered more emerging in nature, rather than planned, and the ability of the independent directors to contribute meaningfully is also in doubt.

Taking all the above factors into consideration, the primary function of the BOD seems to be the control role. This perception is in line with the express intentions and actions of the institutional investors, stock exchanges and securities regulators. This agency theory perspective is reflected in the recommendations of the various corporate governance best practices codes, as aforementioned in Chapter Three above.

Agency theory, resource dependence theory, and stewardship theory all have enhanced our understanding of the various roles and functions of boards of directors and their contribution to corporate performance. However, empirical evidence linking the efficacy of these theories to corporate performance is equivocal as noted from the aforementioned literature review. Perhaps the operationalisation of these three theories have tended to leap from input variables such as board composition and board inter-locks to output variables such as board effectiveness and firm performance. It could also be that ignoring the effects of intervening board process constructs contributes to the reason why extant research findings are inconclusive. Gaining direct access to the inner working of the BOD to study process variables, however, is almost an impossible task, especially when sensitive commercial and strategy related matters are involved. As a result, academic researchers usually would have no choice but to study BOD from its outside appearance, such as board composition, independence of directors and other external structures, including

CEO/Chairman duality. It is also to be noted that the various BOD studies published thus far seems to be a bit dated. This probably is because no major BOD academic study has been published since the 2003 *Academy of Management of Review* series on corporate governance and BOD.

Chapter Five – Research Framework

Introduction

This chapter examines the research framework which outlines the research problem and questions, research objectives, hypotheses development, ethical consideration, and methodology, including data collection.

5.1 Research Framework and Theory

As pointed out in Chapters Three and Four above, the theoretical underpin of the principles and recommendations of all the corporate governance best practice codes is the agency theory. This is true of the original UK 1992 Cadbury Code (and also the present Combined Code, 2003), the Australian Stock Exchange Corporate Governance Council Best Practice Code (ASX CGC Code, 2003, updated 2007), the New Zealand Exchange Corporate Governance Best Practice Code (NZX Code, 2003), the New Zealand Securities Commission Report to the Minister of Commerce on Corporate Governance Principle and Guidelines (NZSC Report, 2004), and amendments to the listing rule of the New York Stock Exchange (NYSX) relating to corporate governance as mandated by provisions of the Sarbanes-Oxley Act, 2002. The agency theory perspective is reflected in the various codes' focus and emphasis on board independence in terms of proportion of independent directors in board composition, separate board leadership structures or presence of lead independent director, preferred committee structures with all or majority independent directors, and the importance of external auditor independence.

Agency theory focuses on the minimisation of agency cost, which arises out of the principals (owners) and agents (managers) relationship. The principal-agent relationship is described by Jensen and Meckling (1976) as a contract under which the owners (principals) engage the managers (agents) to perform some services on their behalf, which involves delegating some decision making authority to the agents. It is this delegation of authority which potentially produces agency problems, the misalignment of interests among principals and agents. To ensure that agents act in the interests of principals, agency theory asserts that firms could employ various governance mechanisms, especially the use of board of directors, to monitor the

behaviours of agents (Fama, 1980; Jensen and Fama, 1983). A detailed analysis of the agency theory (including its assumptions, contributions, and shortcomings) is found in Chapter Two (Section 2.3.1). For the efficacy of agency theory and firm performance, please refer to Chapter Four (Section 4.1.1).

5.2 Research Problem and Questions

As pointed out in Chapter Three (Sections 3.8), there seems to be a general wide acceptance of and compliance with the recommendations of the Cadbury Code/ Combined Code in the U.K. It is noted, however, that more than 16 years after the introduction of the original Cadbury Code in 1992, there have been only a few studies that had determined the relationship between compliance of corporate governance best practice code and firm performance. The results of these few studies had also proven to be inconclusive empirically (see Section 3.9 above). Nevertheless, this research problem has given rise to the opportunity to conduct an original study in New Zealand, taking into account local conditions, to explore the possible link between compliance with NZX Code and firm performance. Analysing the relationship between board structures before and after the introduction of NZX Code may perhaps allow a link to be made between full compliance with the NZX Code and firm financial performance. It may be recalled that NZX Listing Rule 10.5.3(i) requires listed firms to include in their annual reports a corporate governance statement about the extent of their compliance with the NZX Code. As a result of the expected discrepancy (variance) in the extent of compliance with the NZX Code among listed companies, there appears a good opportunity to carry out an original study on the possible relationship between NZX Code compliance and firm financial performance. There is a need, however, to review the extent of compliance with the NZX Code, so that the impact of full compliance on firm financial performance could be established. As such, two research questions are emerging out of the above research problem.

The research questions therefore are as follows:

- 1) To what extent have New Zealand listed companies complied with the recommendations of the NZX Code?

- 2) Would full compliance with the NZX Code have any positive impact on the financial performance of listed companies, assuming all other factors being constant, as predicted by agency theory?

As far as the researcher is aware, no such study has been conducted in New Zealand. There is, therefore, a perceived knowledge gap that needed to be filled.

5.3 Research Objectives

The research objectives here are two-fold. Firstly, to review the extent to which listed firms have complied with the NZX Code requirements and other recommendations. Requirements here refer to the compulsory provisions such as the minimum of two independent directors and the establishment of an audit committee, while recommendations refer to the discretionary provisions such as establishment of remuneration and nomination committees and the performance evaluations of board and individual directors. The latter provisions are dependent on company size and culture. The second objective of this research is to test the agency theory predictions on NZX recommended board structures and practices, so as to enable the researcher to answer the research questions as spelled out in Section 5.1.1 above.

5.4 Theory, Empirical Evidence and Hypotheses

Hypotheses are to be developed from agency theory predictions and extant empirical evidence on NZX preferred board structures and practices, and firm performance. The independent variables to be analysed in this study include ratio of independent directors on the board, non-duality of CEO/Chairman positions, establishment of audit committee, remuneration committee, and nomination committee, and the performance evaluation of board and individual director. The dependent variable to be analysed here is firm financial performance. Each of these variables is to be examined separately, as follows.

5.4.1 Firm Performance

Treating firm performance as a dependent variable is a common practice in organisational research, and particularly so in the field of strategic management studies. March and Sutton (1997), however, caution that trying to identify the causal relationship in organisational performance phenomena with incomplete historical

data is problematic because it may lead to spurious conclusions. The same caution was made earlier by Pettigrew (1992), who contends that “the study of boards and their directors has not been helped by over-ambitious attempts to link independent variables such as board composition to outcome variables such as board and firm performance” (p. 178).

March and Sutton (1997) also argue that since the problems of defining, measuring, and explaining the two terms “performance” and “effectiveness” are virtually identical, scholars tend to use these two terms interchangeably. Although organisational performance could be analysed at a disaggregated level, such as the many value chain activities (Porter, 1985), management scholars should be more concerned about aggregate assessments of organisational performance. Nevertheless, it is justifiable to use socially constructed evaluation criteria to measure the overall organisational effectiveness (March and Sutton, 1997). In addition, Starbuck (2005) posits that although performance measures are prevalent and important, they are methodologically challenging. This is because performance measures frequently evaluate something other than what researchers assume they are. Starbuck (2005) conclude that it is useful to know more about the determinants of performance measures that make them effective, since the importance of performance measures is not that they correlate with other variables, but that performance measures can alter performance itself.

To mitigate the performance measure problem, Combs, Crook, and Shook (2005) suggest that operational performance and organisational performance are distinct and separate constructs. Furthermore, since operational performance itself is multidimensional across many different value chain activities (Porter, 1995), operational performance is best treated as an antecedent to organisational performance. Similarly, organisational performance could be further categorised into accounting returns, stock prices, and growth measures (Combs, Crook and Shook, 2005). They argue that organisational performance measures should be justified based on their appropriateness for the research setting and their validity as established in the literature. Thus, by understanding the dimensions of central constructs and building this knowledge into theories and empirical tests, the determinants of organisational performance could be better known.

A review of the above research findings implies that multidimensional models such as the balanced scoreboard (Kaplan, and Norton, 1992), which comprises both financial and operational measures, might be methodologically too challenging and problematic. Although conceptually attractive to complement financial measures with operational measures under the balanced scoreboard model, it would be very difficult to operationalise the constructs and to validate their efficacy.

In view of the above findings, the researcher is using the accounting measure of return on assets (ROA) as the measurement of firm financial performance in this study. ROA here is calculated as earnings before interest, taxes, depreciation and amortisation (EBITDA) divided by total assets at the beginning of the financial year (Dayha, McConnell and Travlos, 2002). Preliminary survey by the researcher found that some New Zealand listed companies provide EBITDA figures in their annual reports. Total assets at the beginning of the financial year are used because of the lagged effect of asset usage impact on firm earnings which should be captured only at the end of the financial year. Combs, Crook and Shook (2005) suggest that ROA is a reliable accounting measure of a firm's financial performance.

Another reason for the choice of ROA as a performance measure is its wide usage in the literature. Out of the five empirical studies on the relationship between Cadbury Code compliance and firm performance, four of them use ROA as a measure for firm financial performance (see Section 3.7, Chapter Three). Of the four, three of them (Dahya, McConnell, and Travlos, 2002; Dahya and McConnell, 2007; Weir and Laing, 2000) also use stock market returns as an additional measure for firm performance. Weir and Laing (2001), however, use only ROA as the dependent variable for firm performance measure.

In addition, Fox and Hamilton (1994) also use ROA as the sole measure to test agency theory and stewardship theory predictions on the efficacy of the diversification strategies of large New Zealand companies from 1975 to 1985. Commenting on the choice of ROA as a measure of firm performance, they reason that "it appears to be generally accepted as valid measure of overall company performance, one which is not too sensitive to differences in financial structures. It is

also a measure that which can be compared meaningfully with general inflation rates...”(Fox and Hamilton, 1994, p.76).

Although ROA is a good proxy for accounting measurement of firm financial performance, it has some disadvantages too. Some of the major weaknesses of ROA as measurement of firm performance include the argument that ROA ignores changes in working capital, it does not consider capital expenditure requirements, it could be misleading when looking at liquidity, and that ROA does not reflect the quality of earnings (Healy, 2003). It must be noted, however, that the use of ROA as measurement of firm financial performance is guided by literature, for its measurement validity and reliability.

Literature review also convinces the researcher not to use stock market returns as an additional measure of firm performance. Bhagat and Black (2002) caution the use of stock market returns as a performance measure; since they are susceptible to investor anticipation, and therefore always almost result in correlation coefficients to be biased towards zero. In other words, investor anticipation of the effects of board composition on firm performance would render the stock returns rhetoric and insignificant, even if in fact there exists a correlation between board independence and firm financial performance. Furthermore, Starbuck (2005) argues that conflicting sub-goals in organisations result in the volatility of the overall performance measures. Comparing corporate earnings and stock prices of measures of firm financial performance, he posits that the latter is more volatile since stock prices reflect unstable balances between huge numbers of optimistic investors and huge numbers of pessimistic ones. On top of that, when news on changes in profit expectations or world economy that has no bearing on the focal companies they have invested, some investors become more optimistic or more pessimistic, resulting in further volatility in stock prices (Starbuck, 2005).

5.4.2 The Proportion of Independent Directors

One of the devices which board of directors (BOD) could deploy to strengthen its monitoring function is to increase the number of independent directors in their board. This is important because conceptually, an effective board is associated with a greater number of outside directors (Mizruchi, 1983; Fama and Jensen, 1983; Lorsch

and MacIver, 1989; Zahra and Pearce, 1989). Also, in the study of the relative power of CEOs and BODs, and their connection with board performance, Pearce and Zahra (1991) suggest that powerful, independent boards are associated with superior firm financial performance. Other US studies which tie higher ratios of outside directors to better firm performance include Baysinger and Buttler (1985), and Byrd and Hickman (1992). In New Zealand, Hossain, Prevost, and Rao (2001), using data of listed companies for the years 1991 to 1997, find a statistically significant link between outside directors and firm performance. Also, Dahya and McConnell (2007) find that U.K. listed companies which comply with the Cadbury Code recommendations of having at least three outside directors show a significant improvement in corporate performance, as measured by return on assets (ROA). Over the period 1989 to 1996, Cadbury Code compliant firms financially outperformed their non-compliant peers, both in terms of ROA and stock market returns. It is noted that most of the studies use the term outside directors without determining their “independence” from management. Rhoades, Rechner, and Sundaramurthy (2000) in a meta-analysis study that adjusted for stricter definitions of outside directors, reveal a slight positive relationship between higher ratio of independent directors and firm performance.

On the other hand, a meta-analysis by Dalton, Daily, Ellstrand and Johnson (1998) does not reveal correlation between board independence and firm performance. In addition, longitudinal studies by Bhagat and Black (1999; 2002) find that firms with more independent directors in their boards do not perform better than other firms. In the UK, Weir and Laing (2000) also do not find the relationship between proportion of non-executive directors and firm performance. Furthermore, Muth and Donaldson (1998), using data from a sample of 145 companies listed on the Australian Stock Exchange, conclude that the proportion of independent directors is negatively associated with shareholder wealth and sales growth. Using data from the top 100 Australian companies, Lawrence and Stapledon (1999), however, note that there is a slight positive correlation between the proportion of independent directors and firm financial performance.

Despite the lack of conclusive evidence to link the contribution of independent directors to firm performance, the NZX Code requires New Zealand listed

companies to have at least two independent directors in their boards. This requirement is reinforced by the amendment to NZX Listing Rule 3.3, stipulating that the minimum number of independent directors are to be two, or one third (rounded down to the nearest whole number of directors) of the total number of directors, whichever is the greater. In line with NZX Code requirement and agency theory prediction that higher proportion of independent directors enhances board monitoring role effectiveness, and thus better firm performance, it is hypothesised as follows:

H1: New Zealand listed companies which have a higher proportion or percentage of independent directors in their boards would be associated with better firm financial performance.

5.4.3 Board Leadership Structure

NZX Code requires that a director of listed companies “should not simultaneously hold the position of Chief Executive and Chairman of the Board” (Code 2.1). In other words, there should not be a combined leadership structure or duality of role by an individual director. Jensen (1993) asserts that the combined leadership structure is an inappropriate way to design one of the most crucial power relationships in a publicly traded corporation. This agency theory perspective contends that CEO/Chair duality creates a concentrated power base that will allow the CEOs to make decisions in their own interests, and at the expense of shareholders. In contrast, separating the two positions enables the board to carry out its monitoring role more effectively.

Rachner and Dalton (1991) empirically conclude that firms opting for separate leadership structures consistently (over a six year period) perform better than those having the CEO/Chair dual leadership structures. On the other hand, however, Dalton, Daily, Ellstrand, and Johnson (1998) and Baliga, Moyer, and Rao (1996) conclude that there is no difference in firm performance within combined or separated board leadership structures companies. In addition, there are research results which link CEO-Chairman combined leadership structure with high firm performance (Donaldson and Davis, 1991; Finkelstein and D’Aveni, 1994).

Nevertheless, in order to test the agency theory prediction on separated board leadership structure in New Zealand (which is also the rationale of NZX Code recommendation), it is hypothesised as follows:

H2: New Zealand listed companies which separate the positions of CEO and Chairman of the board would perform better than those with combined board leadership structures.

5.4.4 Board Committees

The NZX Code requires the establishment of an audit committee by all listed firms (Code 3.1), and recommends the establishment of a remuneration committee, and a nomination committee (Codes 2.2 and 2.5 respectively). Besides requiring listed firms to have written charters for the various committees to spell out their duties and responsibilities, the NZX Code does not explain the rationales or the potential benefits of establishing such committees.

The New Zealand Securities Commission (NZSC), however, outlined in its handbook (NZSC Handbook, 2004) how board committees can enhance board effectiveness through closer scrutiny of issues, and more efficient decision making in important aspects of board responsibility. Furthermore, committees enable the board to fairly apportion board workload among member directors in order to maximise the use of members' particular skills, knowledge, and experience.

Cadbury (2002) opines that the setting up of board committees is one way to prevent board meetings from becoming otherwise overloaded. Charkham (2005) also states that the main purpose of board committees is to more effectively and efficiently manage board affairs in greater detail than would otherwise be convenient to the whole board. Another purpose is to increase objectivity either because of inherent conflicts of interest such as executive remuneration, or the more sensitive issue of disciplining personal preferences as in the exercise of patronage in the nomination of new directors. The author also suggests that the establishment of board committees provide opportunity for non-executive directors to involve themselves in more detail in some key areas of corporate governance, and "the confidence to intervene when they should and the knowledge about when not to" (Charkham, 2005, p. 322).

Additionally, Lechem (2002) contends that by delegating some of its duties to the committees, the boards have more time to focus on strategic issues. Planned rotation of committee membership gives each individual director an opportunity to experience as many facets of board governance as practicable. Committee structures also allow senior management to present their case in a less formal atmosphere that encourages two-way flows of information. At the end, however, all committees must report to the full board, in order to maintain the accountability of the board (Lechem, 2002).

The importance of having only independent directors in the three board committees can be shown by the analysis of Useem (2003) on the collapse of Enron. The author opines that if Enron's audit committee had not included two directors who were not independent, it may have earlier questioned the purpose of the company's increasingly questionable special purpose entities. Also, if the chair of the compensation committee had not formally served as President of the University of Texas Cancer Center which had received huge Enron donations, he may have more diligently investigated suggestions that the chief financial officer was enriching himself at the expense of the company.

From the above analysis, one may deduce that the establishment of audit, remuneration and nomination committees and their composition are crucial to the efficient operation and effective functioning of the boards. Each of the three board committees are now to be discussed as follows.

Audit Committee

The NZX Code requires that each listed company should establish an audit committee, consisting only of non-executive directors (Code 3.1). This requirement is further enforced through amendment to Listing Rule 3.6, which came into effect on October 29, 2003, with a further condition that at least one of the directors should be an accounting or financial expert (Rule 3.6.2). The timing of the amendment to its Listing Rule is important because although the NZX Code was issued on October 29, 2003, listed companies were given a grace period of 12 months to comply or explain in their annual reports, any material variance between their governance structures and practices, and that of NZX Code.

The NZX Code, however, amended its Listing Rule 3.6 again on May 1, 2004, requiring only that membership of audit committee be comprised of “directors”, instead of the original “non-executive directors”. A minimum of three directors, the majority of them independent directors, is now the new required audit committee composition. This amendment was probably made to accommodate listed firms which only have the minimum three directors on their board. The requirement for a minimum of two independent directors in a listed firm (Rule 3.3.1), out of a minimum of three directors, effective October 29, 2003, also seems to result in the consequential May 2004 amendment to the audit committee membership, thereby enabling listed firms to maintain their relatively small three-member board size. This rather small board size, despite its status as a publicly traded company, may be due to the small pool of New Zealand professional independent directors (Farrar, 2005), or the desire to save compliance cost.

Audit committee potentially offer many significant benefits (Canyon and Mallin, 1997). They include higher quality financial reporting, creating a climate of discipline and control which reduces the chances of fraud, strengthening the position of external auditor and internal audit staff by providing more independent avenues from management interference, and increasing public confidence in the credibility of published financial statements.

The Sarbanes-Oxley Act, 2002 (SOX), and the New York Stock Exchange (NYSE) require firms without an audit committee member with financial expertise to disclose this fact and the reason why it has no such expert. DeFond, Hann, and Hu (2005), studying the issue of audit committee composition over a 10-year period preceding the passage of SOX, reveal a significant and positive three-day cumulative abnormal returns surrounding announcement of appointments of accounting/financial experts to audit committees. Importantly, firms appointing non-accounting and non-financial experts do not register any significant comparable returns. Also, Xie, Davidson, and DaDalt (2003) empirically find a positive association between the presence of financial experts on the audit committees and firm financial reporting quality, as measured by accrued earnings management and earning restatements.

In view of the above findings, and the requirement of NZX Code, it is hypothesised as follows:

H3: NZX listed companies which have audit committees would perform better than those that do not have audit committees

Remuneration Committee

NZX Code recommends that each listed company, unless constrained by size, should establish a remuneration committee (Code 2.5). It is to be noted that the original words “a majority of the remuneration committee should be independent directors” as appears in the May 2003 draft (before approval by the Minister of Commerce upon the recommendation of the Securities Commission), were omitted from the final October 2003 version.

Large companies may benefit from appointing a remuneration committee to make recommendations on remuneration for both the executive and non-executive directors. Remuneration policy of publicly traded companies should be reasonably set to attract, retain, and motivate high quality directors and executives, and should also be based on performance (NZSC Handbook, 2004). Remuneration committee determines and reviews the pay packages of executive directors, and helps alleviate the agency problem by constructing and implementing incentive packages that align the interest of senior managers and shareholders (Jensen, 1993). It is therefore hypothesised as follows:

H4: NZX listed firms with remuneration committees would perform better than those without remuneration committees

Nomination Committee

NZX Code recommends that, unless constrained by size (Code 2.5), a listed company should establish a nomination committee with majority independent directors. The rationale for nomination committee, however, is not mentioned. NZSC Handbook (2004) suggests that listed firms should have the right mix of directors with a balance of skills, knowledge and experience to enhance board effectiveness. Rigorous selection, nomination, appointment, and succession planning processes are needed for nomination committees to better carry out their responsibilities. Conger,

Lawler, and Finegold (2001) recommend that in determining the right mix of board members, factors that need to be considered include knowledge areas (matrices that identify key knowledge areas needed to be presented on the board should be mapped against existing directors' competence to determine the strength and weaknesses of the current board), and the number of independent directors a board should have. Other factors include stakeholder (other than shareholder) representation, gender and race diversity, mandatory retirement age, and board size (number of directors to produce a board that has the right mix of knowledge, information, power, and opportunity).

Charkham (2005) concedes that the Chairman/CEO inevitably has great influence on the choice of new director appointment, and this could lead to the practice of cronyism in the appointment of buddies. As such, a nomination committee could at least bring an element of discipline into the director appointment process by introducing method and objectivity. Lechem (2002) cautions the practice of board chairmen who insist on chairing the nomination committee. Such practice not only accentuates the concentration of power in the hands of one person, but may also negate any board effort for chairman succession plan.

Using data from interviews with non-executive directors of FTSE 350 companies, Gay (2002) finds wide support for the view that workings of board committees have improved the effectiveness of the main boards. Although it often receives less attention from the academics and practitioners, the nomination committees is regarded as the superior committee to the audit and remuneration committees. The nomination committee "is superior in the sense that the human resource activity is always of the greatest importance in the management of a business. Unless effective directors are appointed, boards cannot succeed even if excellent audit and remuneration systems are in place" (Gay, 2002, p. 44).

In view of the above analysis, and the recommendation of NZX, it is hypothesised as follows:

H5: NZX listed firms with nomination committees would perform better than those without such committee.

5.4.5 Board and director evaluation

The NZX Code recommends that boards of listed firms should establish a formal procedure to regularly assess individual director and board performance (Code 2.9). Unlike the UK Combined Code, the NZX Code provides no guidelines on either the process or format of assessing individual director and board performance. While it may be good to be flexible so that boards of each listed firm can devise its own evaluation and report processes, it must also be noted that the need for such evaluation is a relatively new requirement not only in New Zealand but also in all the other Anglo-Saxon countries. Although there are many self-assessment check-lists made available by management consultants, there are little or no market benchmarks to evaluate board and director performance. There is therefore no exemplary best practice model to follow, although the guidelines of the UK Combined Code seem to be quite comprehensive and useful.

The preamble of the NZX Code states that Code principles are meant to “enhance investor confidence through corporate governance and accountability” (appendix 16 of NZX Listing Rules). Cadbury (1997) posits that the fundamental reason why boards of directors have become a focus for public scrutiny and criticism is due to lack of confidence in their system of accountability.

In a typical corporate structure, personnel and functions report through a management hierarchy to a CEO, who in turn reports to the board of directors (BOD). The BOD reports, through the Chairman, to the shareholders. The theoretical reporting and accountability chain however, is problematic in large publicly traded companies that usually have diverse and numerous shareholders who are too disorganised to assess the performance of the boards. Nevertheless, the principle of accountability demands that board and individual director performance evaluations be carried out regularly and rigorously (Dimma, 2002). Not having such performance evaluation can be considered as a dereliction of duty on the parts of the board and the individual directors.

The above line of thought is also shared by Curtis (2007), who suggests that the purpose of board performance evaluation is to determine how effective boards are functioning to fulfil their fiduciary responsibilities to the shareholders. Besides the

benefits of helping boards to identify its strength (areas of expertise) or weakness (lacking any critical skills), efficiency in usage of board time, and performance feedbacks to enable individual directors to develop self-improvement plans, the most significant aspect of board and director performance evaluation process is to demonstrate to investors that their boards are working to improve their governance skills. Investor confidence could be enhanced if stockholders perceive the boards to be accountable as seen through the evaluation process.

Using data collected from attending board meetings and interviewing of Canadian directors, Leblanc and Gillies (2005) reports that boards that conduct formal and rigorous director and board performance evaluations have found the process beneficial. The reported benefits include compelling the chairman and directors to evaluate inwardly the factors relevant for better board performance and how they should be measured. In-depth reviews on issues such as the adequacy of information provided to the directors before and at the board meetings, the length of the meetings in relation to the agendas, and the operations of the committees, are important for effective board performance. In addition, board evaluation compels the directors to assess how well the board is carrying out its strategic tasks, and the effectiveness of its strategic decision making process. Such assessments also help the board to focus on governance issues that might otherwise have been overlooked, besides promoting the exchange of opinions and two-way flow of information on governance matters. Last but not least, when the board has a transparent performance evaluation process and standard of measure, it signals to investors and management that the board is promoting shareholder value.

In addition, research results of Conger, Lawler and Finegold (2001) indicate that board assessments, if conducted properly, could contribute positively to performance improvement at the organisation, board, and individual director level. This finding supports the propositions of Kiel, Nicholson, and Barclay (2005) that boards which commit to a regular evaluation process find benefits in terms of improved leadership, greater clarity of roles and responsibilities, improved teamwork, greater accountability, better decision making, improved communication, and more efficient board operations.

Despite the wide range of benefits associated with a well conducted board and director evaluation programme, this board practice is still far from common. Data from the 2001 Korn/Ferry International survey indicates that although 85 per cent of US directors support formal board performance assessment and 81 per cent support formal director evaluation, only 42 per cent of boards have a regular and formal process of evaluation. However, a recent survey by Thomson Financial/Directorship shows that 93 per cent of those surveyed conduct an annual self- evaluation (Curtis, 2007). This big increase in percentage of boards conducting performance evaluation from 42 per cent to 93 per cent could be due to the New York Stock Exchange requirement in 2004 for listed firms to conduct an annual self-evaluation. Whether the NYSE prescription of “self-evaluation” is equivalent to the “formal process” of Korn/International is a matter of interest that needs to be clarified if the comparison is to be credible. Leblanc and Gillies (2005) contend that in Canada, since the 1994 Dey Report requiring Toronto Stock Exchange listed firms to assess the effectiveness of board, committees and individual directors, the only official review of compliance was done only in 1999. The 1999 report indicated that only 18 per cent of the boards reporting had a process for assessing board effectiveness, and 24 per cent had any process for evaluating director effectiveness. Long (2006) contends that although the UK Combined Code requires listed firms to undertake annual formal performance evaluations, “many boards continue to adopt a minimalist approach” (p. 551). In Australia, Kiel, Nicholson and Barclay (2005), using data from the 1998 Institute of Directors/KPMG study, reported that “only 36 per cent of companies report undertaking a regular board performance review” (p. 3).

Similarly in New Zealand, as part of one of the largest corporate governance studies ever taken in the country, Van der Walt and Ingley (2001) reveal that only 25 per cent of boards conduct evaluations annually, with a further 22 per cent conducting evaluations once every two to three years. Significantly, only 31 per cent of evaluations are deemed to have been conducted on a formal basis. Furthermore, the definition of “formal evaluation” is at best doubtful, taking into consideration the comment of one director who said that evaluation “is done at various levels – formal with pencil and a sheet of paper and informal with a gin” (Van der Walt and Ingley, 2001, p. 329). Figures from this researcher show that in 2003, 18 per cent of NZX listed companies conducted board performance evaluation, with only 13.5 per cent of

them conducting individual director performance evaluations. These figures however, improved to 43.8 per cent and 39.3 percent respectively for board and director performance evaluations in 2007 (see table 6.3.1, Chapter Six). The big improvement could be attributed to implementation of the NZX Code in 2005.

Factors contributing to the low level of board and director performance evaluations could perhaps be generalised from the findings of Van der Walt and Ingley (2001) that directors seemed to be uncomfortable with the notion of peer reviews of director performance and expressed doubts as to whether such evaluations could achieve the intended objective of enhancing board performance. In a subsequent study (analysing the perceptions of seminar participants), Ingley and Van der Walt (2002) found that directors who doubted the benefits of a formal evaluation process were most concerned as to the potential impact on the interpersonal dynamics among board members. These doubtful directors reasoned that since cohesion and trust were crucial to the effective functioning of the board, performance evaluations could negatively impact on interpersonal and working relationships among members of the board. Also, corporate politics arising out of the evaluation process could be a major deterrence to those considering implementing such evaluations. On the other hand, one may also argue that individual directors would likely to “go easy” in evaluating their peers in the anticipation that their own assessments could be similarly and favourably reciprocated!

Commenting on the methods used in board evaluation, Curtis (2007), using data from the Thompson Financial/Directorship survey, reveals that 82 per cent of the boards use the self assessment survey method, 31 per cent of them choose the group question-and-answer session method, while 26 per cent of the sample group use the one-on-one interview method (note that boards could use more than one of the three methods at any given time). The least used director evaluation method is the peer assessment, confirming the finding of Van der Walt and Ingley (2001) that peer review is perceived to be detrimental to board collegiality and cohesion. Curtis (2007) argues that the peer review technique can be divisive and often does not directly deal with the problem as a one-on-one interview. Lechem (2002) opines that the peer review evaluation process is a very difficult technique to implement well, even for pioneers like the Bank of Montreal, which instituted a sophisticated and

meaningful performance evaluation programme in 1995. The peer review survey of the Bank of Montreal covers only directors who have served more than 18 months, and their performance is measured against the Charter of Expectations for Directors on specific areas such as strategic insight, financial literacy, business judgement, accountability, participation, and communication. The raw scores are sent to an external consultant, who correlates and provides individual directors with their own scores, together with summaries of aggregated director performance. The corporate governance committee, which conducts both the board and director performance evaluation surveys, is charged with recommending any changes to procedures and practices based on the evaluation outcomes.

Who should conduct the evaluations and how should the outcomes be dealt with are also important elements of the process. While the NZX Code does not provide any guidelines, the UK Combined Code bestows upon the chairman the responsibility to select an effective process, and to act on the outcome. To instil objectivity to the process, the use of an external third party to conduct the evaluation is also suggested. There is still no unanimity on whether the use of outside consultants would be a benefit or just another expense to add to the total compliance cost. Charkham (2005) reports that at least 21 consulting and other firms in U.K. are offering board performance audits from £12,000 to £80,000 per audit, and that their services are in great demand. The Toronto Stock Exchange guidelines suggest that the nomination committee (or some other appropriate committee) be charged with the responsibilities of managing the director and board performance evaluations (Lechem, 2002). This recommendation is in line with the alignment of processes between the nomination of new director selection and the conduct of director and board performance evaluations. While the NYSE requires listed firms to outline the evaluation processes they are using in their annual reports, they are not required to publish the findings of their evaluations.

This researcher analysed the 2007 annual reports of five large NZX listed companies, and found that the one-on-one interview where the chairman meets individually with the director were used by four of the companies (Auckland International Airport, Fletcher Buildings, Telecom New Zealand, and The Warehouse). Only Air New Zealand utilised the peer review method for retiring

directors standing for re-election, in a process coordinated by the chairman. Similarly, only Fletcher Building and Telecom New Zealand have specific performance measures such as Charters and terms of reference in appointment letters. Telecom New Zealand and Air New Zealand provide feedback to the directors on their evaluation outcomes. Telecom New Zealand is the only company that has undertaken a comprehensive board evaluation survey to seek director feedback on a range of matters relating to board performance, including its role and composition, procedures, practices, and administration.

Lamenting on the failure of Enron, Useem (2003) highlights the importance of having annual performance evaluations of boards and its committees. Had Enron undertaken such reviews, rotation of the committee chairmen could have taken place to inject new perspective and renewal of procedures. In such new scenarios, a fresh audit committee chairman would have been someone more alert and diligent to the many warning signs that were coming from below. As it stands, the same audit committee chairman had occupied the position for more than 13 years when Enron collapsed. However, whether the implementation of board and individual director evaluations practice could have saved Enron is at best a matter of speculation, given the various serious conflicts of interest issues.

Leblanc and Gillies (2005) predict that the driving force leading to more and better board and director performance evaluation in the future would not be to comply with stock exchange ruling, but rather the realisation of chairmen, directors, and shareholders that boards cannot be built to maximise shareholder returns without the knowledge of how business and directors could fulfil their basic functions. To obtain such knowledge, there must be regular board and director performance reviews. Be that as it may be, such realisation and knowledge might not happen by itself without the necessity “to allay concerns about measurement relevance and to educate directors about the purpose of such evaluations and their use by the board as a strategic tool to enhance board and organisation performance, as well as to assess and ensure compliance” (Ingley and Van der Walt, 2002, p. 173). Equally important is the timely manner in which evaluation outcomes are acted upon (Van der Walt and Ingley, 2001). Nevertheless, Leblanc and Gillies (2005) proclaims that the days of the non-accountable director and board are coming to an end, and that those

considering joining a board, together with directors of companies with progressive leadership, should accept the fact that board and director performance evaluation is becoming a regular feature of corporate life. One may also argue that progressive and top performing directors would welcome performance evaluation as an opportunity to rebut accusations that CEO and senior management compensation packets are not in line with their contribution and performance.

From the above analysis, it is hypothesised as follows:

H6: NZX listed companies that have regular and formal board performance evaluation would perform better than those without such practices. H7: NZX listed companies that have regular and formal director performance evaluation would perform better than those without such practices.

Last, but not least, considering hypotheses H1 to H7 in totality, it is hypothesised that listed NZ firms that complied fully with the NZX Code would financially outperform their non-compliant peers (H8).

5.5 Ethical Consideration

All due process and procedures as contained in the Massey University Ethics Research application form and checklist for Research have been followed. This research does not involve human interviews or surveys.

5.6 Methodology

As a result of the mandatory and discretionary aspects of the NZX Code, there is an expected discrepancy (variance) in the extent of compliance among listed firms. The difference and variance shall give rise to the possibility to observe the relationship between adopted governance structures and practices and firm performance. Such discrepancies are to be found in the annual reports of NZX Companies. This is because Listing Rule 10.5.3(i) requires all listed companies to disclose in their annual reports the extent to which their corporate governance practices and processes materially differ from the principles as set out in the NZX Code. As such, one would be able to measure the difference in the ratio of independent directors (continuous variable) among NZX listed firms and to determine whether such firms comply with

separate board leadership structure, the setting up of board committees (audit, remuneration, and nomination), and board and director performance evaluations (binary variables). The impact of code compliance on the financial performance of NZX listed companies could then be measured.

The NZX Code was incorporated as Appendix 16 of the NZX Listing Rule effective October 29, 2003. However, listed firms are given a grace period of 12 months to comply with the NZX Code. As such, the 2003 annual reports of NZX listed firms are to be used as the pre-Code governance structures. The 2007 annual reports of NZX listed firms are to be used as the post-Code governance structures. Hard copies of the 2003 and 2007 annual reports are not all available in the libraries, but they can be found online at the NZX Deep Archive Database (formerly IRG Archive and IRG Online Archive). Corporate financial performance (dependent variable) is to be measured and based on return on assets (ROA), and the independent variables are ratio of independent directors (continuous variable), and binary variables (separation of chairman/CEO positions, establishment of audit, remuneration, and nomination committees, and performance evaluations of board and individual directors). There is no known single publication containing all the required information, and therefore there is no short-cut but to go through each individual annual report to collect the data. Once the data is collected from the annual reports of a constant sample of listed firms for 2003 and 2007, a suitable multiple variables regression model is to be chosen to provide a good fit to the data. Results of the research are to be reported in Chapter Six.

5.7 Sample and Data Collection

All the 167 companies listed on the New Zealand Stock Exchange as at the end of June 2008 are to be considered for purposes of sample selection and data collection. The selected dateline of June 2008 is important because their 2007 annual reports would have been published by then, taking into consideration the extension of time given for any unexpected delays in the publication of audited accounts and the holding of annual general meetings. However, of the 167 counters listed, three of them are warrants and loan notes of listed companies. Therefore the actual number of companies listed was only 164.

Of the 164 companies, they were further tested to fulfil the following two criteria. Firstly, this research is only concerned with New Zealand listed companies that are registered locally under the Companies Act 1993 or any other applicable Acts, and have their primary listing on the New Zealand Stock Exchange. Forty companies which had their registration and primary listing status outside New Zealand were excluded. The list is now narrowed down to 124 companies. Secondly, the companies should be listed in 2003 or prior. This is because 2003 is the year the NZX Code was issued and the board structures of 2003 would represent the pre-Code governance structures. Of the 124 companies, 34 of them were found to be listed after 2003. This further narrowed down the list to 90 companies.

As pointed out earlier, data on firm financial performance are collected from the return on assets (ROA) of each of the 90 companies for 2003 and 2007. Data on board independence are collected from measures of the percentage of independent directors in the board, the separation of chairman/CEO positions, and the establishment of the three board subcommittees (audit, remuneration, and nomination). Board accountability is to be measured by whether boards carry out board and director performance evaluations. The independent director ratio is a continuous variable, while the other independent variables are binary and are to be measured in terms of yes (1) or no (0). The initial data are recorded in Microsoft Excel format and then converted into Notepad format to enable it to be processed by the R statistics software. The data are now fitted into the multiple variables regression models. The basic empirical methodology is the estimation of a series of ordinary least squares (OLS) in multivariate regression models.

5.8 Chapter Summary

Although the NZX Code was issued in October 2003, so far there is no research study on the extent to which listed firms have complied with the requirements and recommendations of the Code. The absence of empirical data on the adoption and implementation of the NZX Code provides the opportunity for the researcher to conduct such original study in New Zealand. The expected variance in the degree of compliance among listed firms provides a good opportunity to establish whether there is a correlation between code compliance and firm financial performance. There is therefore a good opportunity to conduct an original research on the impacts

of compliance with corporate governance best practices code on the financial performance of New Zealand publicly traded firms. This research could benefit from the generalisation of the British data, which may be localised to suit the New Zealand setting. The various hypotheses are to be tested against agency theory predictions on the expected positive relationship between governance structures and firm financial performance, assuming all other things remain constant. The research findings in the next chapter are expected to provide answers to the research questions.

Chapter Six – Research Findings

Introduction

This chapter reviews the extent to which the New Zealand listed companies have complied with the recommendations of the New Zealand Exchange (NZX) Corporate Governance Best Practice Code (NZX Code). The research finding on the extent of compliance with the NZX Code should provide answer to the first of the two research questions. Data analysis to investigate the impact of NZX Code compliance on the financial performance of New Zealand publicly listed companies is expected to produce research finding needed to answer the second research question.

6.1 Research Questions and Knowledge Gap

As pointed out in Chapter Five, the research questions are:

(1) To what extent have New Zealand listed companies complied with the recommendations of the NZX Code?

(2) Would compliance with the NZX Code have any positive impact on the financial performance of listed companies, assuming all other factors being constant, as predicted by agency theory?

There is no official or trade review of compliance with NZX Code and so far no systemic research has been done to gather empirical data on the extent of compliance with NZX Code by listed companies. The UK Cadbury Code, which was issued in 1992, was officially reviewed by the Cadbury Commission itself in 1995 (Conyon and Mallin, 1997). The Toronto Stock Exchange (TSE) guidelines on corporate governance, issued in 1994, were officially reviewed by the TSE in conjunction with the Institute of Directors in 1999 (Leblanc and Gillies, 2005). The Australian Stock Exchange (ASX) Corporate Governance Council (ASX CGC Code) issued its corporate governance principles and recommendations in March 2003 and released its Implementation Review Group Report in March 2004. The ASX CGC Code has since been updated in 2007 (Farrar, 2008). This research therefore is timely to provide some answers to the perceived knowledge gap in New Zealand regarding the extent of compliance with the NZX Code by New Zealand listed companies.

As discussed in Chapter Three, only five British cases have been published on research relating to the relationship between compliance with Cadbury Code/Combined Code and firm performance. The only Australian case available covers only the ten-year period (1992 – 2002) before the introduction of the ASX CGC Code in 2003 (Henry, 2008). In addition, in Canada, Park and Shin (2004) empirically found that monitoring of abnormal accruals by outside directors is not more effective after the issuance of the Toronto Stock Exchange's Corporate Governance Guidelines in 1994. There is, however, no such empirical study ever published yet in New Zealand. This research therefore is timely to provide some answers to the perceived knowledge gap in New Zealand regarding the possible relationship between NZX Code compliance and financial performance of New Zealand listed firms.

6.2 Data Analysis

The main purpose of this data analysis is to review the extent to which listed firms have complied with the NZX Code requirements and recommendations, and to test the agency theory predictions on NZX Code recommended board structures and practices. These research findings would enable the researcher to answer the research questions above. As pointed out in Chapter Five, financial performance of the listed companies is to be measured by return on assets (ROA). The independent variables are percentage of independent directors, separate CEO/Chairman board leadership structure, establishment of board committees (audit, remuneration, and nomination), and performance evaluation of board and individual directors.

The same data for the dependent variable (ROA) and the independent variables as mentioned above were collected for the years 2003 and 2007 for each of the 90 companies, and all data are at balancing dates. The listed companies are also classified into the various industry groups as determined by the NZX. These collected data include the following:

- (a) Response variable: return on assets
- (b) Independent variables:
 - (1) The percentage of independent directors, a continuous variable;

- (2) Classification by industry group/sector;
- (3) Duality of CEO/Chairman position, a binary variable: 1 (yes) and 0 (no);
- (4) Establishment of Audit Committee, a binary variable: 1 (yes) and 0 (no);
- (5) Establishment of Remuneration Committee, a binary variable: 1 (yes) and 0 (no);
- (6) Establishment of Nomination Committee, a binary variable: 1 (yes) and 0 (no);
- (7) Establishment of Board of performance evaluation, a binary variable: 1 (yes) and 0 (no);
- (8) Individual director performance evaluation, a binary variable: 1 (yes) and 0 (no);
- (9) Full compliance with NZX Code recommendations, a binary variable: 1 (yes) and 0 (no);

For statistical analysis purposes, the response variable and independent variables have been renamed as follows:

Return on assets = ROA2003 / ROA2007

Independent variables:

- (1) = idpDpcent03 / idpDpcent07 (percentage of independent directors)
- (2) = BusinessSec (business group sectors)
- (3) = dual03 / dual07 (CEO/Chairman duality)
- (4) = audi03 / audi07 (audit committee)
- (5) = remu03 / remu07 (remuneration committee)
- (6) = nomi03 / nomi07 (nomination committee)
- (7) = bpeva03 / bpeva07 (board performance evaluation)
- (8) = inddeva03 / inddeva07 (individual director performance evaluation)
- (9) = fullcom03 / fullcom07 (full compliance with Code recommendations)

A numerical summary on the ROA variable has shown one extreme outlier case which deserves separate treatment. It may be reasonable to single out this extreme case for exclusion so as to make the statistical analysis more robust and reliable. This extreme case is excluded because its financial performance (as shown in Tables 6.1

and 6.1.1 below) is so extreme that its inclusion would distort the overall performance pattern significantly.

Table 6.1:

share code	BusinessSec	ROA03	ROA07	fullcom03	fullcom07
TRS	Investment	-7.95	-0.5	0	0

Table 6.1.1:

idpDpcent	dual	audi	remu	nomi	peva	inddeva	fullcom
03/07	03/07	03/07	03/07	03/07	03/07	03/07	03/07
40	0	1	1	0	0	0	0
33.4	0	1	0	0	0	0	0

The company concerned is TRS Investment, which in February 2007 sold its corporate training business to focus on investment in Australian equities. The company had an accumulated loss of NZ\$15.02 million and a negative equity of NZ\$95,000 as at March 31, 2007. In almost any other well managed stock exchanges, a listed company with negative equity would have its listing status suspended pending the successful implementation of a financial restructuring plan. Whether such corrective action should be taken against TRS Investment is an urgent matter for NZ securities regulators to consider, if NZX is really serious about further developing the local stock market.

After excluding this extreme case, there are now 89 companies included in the data set for analysis using the R statistics package. The raw data set is then split into three data sets ready for statistical analysis. These data are in plain text format and saved in files 'data2003.txt', 'data2007', and 'dataset3'. Before fitting the collected data into the linear multiple variables regression models, it may be useful to review compliance with the recommendations of the NZX Code in order to provide answers to research question number one.

6.3 A Review of Compliance with NZX Code

Compliance with the recommendations of the NZX Code are to be analysed according to the percentage of independent directors, duality of the post of CEO/Chairman, establishment of board committees (audit, remuneration, and nomination), and the performance evaluation of board and individual directors. NZX Listing Rule 10.5.3 (i) requires that issuers shall disclose in their annual reports the extent to which its corporate governance processes materially differ from the principles set out in the NZX Code. It must also be noted that since January 1st, 1999 the NZ Stock Exchange has required listed companies to include in their annual reports “a statement of any corporate governance policies, practices and processes they have adopted or followed” (Chiu and Monin, 2003, p.127). Each of the Code recommendations and their compliance in 2003 and 2007 by the 89 listed companies (data as collected from their respective annual reports in 2003 and 2007) are reported as follows.

6.3.1 Percentage of Independent Directors (Continuous Independent Variable)

A box plot is drawn on idpDpcent03 and idpDpcent07 to show the distribution of these two variables, as shown in Figure 6.1 below. Table 6.2 and Table 6.2.1 below give a more detailed numerical summary of these two variables. The box plot and Tables 6.2 and 6.2.1 together would provide the necessary information to determine whether there is a real increase in the percentage change of independents directors between 2003 and 2007.

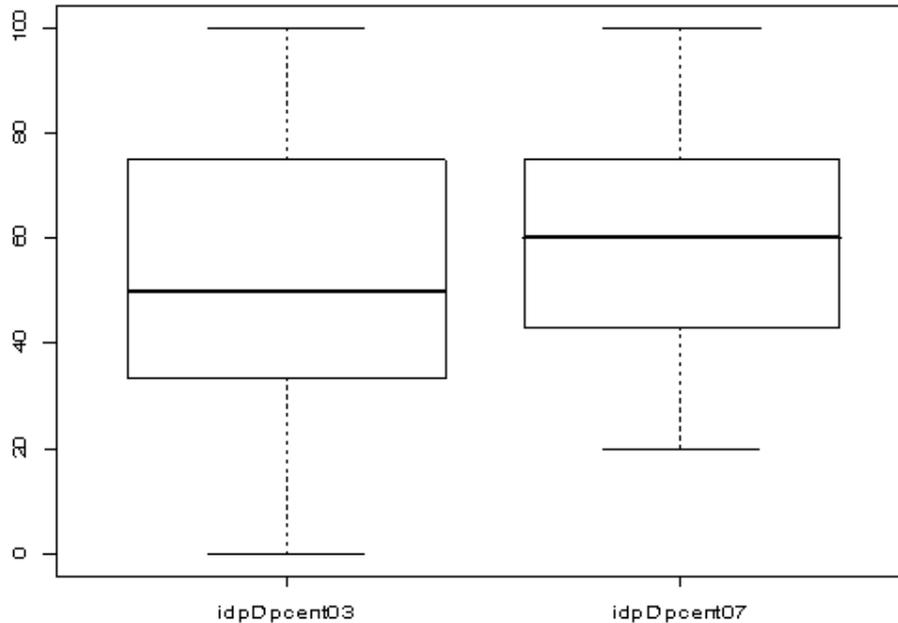
Table 6.2: Numerical summary of idpDpcent03

Minimum	First quartile	Median	Mean	Third quartile	Maximum
0.00	33.40	50	54.48	75.00	100.00

Table 6.2.1: Numerical summary of idpDpcent07

Minimum	First quartile	Median	Mean	Third quartile	Maximum
20.00	42.90	60	60.69	75.00	100.00

Figure 6.1 Comparison of Independent Director Percentage



The above box plot (Figure 6.1) shows that the distributions of independent directors in 2003 and 2007 are relatively symmetrical. It seems that there is a true difference between the percentage of independent director figures for 2003 and 2007, because the numerical values of the minimum, lower quartile and median are all skewed up in 2007. Thus, it can be said that the ratio of independent directors for 2007 is higher than that of 2003. This result is confirmed by the average mean number of independent directors which increased from 3.169 (282/89) in 2003 to 3.506 (312/89) in 2007. The percentage of independent directors to total directors increased from 55.2 per cent (282/511) in 2003 to 60 per cent (312/520) in 2007. It is noted that the increase in total directors between 2003 and 2007 is minimal, which rose from 511 to 520 (1.76 per cent). This is also reflected in the minimal average increase in board size which rose from 5.74 directors (511/89) in 2003 to 5.84 directors (520/89) in 2007.

6.3.2 Binary Independent Variables

The binary independent variables are duality of the CEO/Chairman position (dualCC); establishment of an audit committee (audi), remuneration committee (remu), and nomination committee (nomi); the performance evaluation of the board (bpeva); the performance evaluation of individual directors (inddeva); and full compliance with the NZX Code (fullcom).

A summary of compliance with the various recommendations of the NZX Code corresponding with the binary variables is provided in Table 6.3 below.

Table 6.3

		dualCC	audi	remu	nomi	pevab	inddeva	fullcom
YES (1)	2003	8	69	49	9	16	12	5
	2007	3	86	62	32	39	35	20
NO (0)	2003	81	20	40	80	73	77	84
	2007	86	4	27	57	50	54	69
						Sample size		89

6.3.3 Combination of Continuous and Binary Independent Variables

NZX Code compliance summary for 2003 and 2007 by the 89 listed companies are to be found in Table 6.3.1 below.

Table 6.3.1

	NZX Code Recommendations	2003 Yes/No	2007 Yes/No
(1)	TID	79/10	87/2
(2)	SCC	81/8	86/3
(3)	AUC	69/20	85/4
(4)	REC	49/40	62/27
(5)	NOC	9/80	32/57
(6)	BDE	16/73	39/50
(7)	DPE	12/77	35/54
(8)	FCC	5/84	20/69
	Total # (companies)	89	89

Table 6.3.1 Explanatory Notes

- (1) minimum of two independent directors (TID)
- (2) separate CEO/Chairman positions (SCC)
- (3) presence of audit committee (AUC)
- (4) presence of remuneration committee (REC)
- (5) presence of nomination committee (NOC)
- (6) entire board performance evaluation (BPE)
- (7) individual director performance evaluation (DPE)
- (8) full code compliance (FCC)

An analysis of listed companies' compliance with each of the eight recommendation of NZX Code is detailed as follows.

Results

Compliance with Minimum of Two Independent Directors (TID)

As shown in Table 6.3.1 above, 79 listed companies in 2003 have the minimum two independent directors (or one third of their board, whichever is higher). This constituted 88.8 per cent of the 89 companies that are the subject of study under this

research. In 2007, 87 of the 89 listed companies complied with this requirement, or a 97.8 per cent compliance rate.

In 2003, out of the total 511 directors, 55.19 per cent or 282 directors were classified as independent directors. By 2007, the number of independent directors had increased to 312, or an increase of 10.64 per cent. The percentage of independent directors in 2007 constituted 60 per cent of total directors (312 of 520). The average number of independent directors increased from 3.17 in 2003 to 3.51 in 2007. The average board size increased marginally from 5.74 directors in 2003 to 5.84 directors in 2007. In 2003, board sizes ranged from one director (Beauty Direct and Online Limited) to 11 directors (New Zealand Refining Company). It is to be noted that NZX Listing Rule 3.3.1 (a) was amended only on 29/10/2003, which required all listed companies to have at least three directors. Thus, by 2007, the minimum board size had increased to three directors (seven companies), with the maximum rising to 12 directors (New Zealand Refining Company).

NZX Listing Rule 3.3.1A requires the individual boards of listed companies to determine and identify which of their directors are considered as independent directors. In addition, Listing Rule 10.5.3(j) requires an issuer to disclose in its annual report a statement as to which of its directors are independent and which of them are not. However, the listing rules do not give guidelines or criteria of what constitutes an independent director. A perusal of the annual reports of the 89 companies reveal that most of them consider an independent director as one who is a non-executive, holding less than five per cent of the shares on issue, and may not have a relationship with the company whereby a substantial portion of the director's annual revenue is derived from the company in any year. In other words, an independent director is one who is not an executive of the company, and who has no "disqualifying relationship" with the company. A "disqualifying relationship" means any direct or indirect interest or relationship that could reasonably influence, in a material way, the director's unfettered and independent judgment. Thus, a director must be independent of management and free from any business, or other relationship or circumstance that could materially interfere with the exercise of a director's independent judgment, in order to qualify as an independent director. It is to be noted that the criteria used by the 89 listed companies are a combination of

guidelines from the UK Cadbury Code and the ASX CGC Code. The above criteria were used consistently by the researcher to determine compliance with the requirement of minimum of two directors, for the years 2003 and 2007 respectively.

Compliance with Separate CEO/Chairman Positions (SCC)

The NZX Code stipulates that “a director should not simultaneously hold the positions of Chief Executive and Chairman of the Board of the issuer” (Code 2.1). In 2003, 91 per cent of the listed companies (81 out of 89) complied with the requirement of separate CEO/Chairman positions (see Table 6.5 above). By 2007, this compliance rate rose to 96.6 per cent (86 out of 89 issuers). Thus, unlike in the US where duality of CEO/Chairman board leadership structure is common (Bhagat and Black, 2002; Leblanc and Gillies, 2005), the practice of combined CEO/Chairman position is indeed very rare among NZ listed companies. Furthermore, it is interesting to note that only 56.2 per cent (50 out of 89 companies) of NZ publicly traded companies appoint their chief executive officers to be also members of the boards, as evidenced from their 2007 annual reports. Commenting on board practices of large companies in North America, Leblanc and Gillies (2005) proclaim: “It is almost unheard of for the chief executive officer of the corporation not to be a member of the board of directors” (p. 92). Thus, this NZ board practice is indeed very unique among the Anglo-Saxon countries. It could be partly due to the presence of very large shareholders; this researcher finds that in 2007 almost 24 per cent (21/89) of listed NZ companies are owned by holding companies or related groups and individuals (owning more than 50 per cent of the shares of the listed companies). Whether such practice benefits the corporations is another matter. If the board is the bridge between the shareholders and the management, then the CEO should serve as the link between the management and the board. Although the CEO can be a co-opted member during board meetings, it is argued that without treating the CEO as equal in the board, the governance chain is distorted. From the experience of the researcher (more than 20 years of serving as executive and non-executive board member of private and publicly traded companies in Malaysia, Australia, the UK, Hong Kong, and China), such distortion would result in the CEO reporting to the chairman instead of the board directly.

Compliance with Establishment of Audit Committee (AUC)

The NZX Code, as amended by Listing Rule 3.6, requires each issuer to establish an audit committee with a minimum of three directors, the majority of whom should be independent directors. In addition, directors who are not members of the audit committee can attend its meetings only at the invitation of the audit committee (Code 3.4). This latter provision seems to contradict the recommendation of the New Zealand Institute of Directors Code of Proper Practice, which states that any “non-executive director should be entitled to attend meetings of any Board committee provided the director is not specifically excluded for reasons of conflict of interest, even if the director is not an appointed member of the committee” (IOD, 2003, p. 35).

From Table 6.3.1 above, it is noted that in 2003, 77.5 per cent of the NZ listed companies (69 out of 89) complied with the recommendation to establish an audit committee. By 2007, the compliance rate increased to 96.6 per cent (85 out of the 89 listed companies). This 2007 compliance rate (four years after the NZX Code) is comparable to the UK experience that by 1995 (three years after the Cadbury Code) 98.57 per cent of the FTSE 100 and mid-250 listed companies had established an audit committee (Conyon and Mallin, 1997).

Compliance with Establishment of Remuneration Committee (REC)

Code 2.5 of the NZX Code recommends that unless constrained by size, a listed company should establish a remuneration committee. As mentioned in Chapter Five above, the original stipulation of majority independent directors in the remuneration committee was deleted after consultation with the Securities Commission and the Minister of Commerce. Both the UK Cadbury Code (and subsequent Combined Code) and the ASX CGC recommend that the majority of remuneration committee members should be comprised of independent directors.

The rate of compliance by New Zealand listed companies to establish a remuneration committee increased from 51.1 per cent (44 out of the 89 companies) in 2003, to 69.7 per cent (62 out of the 89 companies) in 2007 (see Table 6.3.1 above). The 2007 compliance rate (four years after the NZX Code) is relatively low when compared with the UK where by 1995 (three years after the Cadbury Code) 95 per cent of the

FTSE 100 and mid-250 listed companies had established remuneration committees (Conyon and Mallin, 1997).

Compliance with Establishment of Nomination Committee (NOC)

Unless constrained by size, NZX Code requires that a listed company establish a nomination committee whose membership should comprise of majority independent directors (Codes 2.2 and 3.10). This majority independent director requirement is in line with the recommendations of the UK Combined Code and the ASX CGC Code.

Unlike the relatively high compliance rates on the establishment of the audit committees and remuneration committees, the compliance rate of nomination committee adoption is rather disappointing. In 2003, only nine out of the 89 New Zealand listed companies had established a nomination committee, a disappointingly low compliance rate of 10.1 per cent (see Table 6.3.1 above). By 2007, the rate of compliance increased to 36 per cent (32 out of the 89 listed companies). It is to be noted that there were actually 39 companies that had established a nomination committee in 2007, although seven of them were found not to comply with the requirement of majority independent director composition. If the seven companies were included, the rate of compliance would have improved to 43.8 per cent, instead of the stated 36 per cent.

In the UK, 50 per cent of the top 500 listed companies had established a nomination committee by 1994. Conyon and Mallin (1997) considers the 1994 compliance rate as “disappointingly low adoption rate of Nomination Committees by UK companies, which contrasts with the relatively high incidence reported in US companies, represents a distinct failure in the UK corporate governance system” (p. 32). Whether the 36 per cent compliance rate in 2007 for NZX listed companies “represents a distinct failure” in the current New Zealand corporate governance arrangement is debatable, taking into consideration the relatively smaller average board size and the difficulty of recruiting suitably qualified independent directors.

The failure to establish a nomination committee seems to be the main reason why otherwise respected companies like the New Zealand Exchange (NZX) and Air New Zealand fail to fully comply with the NZX Code. Air New Zealand, with seven

directors, failed to establish a nomination committee on the grounds that the whole board should be involved in the selection and employment process of any new board member. On the other hand, NZX cites the constraint of board, despite having six board members, as the reason for not establishing a nomination committee. What is not stated, however, is perhaps the unwillingness of the board chairman to relinquish his traditional prerogative to appoint new directors. It is a common practice for the board chairman to dominate the process of new board appointments in countries such as the UK, Canada, and the US (Charkham, 2005; Lechem, 2002; Conger, Lawler, and Finegold, 2001). As such, it can be assumed that the same practice is applicable to the New Zealand setting, in view of common heritage. Unless directors are appointed through a transparent process and a formal selection procedure under the auspices of a nomination committee, “there is the distinct opportunity for the chairman or chief executive officer to influence board appointments in a way that reflects his own interest rather than that of shareholders” (Conyon and Mallin, 1997, p. 32). In the case of Telecom New Zealand, there is a twist to the arrangement where the chairman of the board also serves as chairman of the nomination committee, thus confirming the earlier argument that board chairman is not willing to share their traditional dominance of new director selection process. Lechem (2002) opines that such committee structure only serves to concentrate power in the hand of the chairman.

Compliance with Board and Director Performance Evaluations (BPE and DPE)

The NZX Code requires that listed companies “should establish a formal procedure to regularly assess individual and Board performance” (Code 2.9). As noted in Chapter Five above, the NZX Code does not provide any guidelines regarding the process or frequency of board and director evaluations. Such guidelines are sorely needed especially when board and director performance evaluation is a relatively new phenomenon, and not widely practised even in the US. Conger, Lawler, and Finegold (2001), based on data from Korn/Ferry International Survey, opine that despite the potential of board evaluations to enhance effective board performance, only one-third of the largest US companies evaluated the performance of the entire board. Individual director performance evaluations occur in only twenty per cent of the US firms surveyed.

In New Zealand, only 18 per cent (16 out of the 89 listed companies) of NZX issuers carry out a full board performance evaluation in 2003 (see Table 6.3.1 above). The compliance rate, however, improved more than twice in 2007 to 43.8 per cent (39 out of the 89 listed companies). For individual director performance evaluation, only 13.5 per cent (12 out of the 89 companies) of NZX issuers complied with this requirement in 2003. For 2007, the compliance rate almost tripled to 39.3 per cent (35 out of the 89 listed companies).

Full Compliance with NZX Code (FCC)

The full compliance rates for both 2003 and 2007 are disappointingly low. In 2003, only five out of the 89 listed companies, or 5.6 per cent, complied fully with the NZX Code (see Table 6.3.1 above). In 2007, the compliance rate rose sharply to 24.5 per cent (20 out of the 89 listed companies studied), albeit still a very low rate of compliance. The low full compliance rate of New Zealand listed companies is a direct contrast to the relatively high rate of compliance in the UK, where Davies (2006) notes that the “ABI Report for 2004 shows 70 per cent of FTSE 100 companies meeting the terms of the Combined Code” (p. 137).

Table 6.4 below shows the full Code compliance companies by group sector classification. It is noted that the property sector has not produced any full compliance companies for both the years 2003 and 2007. The services sector seems to be the single largest group of companies, with the energy sector being the smallest group. The services sector also constitutes 50 per cent of all the companies that fully complied with the NZX Code (10 out of 20) in 2007.

Table 6.4 Full Compliance Companies by Industry Sectors

Group Sector	Full Compliance (number of companies)	
	2003	2007
	Yes/No	Yes/No
Energy	0/5	1/4
Goods	1/11	4/8
Investment	0/11	1/10
Primary	2/11	4/9
Property	0/9	0/9
Services	2/37	10/29
Total	5/84	20/69

More importantly, five companies did not provide Code compliance statements in their 2007 annual reports, which is contrary to NZX Listing Rule 10.5.3(i). As expected, none of the five companies complied fully with the NZX Code. This breach of NZX Listing Rule, which did not lead to any apparent adverse consequences, forces one to wonder how serious the regulators (NZX and Securities Commission) are about the enforcement of corporate governance best practice standards in New Zealand. Ironically, even the New Zealand Exchange itself (presumably the commercial entity, and not in the capacity of co-regulator together with the Securities Commission) did not comply fully with the NZX Code in 2007, after failing to establish a nomination committee. This is hardly the case of leadership by example. Despite having six directors, five of whom are considered independent directors, New Zealand Exchange cited board size as an excuse for not having a nomination committee: “Given the size of the Board, there is no nomination and succession committee. Rather, the full Board is involved in the Director Nomination process” (NZX 2007 Annual Report, p. 18). The NZX position is in sharp contrast to that of an exemplary company, New Zealand Experience Limited, which manages NZ’s premier theme park, Rainbow’s End. Despite having only three members, two of whom are considered as independent directors, the company embraces and adopts wholeheartedly the NZX Code:

Due to the size of the company and its board, the benefits of committees are more limited than larger companies; however, the directors ensure that separate meetings are scheduled to provide an appropriate level of focus on specific committee responsibilities and issues. The committees each have a separate written charter which clearly defines the relevant objectives and responsibilities of the committee. The board and its committees met on a regular basis throughout the year (New Zealand Experience Limited, 2007 Annual Report, p. 7).

From the above review of compliance with the NZX Code, it seems that New Zealand listed companies are not fully committed to implement and adopt the recommended corporate governance best practice standards. The acceptance of NZX Code by the listed companies is at best unremarkable, as reflected in the low 22.5 per cent rate of full compliance in 2007. This is particularly so when compared to the U.K., where 70 per cent of listed companies fully complied with the recommendation of the Combined Code during 2004 (see Section 3.6 above).

Nevertheless, the 2007 compliance rates with the requirements of the minimum two independent directors, separation of CEO/Chairman positions, and establishment of audit committee, are rather high, and comparable to that of UK listed companies. A 70 percent compliance rate for adoption of remuneration committee can be considered quite high, especially in contrast with the rather disappointingly low 36 per cent compliance rate for the establishment of a nomination committee. Compliance rates of 43.8 per cent and 39.3 per cent for board and individual director performance evaluations respectively could best be described as unremarkable, with much room for improvement. As such, official reviews of the implementation of NZX Code by regulators such as the NZX and Securities Commission are crucial to determine the strengths and weaknesses of current recommendations, and to improve the compliance rates of listed companies. It is now more than five years after the introduction of the NZX Code, and is timely for an official review to be carried out, similar to those already done so in the UK (Conyon and Mallin, 1977) and Canada (Leblanc and Gillies, 2005). This researcher hopes that his review would start the momentum to more systematic studies to be undertaken on compliance with the NZX Code and the NZ Securities Commission's corporate governance principles and guidelines.

6.3.4 Analysis of Dependent Variable

So far the data analysis has been on the independent variable. It is now time to analyse the data for the dependent variable, which is the financial performance of the 89 listed companies as measured by the return on asset (ROA).

A box plot is drawn on ROA 2003 and ROA 2007 to show their distribution, and to enable us to compare these two dependent variables. Figure 6.2 below provides the comparative results. In addition, Table 6.5 and Table 6.5.1 below give a more detailed numerical summary of ROA 2003 and ROA 2007 respectively.

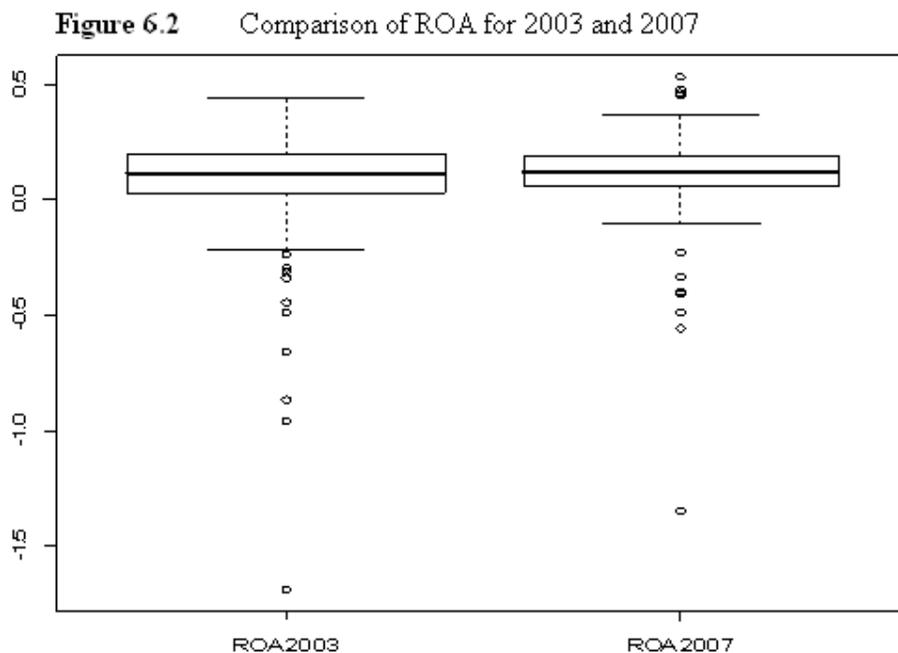


Table 6.5: Numerical summary of ROA 2003

Minimum	First quartile	Median	Mean	Third quartile	Maximum	Standard deviation
-1.6900	0.03061	0.1165	0.05258	0.1996	0.4379	0.3182

Table 6.5.1: Numerical summary of ROA 2007

Minimum	First quartile	Median	Mean	Third quartile	Maximum	Standard deviation
-1.3490	0.06190	0.1182	0.09291	0.1881	0.5335	0.2412

From the above data, it could be deduced that for both the 2003 and 2007 ROA data; the distribution of corporate financial performance (in terms of ROA) is skewed to the lower end (negative end). The variation in ROA among companies in 2007 is much smaller than that of 2003. In terms of the median level of corporate financial performance, there is only a slight difference of less than one per cent (0.0017). However, in terms of the mean level of corporate financial performance, it has improved by about four percent (0.04033) as seen in Table 6.5 and Table 6.5.1 above. The above analysis is based on the assumption that the data from the 89 companies are considered as from the entire population. If these data are treated as a random sample from a population of companies, then a further t-test outcome reveals that the mean level difference may be due to random fluctuation. That is to say, there may not be a true difference in corporate financial performance between the years 2003 and 2007, as shown in Figure 6.3 below.

Figure 6.3 Comparative ROA Study for 2003 and 2007

Paired t-test
Data: ROA 2003 and ROA 2007
$t = -1.376, df = 88, p\text{-value} = 0.1723$
Alternative hypothesis: true difference in means is not equal to 0
95 per cent confidence interval: [-0.09858, 0.01792]
Sample estimates: mean of the differences: -0.04033

6.3.5 Impact of the Various Independent Variables on ROA

To investigate the impact of compliance with the NZX Code recommendations as represented by the independent variables on firm financial performance of NZ listed companies as represented by the dependent variable (ROA), the respective data are to be fitted into a multiple linear regression model as follows:

$$y_p \sim x_1 + x_2 + x_3 + x_4 + x_5 + x_6 + x_7 + x_8$$

y_p : is to represent the response variables: ROA 2003 / ROA 2007;

x_1 : is for independent variable (1) = $idpDpcent03$ / $idpDpcent07$, a continuous and quantitative variable;

x_2 : is for independent variable (2) = $dual03$ / $dual07$, a binary variable;

x_3 : is for independent variable (3) = $audi03$ / $audi07$, a binary variable;

x_4 : is for independent variable (4) = $remu03$ / $remu07$, a binary variable;

x_5 : is for independent variable (5) = $nomi03$ / $nomi07$, a binary variable;

x_6 : is for independent variable (6) = $bpeva03$ / $bpeva07$, a binary variable;

x_7 : is for independent variable (7) = $inddeva03$ / $inddeva07$, a binary variable;

x_8 : is for independent variable (8) = $fullcom03$ / $fullcom07$, a binary variable.

It is to be noted that x_1 is the quantitative variable, and x_2 , x_3 , x_4 , x_5 , x_6 , x_7 , and x_8 are qualitative variables, sometimes also called 'dummy' variables. Therefore, the impact of x_1 on y_p can be measured by correlation coefficient. The impact of each binary variable, $x_2 \sim x_8$, can be measured by the mean difference in y_p in terms of binary levels (that is, 0 or 1).

6.4 Regression Analysis

After fitting all the collected data into the multiple linear regression models, the 2003 and 2007 regression results are reported as in Figure 6.4 below.

For 2003 data:

$$y_p = -0.162 + 0.00063*x_1 - 0.173*x_2 + 0.166*x_3 + 0.0968*x_4 + 0.0069*x_5 + 0.0919*x_6 - 0.0158*x_7 - 0.0523*x_8 + \text{error term}$$

p-value for each estimated parameters (in bracket): x1(0.651), x2(0.125), x3(0.089), x4(0.241), x5(0.965), x6(0.482), x7(0.920), x8(0.823).

For 2007 data:

$$y_p = -0.309 + 0.0015*x_1 + 0.00563*x_2 + 0.225*x_3 + 0.118*x_4 - 0.0069*x_5 + 0.0233*x_6 - 0.0181*x_7 + 0.0421*x_8 + \text{error term}$$

p-value for each estimated parameters (in bracket): x1(0.218), x2(0.699), x3(0.074), x4(0.086), x5(0.933), x6(0.822), x7(0.863), x8(0.688).

Figure 6.4 Regression Results

Shaver (2007) argues that the standard practice when reporting results from linear regression models is to present coefficient estimates and assess if they are statistically significant. Independent variables with coefficients that are statistically significant (differ from zero) are said to affect the dependent variable. This is because coefficient estimates capture how independent variables affect the dependent variable. Regression coefficients in their linear regression model are partial derivatives, or marginal effects of the predicted values from the estimates. Therefore, assuming all other factors being constant, coefficient estimates represent the change in the expected value of the dependent variable (ROA) that corresponds to a change in the independent variable.

With coefficient estimation, one goes to the data to seek description of the sample; to estimate parameters to describe the samples. With hypothesis testing, one assesses if the prior belief about the population (the maintained hypothesis) is consistent with the estimated parameters. Coefficient estimation and hypothesis testing are therefore intertwined. Researchers use properties of the estimators that are employed to test if the maintained hypothesis is refuted. The standard hypothesis test is the two-tailed test with a null hypothesis that the coefficient estimate equals zero. When the coefficient estimate equals zero, it means that the independent variable does not affect the dependent variable. This interpretation is adopted provided that researchers have satisfied the assumptions underlying the test, the probability that the true value of the coefficient estimate in the population equals zero is less than the cut-off point of the test. A small p-value indicates that the estimated parameter is likely to be

statistically significant (that is, not equal to zero). A popular criterion is to choose the p-value of 0.05 (that is, the critical five per cent region); then the probability that the true value of the coefficient estimate in the population equals zero is five per cent. Thus, if the p-value is less than 0.05, it can be said that the estimated parameter is significantly away from zero, that is, there is a real impact on the response variable (ROA). This researcher is adhering to the good practice and time-tested criterion of choosing the p-value of 0.05.

Based on data produced by the linear regression models for both the years 2003 and 2007 (see Figure 6.4 above), it is noted that all the p-values are greater than the chosen cut-off test of 0.05. This implies that both the 2003 and 2007 results are inconclusive, since no inference can be made as to whether or not the selected independent variables have a true impact on the response variable, ROA.

Nevertheless, it is noted that x3 (the audit committee variable) has the smallest p-value (less than 0.1, or within the 10 per cent critical region) in both the 2003 and 2007 models. Thus, one may deduce that compliance with the establishment of Audit Committee (x3 independent variable) has the most possible impact on ROA, assuming that all other things remained unchanged in the two specified regression models. This inconclusive finding is in line with the results of reported U.K. Cadbury Code related cases (Weir and Laing, 2000; 2001).

There may be several reasons for the inconclusive regression results. Firstly, with eight independent variables in the model, and based on the standard deviations calculated from ROA 2003 and ROA 2007 (as shown in Tables 6.5 and 6.5.1 above), and their mean levels differences, one may need 60 to 80 observations to detect the effect of one independent variable on the dependent variable (ROA). With eight independent variables, it is reasonable to assume that one needs at least 500 observations to perform the proposed hypothesis tests. Thus with 89 observations, it is quite obvious that no conclusive result can be deduced from the regression analysis. This is the typical situation where statistical tests lack the power to identify meaningful effects due to small sample sizes (Ferguson and Ketchen, 1999).

Another possible reason is that independent variables x1 to x5 are interrelated in the sense that they are all meant to measure the degree of board independence and its

impact on firm financial performance (ROA). Similarly, independent variables x6 and x7 are interrelated in the sense that they both measure board accountability. As such, the so-called 'co-linearity' problem occurs and some involved x variables may appear non-significant in the models even if they may be statistically significant (Agrawal and Knoeber, 1996; Bhagat and Jefferis, 2002). In view of the above, it may be useful to analyse the impact of each x independent variable, one at a time, on the dependent variable (ROA). It may be reasonable to treat the 89 listed companies as a specific population for the next statistical study. The selected companies are based on the criteria of local incorporation, primary listing status with the New Zealand Stock Exchange, as well as the time frame of listing on or before 2003 (pre-NZX Code board structures) for purposes of comparison with the 2007 data (post NXZ Code board structures). As such, they are not the usual random sample but rather a special targeted population group of listed NZ companies.

6.4.1 Impact of Individual Independent Variable on Firm Financial Performance

2003 Results

The relationships between each individual independent variable (separately, one variable at any one time) and ROA for the year 2003 can be deduced from Figure 6.5 to Figure 6.5.7, and Table 6.6 below. The impact of x1 (a quantitative, continuous independent variable) on yp (dependent, respond variable, ROA) can be measured by correlation coefficient. The impact of each binary variable, x2 to x8 (each at a time) on ROA can be measured by the mean levels difference in yp in terms of binary levels (that is, 0 or 1). It is to be noted that Figure 6.5 below is a scatter plot which shows the relationship between x1 independent variable (percentage of independent directors) and yp dependent variable (ROA). The red line is a best fit OLS (ordinary least square) line. It shows a slightly positive correlation. This implies that a higher ratio of independent director is affecting positively on the financial performance of listed companies that have more independent directors on their boards. According to Table 6.6 below, however, the correlation is not statistically significant since the high p-value correlation test of 0.1832 is outside the chosen 0.05 criteria. In view of the above, higher ratio of independent directors does not seem to affect the financial performance of New Zealand listed companies in 2003.

Figure 6.5 Relationship of ROA vs IdpDpcent (2003)

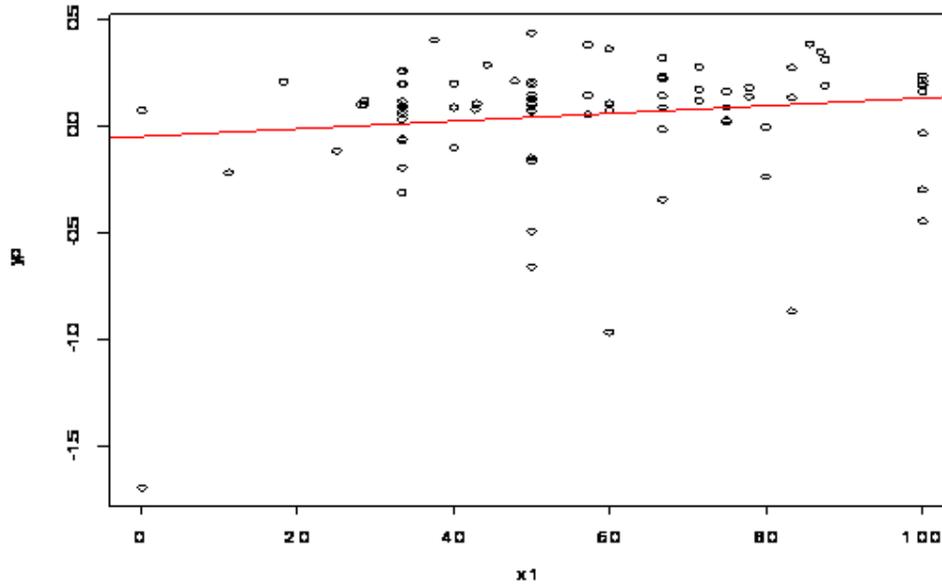


Figure 6.5.1
Impact of duality on ROA

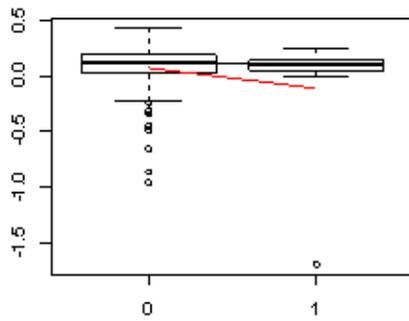


Figure 6.5.2
Impact of audit on ROA

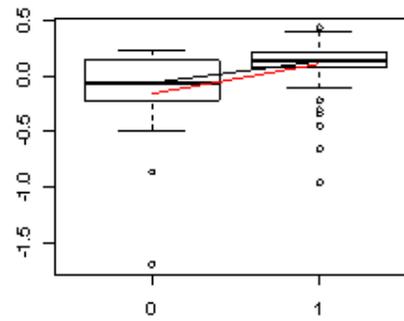


Figure 6.5.3
Impact of remuneration on ROA

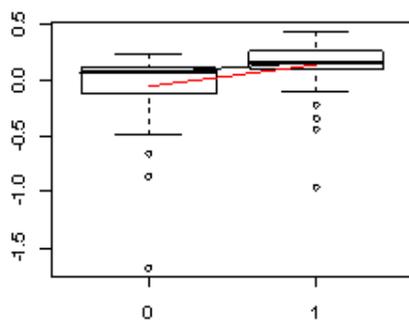


Figure 6.5.4
Impact of nomination on ROA

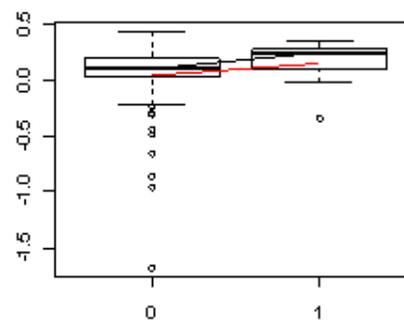


Figure 6.5.5
Impact of Board Evaluation on ROA

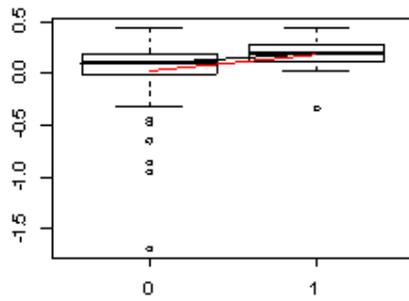


Figure 6.5.6
Impact of Director Evaluation on ROA

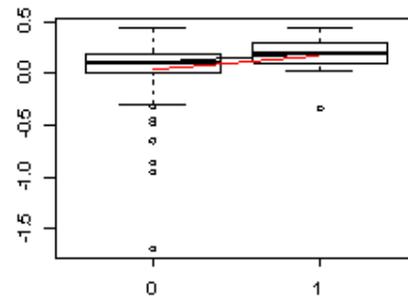


Figure 6.5.7
Impact of Full Compliance on ROA

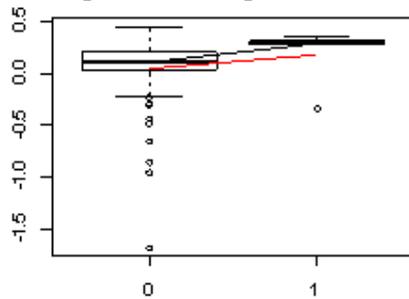


Figure 6.5.1 to Figure 6.5.7 above are the seven box plots which compare the mean ROA in terms of each binary level (0 or 1). Since the small horizontal bar in the middle of the box represents the median, a black line segment connecting two medians depicts the change in median between two binary levels.

The red line segments represent the change in means. Although both the means and the medians are statistics describing the average level, it should be noted that means are easily affected by one or two extreme values. Since the medians behave more evenly, they are the more robust measurement of average. When comparing the mean levels of two groups, the result would be more reliable if each of the groups has roughly the same number of observations. Thus, it can be seen from Table 6.6 that both x2 (duality variable) and x8 (full compliance variable) have very imbalanced observations (81/8 and 84/5 respectively). This makes their results unreliable to use as a basis to form any statistical inference.

Table 6.6 Impact of Individual Independent Variables on ROA for 2003

Percentage of independent directors (x1)	Correlation coefficient		p-value of correlation test
	0.1424		0.1832
Mean level of ROA	0	1	p-value of t-test
Duality (x2)	0.0679	-0.1030	0.4808
(No. of Obs.)	(81)	(8)	
Audit committee (x3)	-0.1509	0.1115	0.0201
(No. of Obs.)	(20)	(69)	
Remuneration committee (x4)	-0.0552	0.1406	0.0041
(No. of Obs.)	(40)	(49)	
Nomination committee (x5)	0.0413	0.1531	0.1925
(No. of Obs.)	(80)	(9)	
Board of performance evaluation (x6)	0.0238	0.1839	0.0086
(No. of Obs.)	(73)	(16)	
Individual performance evaluation (x7)	0.0334	0.1759	0.0499
(No. of Obs.)	(77)	(12)	
Full compliance (x8)	0.0451	0.1775	0.3744
(No. of Obs.)	(84)	(5)	

Note: No. of Obs. = number of observations

While the nomination committee variable (x5) seems not to have a significant impact on ROA (p-value of 0.1925), the audit committee variable (x3), the remuneration committee variable (x4) and the board and director performance evaluation variables

(x6 and x7) seem to have a significant impact on ROA. As stated above, the impact of each binary variable (x3, x4, x6, and x7) are measured by the mean levels difference in ROA in terms of binary levels (0 or 1). All the p-values of t. test relating to x3, x4, x6, and x7 are within the 0.05 level. It is noted that, however, the three independent variables of duality of CEO/Chair position, the establishment of a nomination committee, and full compliance with NZX Code recommendations do not seem to have an impact on firm financial performance of NZ listed companies in 2003, as reflected in their rather high p-values. The overall 2003 result is therefore inconclusive.

2007 Results

The relationships between each individual independent variable and ROA for the year 2007 are shown in Figure 6.6 to Figure 6.6.7 and Table 6.6.1 below. Figure 6.6 below is a scatter plot which shows the relationship between x1 independent variable (percentage of independent directors) and y_p dependent variable (ROA) in 2007. The red line is a best fit OLS (ordinary least square) line. It shows a positive correlation. This positive relationship between higher percentage of independent director and firm financial performance in 2007 is confirmed by the correlation coefficient measurement with a p-value of 0.0444 as shown in Table 6.6.1 below. Thus, it could be deduced that NZ listed companies which have higher percentage of independent director in their boards perform better financially in 2007.

Figure 6.6.1 to Figure 6.6.7 are the seven box plots which compare the mean ROA in terms of each binary level (0 or 1), in 2007. Since the small horizontal bar in the middle of the box represents the median, a black line segment connecting two medians depicts the change in median between two binary levels. The red line segments represent the change in means. When comparing the mean levels of two groups, the result would be more reliable if each of the groups has roughly the same number of observations. It is noted that the x2 (duality) and x3 variable (audit committee) have very unbalanced distributions of observations as shown in Table 6.6.1 below.

Figure 6.6 Relationship of ROA vs idpDpcent (2007)

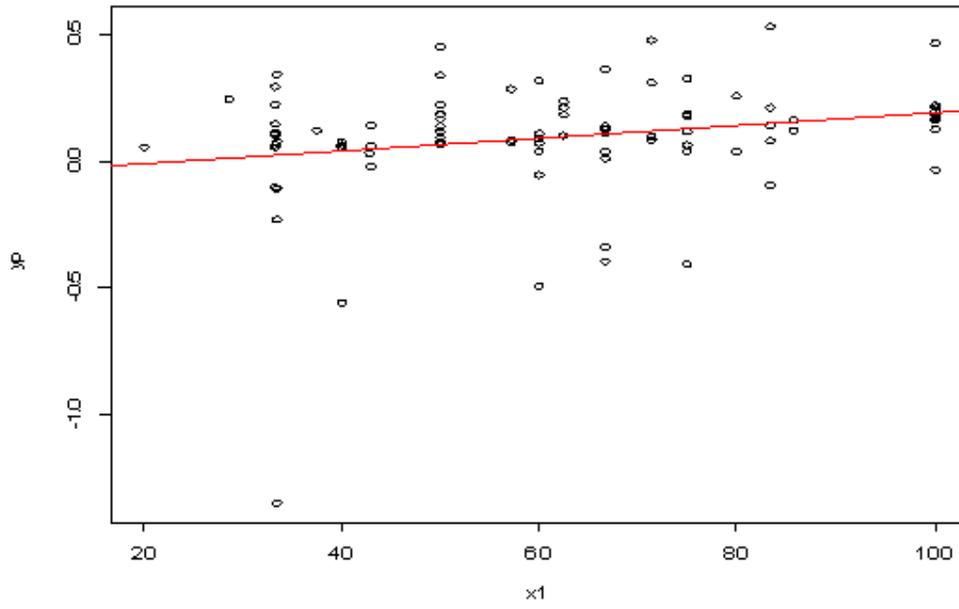


Figure 6.6.1 Impact of duality on ROA

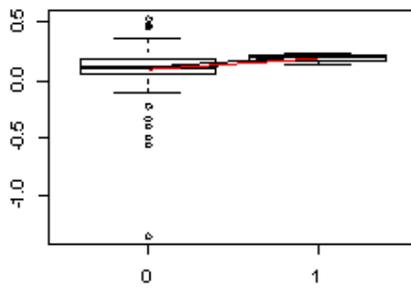


Figure 6.6.2 Impact of audit on ROA

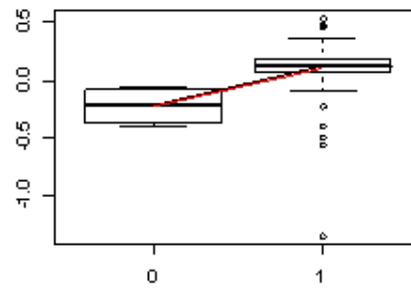


Figure 6.6.3 Impact of remuneration on ROA

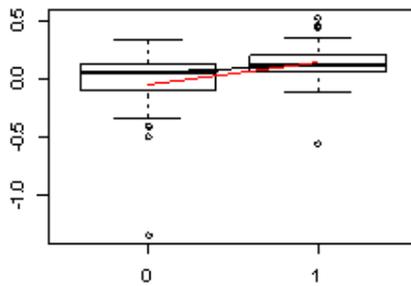


Figure 6.6.4 Impact of nomination on ROA

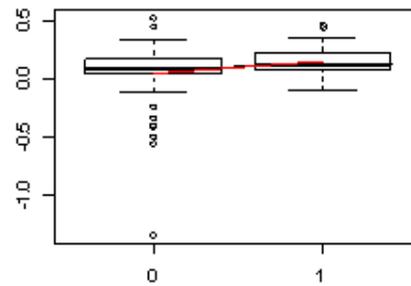


Figure 6.6.5
Impact of Board Evaluation on ROA

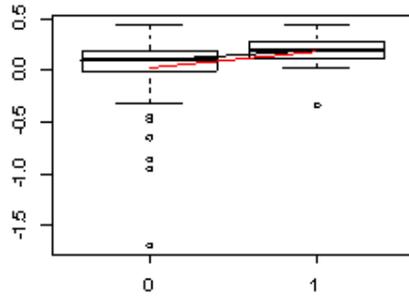


Figure 6.6.6
Impact of Director Evaluation on ROA

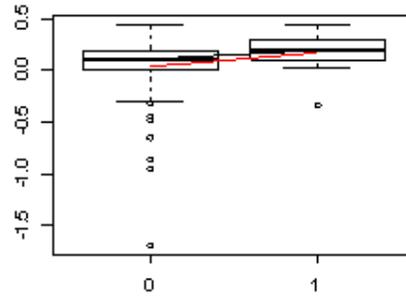
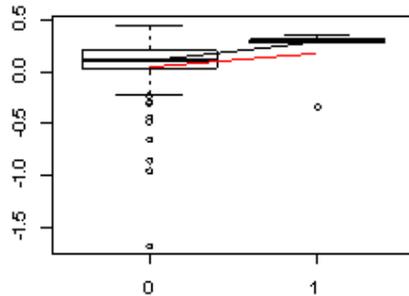


Figure 6.6.7
Impact of Full Compliance on ROA



From Figure 6.6 to Figure 6.6.7 and Table 6.6.1 above, it is noted that unlike the 2003 result, the 2007 data reveals that all the independent variables (x1 to x8) seem to have a significant positive impact on ROA. Furthermore, the distributions of observations appear to be more balanced. Significantly, full compliance with NZX Code seems to produce a very strong positive impact on firm financial performance (p-value of 0.0081). One surprising result is that the duality variable (x2) seems to have a slight positive impact on ROA (p-value of 0.0463), which is contrary to agency theory prediction, although such an inference must be made with the caution that the distribution of observations is quite unbalanced (86/3). The 2007 results, therefore, show a consistent positive pattern of relationships between compliance with individual NZX Code recommendations and the financial performance of listed companies.

Table 6.6.1 Impact of Individual Independent Variables on ROA for 2007

Percentage of independent directors (x1)	Correlation coefficient		p-value of correlation test
	0.2137		0.0444
Mean level of ROA	0	1	p-value of t.test
Duality (x2)	0.0894	0.1930	0.0463
(No. of Obs.)	(86)	(3)	
Audit committee (x3)	-0.2227	0.1078	0.024
(No. of Obs.)	(4)	(85)	
Remuneration committee (x4)	-0.0354	0.1488	0.0108
(No. of Obs.)	(27)	(62)	
Nomination committee (x5)	0.0527	0.1645	0.0116
(No. of Obs.)	(57)	(32)	
Board of performance evaluation (x6)	0.0469	0.1519	0.0261
(No. of Obs.)	(50)	(39)	
Individual performance evaluation (x7)	0.0554	0.1508	0.0347
(No. of Obs.)	(54)	(35)	
Full compliance (x8)	0.0674	0.1811	0.0081
(No. of Obs.)	(69)	(20)	

Note: No. of Obs. = number of observations

The full compliance variable is now to be tested separately again to reconfirm its positive relationship with firm financial performance, so that the finding could be combined with the industry ROA performance to determine whether the results are

the same when listed companies which complied fully with the NZX Code are assessed and compared with only companies that operate within their individual industries.

6.4.2 Full Code Compliance and Firm Financial Performance

2003 Results

Figure 6.7 and Figure 6.7.1 below are box plots for 2003 and 2007 respectively, to be used to investigate whether companies which complied fully with the NZX Code (denoted with a binary of 1) perform better financially than those that have not complied fully (denoted with a binary of 0). A dashed red line shows the overall mean level of ROA. As can be seen from Figure 6.7, those companies under the binary of 1 (full compliance status) are above the red line, whereas those companies under the binary of 0 (not fully complied) are below the red line. Table 6.7 below also shows that the mean level ROA difference and median level ROA difference are statistically significant between full Code compliance companies and non-full compliance companies. Thus, it appears that in 2003, companies which fully complied with the NZX Code perform better than those companies that have not complied fully. However, the Welsh Two Sample t-test result as shown in Figure 6.8 below confirms that the mean level ROA difference is not significant. This is due to the high p-value of 0.3744. Therefore, the 2003 t-test results do not support the initial inference that companies which fully complied with the NZX Code perform better than those companies that have not complied fully.

Figure 6.7
Comparison of ROA by Code Compliance Status (2003)

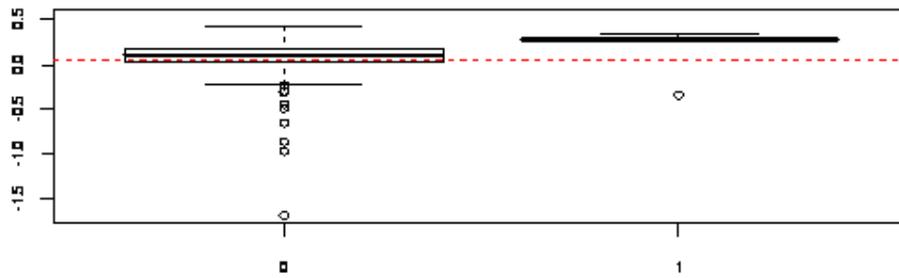


Figure 6.7.1
Comparison of ROA by Code Compliance Status (2007)

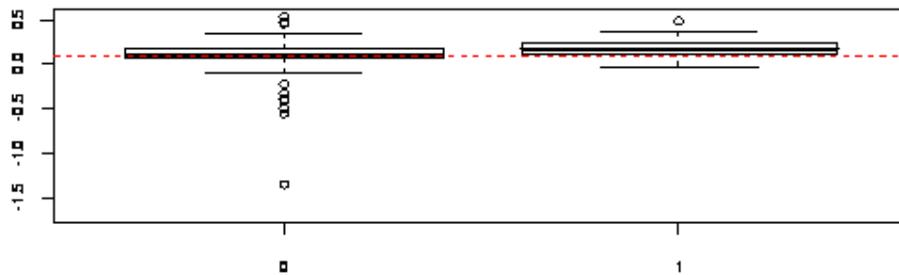


Table 6.7 Comparison of ROA by Compliance Status of Listed Companies

Full Compliance Status (Yes=1, No=0)	2003		2007	
	0	1	0	1
Mean	0.04514	0.17753	0.06735	0.18109
Median	0.10930	0.28752	0.10843	0.17101
Number of Observations	84	5	69	20

Figure 6.8 Results of Welch Two Sample t-test (2003)

```
m31 = ROA03[which(f03==1)]; m30 = ROA03[which(f03==0)]
t.test(m31,m30)
Welch Two Sample t-test : data: m31 and m30
t = 0.984, df = 4.565, p-value = 0.3744
alternative hypothesis: true difference in means is not equal to 0
95 percent confidence interval: [-0.22360, 0.48837]
sample estimates of difference in means: 0.17753 - 0.04514 = 0.13239
```

Figure 6.8.1 Results of Welch Two Sample t-test (2007)

```
m71 = ROA07[which(f07==1)]; m70 = ROA07[which(f07==0)]
t.test(m71,m70)
Welch Two Sample t-test: data: m71 and m70
t = 2.7265, df = 68.537, p-value = 0.00812
alternative hypothesis: true difference in means is not equal to 0
95 percent confidence interval: [ 0.03051, 0.19698]
sample estimates of difference in means: 0.18109 - 0.06735 = 0.11374
```

2007 Results

The dashed red line in Figure 6.7.1 above shows the overall mean level of ROA in 2007. As can be seen from the box plot, those companies under the binary of 1 (full compliance status) are above the red line, whereas those companies under the binary of 0 (not fully complied) are below the red line. It appears that those companies which fully complied with the NZX Code perform better financially than those which did not comply fully in 2007. Mean level ROA difference in Table 6.7 also supports the box plot inference. This result is further confirmed by the Welch Two Sample t-test, as shown in Figure 6.8.1 above. This is because the low p-value suggests strong evidence that there is a true difference between 0 and 1. Therefore

for 2007, companies which complied fully with the NZX Code empirically perform better in term of ROA than those companies which have not complied fully with the NZX Code. Thus, it seems that compliance with NZX Code recommendations impacts positively on the financial performance of NZ listed companies in 2007. This provides the empirical evidence to answer the second research question on compliance with NZX Code and its impact on the financial performance of NZ listed companies.

In order to have a more robust statistical analysis of the relationship between NZX Code compliance and the financial performance of NZ listed companies, it may be useful to reclassify the data set from the 89 companies into the various industry group sectors. Results from such analysis (to be reported under Section 6.5) may then be used to confirm or disprove the statistical results as contained in Sections 6.4.1 and 6.4.2 above.

6.4.3 NZX Code Compliance and Corporate Financial Performance by Group Sector

In order to investigate the relationship between NZX Code compliance and corporate financial performance of NZ listed companies, classified in accordance to the various business group sectors, the first step is to analyse the changes in the ROA mean level among business group sectors. A box plot is drawn to show the distributions of ROA in each industry group (as shown in Figures 6.8 and 6.8.1). Table 6.8 gives a detailed comparison of ROA mean levels.

Figure 6.8 and Figure 6.8.1 are box plots for 2003 and 2007 respectively. A dashed red line shows the overall mean level of ROA. As shown in the box plots, the investment sector has a lower overall ROA compared to the other industries for both the years 2003 and 2007. This finding is confirmed by analysing Table 6.8 which shows that the investment sector is consistently having the lowest performance in terms of the mean and median levels of ROA among all the industry sectors for both the years 2003 and 2007. On the other hand, the energy sector, although constituting only 5.62 per cent (5 out of 89) of the population, has shown that it is the most profitable industry in terms of the mean and median levels of ROA among all the industry sectors for both the years 2003 and 2007. This could be due to their oligopoly structure and the huge capital outlay as a barrier to entry. There is also a

discernable trend of relative lower profitability in the primary sector, as shown by the declining levels in both the mean and median ROA for both the years 2003 and 2007. The goods sector registered a decline in profitability in term of mean ROA level, but the median ROA level improved marginally from 2003 to 2007.

Figure 6.8 Comparison of ROA by Industry (2003)

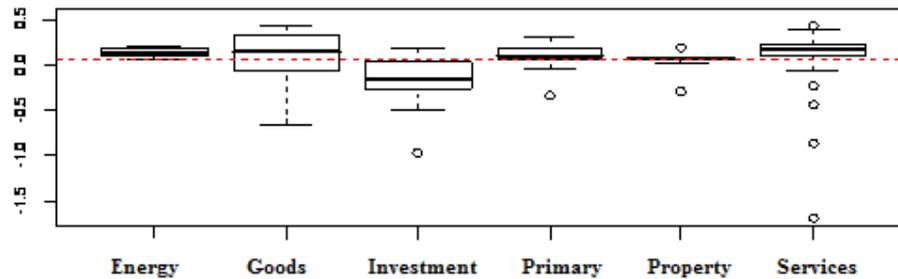


Figure 6.8.1 Comparison of ROA by Industry (2007)

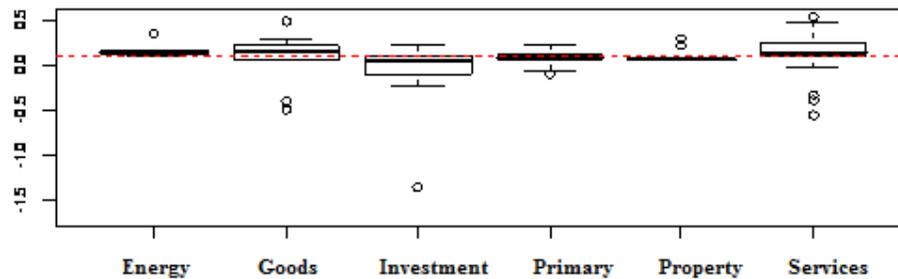


Table 6.8 Comparison of ROA Means Level by Industries

Industry	Energy	Goods	Investment	Primary	Property	Services
Mean(2003)	0.14235	0.09637	-0.18849	0.09254	0.04422	0.08420
Mean(2007)	0.16922	0.08047	-0.10092	0.07570	0.10709	0.14409
Median(2003)	0.13239	0.14376	-0.16250	0.10105	0.07680	0.17384
Median(2007)	0.13682	0.15175	0.04008	0.08312	0.06641	0.14389
Number of observations	(5)	(12)	(11)	(13)	(9)	(39)

The services sector constitutes 43.82 per cent (39 out of 89) of the population, which makes it the largest sector, but it also has the most extreme variation in terms of ROA among the listed companies under study. This is shown in the mean levels of ROA which increased from 0.08420 in 2003 to 0.14409 in 2007. However, due to the extreme range of financial performance among its sector companies, the median level of ROA decreased from 0.17384 in 2003 to 0.14389 in 2007.

From the above analysis of comparative corporate financial performance according to industry sector classification among the 89 companies under study, it is to be noted that any analysis of financial performance of New Zealand listed companies must take into consideration the differing rates of return among the various industries. Therefore, it will be meaningless to compare for example the financial performance of a listed investment company (operating within an industry that has the lowest mean level of ROA) with a listed energy company (operating within an industry that has the highest mean level of ROA) without adjusting for the inherent industry performance factor (differences in profitability according to each individual industry). With this caution in mind, it is perhaps timely to investigate whether listed companies which comply fully with the NZX Code perform financially better than those who have not, after holding the industry performance factor constant.

6.5 Combined ROA Comparison by Industry and Code Compliance Status

In order to hold the industry performance factor constant, the research now moves to combine the data of companies who have fully complied with the NZX Code (see Table 6.6 and Table 6.6.1 above) and the industry performance data (see Table 6.8 above). The purpose of this particular study is to investigate whether NZX Code fully complying companies which have been empirically shown to perform financially better than those which have not fully complied (as reported in Section 6.4.2 above), would have the same result after being classified and assessed within their respective industries. They are to be measured by their respective ROA mean level difference to determine whether there is a true difference in financial performance between full code compliance and non-full compliance companies operating within the same industry.

Results

2003 Result

The performance data of listed companies classified according to their own industry are now reported in Table 6.9 below. It is noted that in 2003, three (energy, investment, and property sectors) out of the six industry sectors do not even have a single company which fully complied with the NZX Code. Only five companies fully complied with the NZX Code, shared by the services sector (two companies), the primary sector (two companies), and the goods sector (one company). While the goods and services sector produced higher ROA mean level among companies which fully complied with the NZX Code, the reverse is true for the primary sector. In view of the small number of compliance companies and the mixed ROA mean level difference, no conclusive statistical inference can be made for 2003.

Table 6.9: Combined ROA Mean Level Comparison (Industry x Compliance Status)

Compliance Status/Sector Classification	2003		2007	
	0	1	0	1
Energy	0.142	NA	0.182	0.119
(No. of Obs.)	(5)	(0)	(4)	(1)
Goods	0.073	0.350	0.023	0.196
(No. of Obs.)	(11)	(1)	(8)	(4)
Investment	-0.188	NA	-0.115	0.040
(No. of Obs.)	(11)	(0)	(10)	(1)
Primary	0.112	-0.015	0.044	0.148
(No. of Obs.)	(11)	(2)	(9)	(4)
Property	0.044	NA	0.107	NA
(No. of Obs.)	(9)	(0)	(9)	(0)
Services	0.073	0.284	0.122	0.209
(No. of Obs.)	(37)	(2)	(29)	(10)

Note: No. Of Obs. = number of observances

2007 Result

For 2007, the result is completely different to that of 2003. From Table 6.9 above, it can be seen that the number of full code compliance companies have increased from five (5.62 per cent) in 2003 to twenty (22.47 per cent) in 2007. Five out of the six industry sectors have companies which fully complied with the Code. Within companies operating in the goods, investment, primary, and services industries, those which fully complied with the Code seem to perform financially better than those who have not fully comply with the Code, as reflected in higher levels of mean ROA. From the 2007 data, therefore, there is strong evidence to suggest that among companies operating in the same industry, those which fully complied with the Code empirically perform better financially (higher levels of mean ROA) than those who have not complied fully with the NZX Code. This result reinforces the empirical evidence reported in Section 6.4.2 above that listed companies which complied fully with the NZX Code in 2007 out performed financially listed companies which do not fully comply with the recommended best practice code. This finding also provides additional evidence to answer the second research question on compliance with NZX Code and its impact on the financial performance of NZ listed companies.

6.6 Chapter Summary

Although the percentage of New Zealand listed companies which complied fully with the NZX Code increased sharply from 5.6 per cent in 2003 to 24.5 per cent in 2007, the low overall rate is rather disappointing and unremarkable. This is in sharp contrast to the relatively high 70 per cent rate of compliance with the UK Combined Code by the FTSE 100 companies in 2004.

Nevertheless, compliance rates on individual NZX Code recommendations such as a minimum of two independent directors, separation of CEO/Chairman positions, and establishment of an audit committee are very impressive, averaging more than 96 per cent in 2007. Although a compliance rate of almost 70 per cent on the establishment of a remuneration committee is considered to be quite high, the compliance rates on the establishment of a nomination committee (36 per cent), board performance evaluation (43.8 per cent), and individual director performance evaluation (39.3 per cent) are rather low in 2007.

Results from both the 2003 and 2007 regression analysis show that all the independent variables have high p-values (all above 0.05). The variable on the establishment of an audit committee, however, has the lowest relative p-values (less than 0.1) for both the years 2003 and 2007. The inconclusive regression results for both the years 2003 and 2007 could possibly be due to the small sample size in relation to the number of variables in the regression models, and the so called “co-linearity” problem when the various variables are interrelated.

However, treating the 89 companies as a population of specially targeted New Zealand listed companies, the resulting statistical inferences are quite clear. Although the overall 2003 result is quite inconclusive, the 2007 result shows a consistent positive pattern that listed companies which complied fully with the NZX Code outperformed financially companies that had not complied fully. The positive relationship between full compliance with the NZX Code and firm financial performance in 2007 is replicated even when the 89 companies are classified according to their respective industry sectors and compared within their own group sectors performance. The 2007 result as a whole confirms the agency theory predictions on the positive relationship between board independence and firm financial performance, assuming all other factors being constant. It must be pointed out that duality of CEO/Chairman position in 2007 does not seem to have an adverse impact on the financial performance of companies which do not separate the CEO/Chairman leadership positions, which is contrary to agency theory prediction.

The findings of this research on the extent of compliance on NZX Code and its positive impact on the financial performance of listed companies as reported above provide the necessary answers to the research questions as stated in Section 6.1 above. The research findings also provide some answers to fill the perceived knowledge gap on the relationship between corporate governance best practices and financial performance of New Zealand publicly traded companies. The implications and significance of these research findings, and suggestions on further research are to be discussed in the next concluding chapter.

Chapter Seven – Concluding Chapter

A survey of extant literature review shows that there is no uniform definition of the term “corporate governance” among either academic scholars or practising managers. However, two distinct characteristics can be identified among the many diverse definitions. Firstly, the term is defined either too narrowly or too widely in its scope, reflecting differing disciplines and theoretical backgrounds. Secondly, it is defined from two differing theoretical perspectives on the role and fundamental purpose of big publicly traded corporations.

Analysing the various definitions should enable us to identify the role of governance and where the responsibility for governance lies in corporations. Thus, one can say that the role of governance in an organisation is to ensure the effective usage of firm resources to achieve the established objectives of its owners and to also care for the interests of its other stakeholders. The responsibility for governance lies in the hands of its board and management, whose relationships should be based on mutual respect, trust, and personal integrity.

The various definitions of corporate governance reflect the differing theoretical perspectives and disciplinary backgrounds of the scholars and practitioners. While the shareholder value theory advocates that the board of directors (BOD) should maximise shareholders value, the stakeholder theorists laments that the BOD should also take care of the legitimate interests of other non-shareholder stakeholders when making strategic decisions.

The shareholder-oriented approach of the Anglo-American model is in stark contrast to the stakeholder-oriented approach of the German and Japanese models. The purpose and accountability of public listed company are also different under the shareholder value and stakeholder value perspectives. While public companies are viewed as economic entities to maximise profits for its shareholders under the Anglo-American model, they are viewed as social institutions to cater to the needs of all stakeholders under the German/Japanese models. Although there are calls for convergence of governance systems on the grounds of competitive advantage, it

must be noted that each country has its own form of value systems, be they economic, political, cultural, or social in nature. While the much debated convergence of corporate governance models is not expected to happen any time soon, the convergence of views on the principles of good corporate governance practices are evidenced from the proliferation of best practice codes across both the developed and developing nations, with the common feature of adopting the good principles of the U. K. Cadbury Code of Best Practice.

The Cadbury Code of Best Practice is the most important recommendation of the Cadbury Report, 1992. The Cadbury Code, besides putting public pressures on British directors to change their behaviour and to adopt new practices in corporate governance, is also thought to represent a watershed in the development of corporate governance in Britain. The impact of the Cadbury Code goes beyond the shores of the UK. It spurs the development of corporate governance best practice codes not only in the Anglo-Saxon countries (Canada, Australia and New Zealand but not the US, which chose to legislate), but almost throughout the world including groupings and institutions such as OECD, Commonwealth Association, World Bank, and the International Monetary Fund.

Literature review shows that a single generic governance model and a single “one size fits all” best practice code may not address the complexity and variation as seen across the widely differing structures and imperatives of the New Zealand corporate setting. This raises also the differing perspectives of the private and public sectors on the definition of corporate governance. There is now an emerging private sector consensus that corporate governance is about maximising shareholders value in the long run, though in the process it requires balancing the interests of shareholders and other stakeholders. From a public policy perspective, corporate governance is about providing firms with the incentives and discipline to minimise the divergence between private and social returns, while ensuring accountability in the exercise of power and patronage by the firms.

There seems to be a common theoretical underpin in the various corporate governance best practice codes of the UK, Australia, New Zealand, and the New York Stock Exchange recommendations for listed companies. The agency theory

perspective and focus on board independence seems to be the underlying theme of the various best practice codes. The board of directors (BOD) is thus expected to focus on the control role as its primary function.

The roles and functions of board of directors are defined differently in accordance with differing and sometimes contrasting theoretical perspectives. While the agency theory, and to a lesser extent, the legalistic theory, promote the primary role of the BOD as controlling and monitoring of managerial opportunism, the managerial hegemony theory laments that the board is a creation of the chief executive officer (CEO), and a legal fiction. Such contrasting perspectives, however, do not seem to take into account the changes taking place in the 21st century boardrooms arising out of the recent corporate governance reforms, especially the adoption of best practice codes, which are shifting the balance of powers increasingly to the advantage of the BOD. The resource dependence role and the service role of the BOD, on the other hand, are very much dependent on the working relationship between the executive and non-executive directors. Herein underscores the dilemma for outside directors, as research shows that good social ties between directors and management foster trust, which encourages managers to seek greater input from directors and reduce the need for impression management. However, outside directors, as explicitly stated in the corporate governance best practice code, are supposed to be independent and are therefore expected to focus on their control role. This only makes it hard for the non-executive directors to carry out their service role, since their views may not be considered by the management seriously. The choice between the control approach and the collaborative approach is a fine balance that the BOD and the independent directors in particular, must learn to pursue and live with.

Literature review shows that there is wide spread support and acceptance of the U.K. Cadbury Code and its successor the Combined Code. This is evidenced by the rather high rates of compliance with the two Codes; 73 per cent and 70 per cent respectively (see Section 3.8 above). Although there is no consistent and conclusive empirical evidence to link full compliance with the Cadbury Code and firm financial performance, the relevant U.K. data could be generalised and be adapted to the New Zealand setting to suit local context. There is therefore this opportunity to conduct an original study in New Zealand to address the still open research question on

compliance with the NZX Code and its impact on the financial performance of listed companies.

Research Questions and Findings

More than five years after the issuance of the New Zealand Exchange (NZX) Corporate Governance Best Practice Code (NZX Code) in October, 2003, there is no official or research study on the extent of compliance with the recommendations of the NZX Code. There is, therefore, a good opportunity to conduct an original research to gather empirical data on the adoption and implementation of the NZX Code. The expected variance in the degree of compliance and adoption of the various recommendations of the NZX Code by New Zealand (NZ) listed companies offers a good opportunity to investigate the possible correlation between the implementation and adoption of the NZX Code, and positive financial performance of listed companies as predicted by the agency theory. This provides the researcher with an opportunity to conduct an original study on the relationship between full compliance with the NZX Code and its impact on the financial performance of NZ listed corporations.

This thesis has asked these two questions:

- 1) To what extent have New Zealand listed companies complied with the recommendations of the NZX Code?
- 2) Would compliance with the NZX Code have any positive impact on the financial performance of listed companies, assuming all other factors being constant, as predicted by agency theory?

These two research questions have been answered as follows. The empirical data on the extent of compliance and implementation of the recommendations of the NZX Code by NZ listed companies provide the necessary answer to the first of the two research questions. Answer to the second research question is found from the results of statistical analysis of the impact of full compliance of NZX Code on the financial performance of NZ listed companies.

Data analysis reveals that the rate of full compliance of the NZX Code for both the years 2003 and 2007 are rather disappointing, and at best could be described as

unremarkable. The full compliance rate jumped from 5.6 per cent in 2003 to 24.5 per cent in 2007. Although full compliance with the NZX Code increased more than four times during the period between 2003 and 2007, the full compliance rate is still very low when compared to the relatively high 70 per cent full compliance with the United Kingdom (UK) Combined Code by the FTSE 100 companies in 2004.

Of the total five listed companies which fully complied with the NZX Code in 2003, two of them were involved in the primary industry sector. Another two full compliance listed firms came from the services industry sector, while the balance of one listed company was engaged in the goods industry sector. The investment and property group sectors did not produce any full compliance company in 2003. For 2007, again the property sector was not represented in the 20 NZX Code full compliance companies. The investment sector, however, managed to produce one fully complied listed firm, with the balance of 19 fully complied companies engaging in the services sector (ten firms), the primary and goods sectors (each with four firms represented), and the energy sector (one firm).

Among the seven independent variables studied, implementation of the recommendation of the minimum two independent directors, the separation of CEO/Chair positions, and the establishment of an audit committee by the NZ listed companies were rather impressive, averaging more than 96 per cent in 2007 for each of the three individual variables. The variable on the establishment of a remuneration committee also registered a relatively high compliance rate of 69.7 per cent in 2007, when compared with the compliance rate of 36 per cent for the establishment of a nomination committee, 43.8 per cent for board performance evaluation, and 39.3 per cent for individual director performance evaluation.

The 2003 (pre- NZX Code governance structures) and 2007 (post NZX Code governance structures) regression analysis results reveal that all the seven independent variables have relative high p-values (above 0.05), although the variable on the establishment of an audit committee registered the lowest p-value (less than 0.1) for both the years 2003 and 2007. Thus, the 2003 and 2007 multiple linear regression results are inconclusive and cannot be relied upon to make any meaningful statistical inference. There are two possible reasons for the inconclusive

multiple variables linear regression results. Firstly, 89 companies in the sample are relatively too small when there are seven independent variables to impact on the dependent variable. Secondly, some of the so called independent variables are actually interrelated, causing the co-linearity problem.

By treating the 89 companies as a specially targeted population of NZ listed companies, and using a simpler and more descriptive tool to analyse the impact of individual independent variables on corporate financial performance of listed firms, the 2007 results show a consistent pattern of a positive relationship between NZX Code compliance and firm financial performance, assuming all factors being constant. This positive relationship is further reinforced when the 89 companies are divided according to the NZX classified industry sectors, which also results in a consistent pattern of companies which comply fully with the NZX Code financially outperforming companies that only partially comply with the Code during 2007. One surprising result is that listed companies adhering to the CEO/Chairman dual leadership role do not seem to have an adverse impact on their financial performance during 2007, which is contrary to agency theory expectations.

Implications of Findings

Since full compliance with the NZX Code impacts positively on firm financial performance, from a regulatory perspective, the implication is whether NZX Code recommendations should be made mandatory and with explicit penalty. This is particularly so when the full compliance rate is still very low at 24.5 per cent during 2007. Even if it is decided that the present voluntary basis of the Code is to be maintained, another policy implication is the urgent need to amend the present rather lax disclosure mechanism of only reporting when there is *material difference* in governance practices, rather than the more comprehensive “comply or explain” formal self-regulation. This measure would bring NZX to be more in line with the practices of other major world stock exchanges, in order to maintain existing international investor confidence. Another policy implication is that NZX Listing Rules pertaining to the NZX Code should be more vigorously monitored. Any non-adherence to the NZX Code recommendations should be explained clearly and stated in the annual reports, and not just only if they have ‘materially’ differed from the Code principles. Any listed company that does not provide an NZX Code

compliance statement in its annual report should be warned to do so in writing; further non-compliance is to be followed by a public reprimand, and suspension of listing status as a last resort penalty. The supports of investor groups such as fund managers, institutional investors, and minority shareholders associations, and the financial press should be actively sought and co-ordinated by the NZX and the Securities Commission in a concerted effort to raise awareness on the importance of good corporate governance practices in order to boost investor confidence in the New Zealand equity market.

Contribution of this Thesis

The aforementioned research findings contribute to both the academic and professional fields. From an academic perspective, these research findings add to the knowledge creation chain by providing some answers to the perceived gaps in the existing knowledge on the extent of the implementation of the NZX Code, and the positive impact of Code compliance on the financial performance of New Zealand listed companies. The research findings should provide pointers to other researchers to investigate further other aspects of corporate governance best practice code. To the corporate directors, other professionals, and managers, the empirical evidence should induce confidence in the full implementation of the NZX Code recommendations, and not to treat it as just another expense item to be added to the already high compliance cost of doing business in New Zealand. There seems to be financial benefits associated with best practice code, and not just treat it as a “tick off the boxes” exercise imposed upon by the securities regulators. These research findings also add value to the present debates on corporate governance by contributing empirical data and evidence from the NZ setting.

Limitations and Scope

This study is only confined to the corporate governance practices of publicly traded NZ companies. It is to be noted that there are many other forms of business enterprises which might have different governance structures and needs. They include privately owned limited companies, subsidiaries of foreign held firms, state-owned entities, local government entities, co-operatives, and charitable trusts. This research only concerns with shareholder interests, and does not take into consideration the interests of other stakeholders.

This study is limited to the testable aspects of the NZX Code. For example, ethical consideration, although an integral part of corporate governance practice, is not so easily quantifiable. In addition, quantitative method as used in this research tends to measure variables in respect of structural independence rather than board effectiveness and director effectiveness. This study also does not cover behaviour of the board, which may be more important than board practice itself for corporate performance. If one accepts the notion that a board is only as effective as its own directors, then both the calibre and behaviour of the board members should be accounted for in board effectiveness and corporate performance.

Further Research

The research findings point the way to areas of further research. Although a formal and transparent director selection process is theoretically perceived as essential to board effectiveness, yet how the director selection process really operates is still an open research question. Thus, further studies on director selection process should focus on the insider perspective, especially the role of board chairman and CEO on the selection of new directors. Another area of further research is the relationship between director selection process and the performance evaluations of board and individual director. The identification of common links among these processes could add value and contribute to better understanding of the determinants of board effectiveness, and thus firm performance.

Compliance and implementation of corporate governance best practices code, crucial though it may be to constitute an effective board, could be adopted for the wrong reasons, besides the mandated compliance. For example, they may be adopted because investors are impressed by them and not due to the board's genuine desire to enhance its own effectiveness; reducing the implementation of the code to "tick off the boxes" approach. Nevertheless, it must be noted that there are many other reasons besides perceived good corporate governance practices which account for a company's financial performance. That is why it might be useful for other researchers to explore the feasibility of isolating the measurement of the efficacy of board governance practices, in proportion to the overall corporate performance.

Another research question that this study raises is whether the findings and data from New Zealand listed companies could perhaps be generalised to other nations that have adopted similar corporate governance best practice codes. I leave this challenge for other researchers to investigate.

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