From: david white [whitedr@bigpond.net.au]
Sent: 19 May 2009 11:31
To: Chris Hodge
Subject: Submission to Code Review - White

Attachments: PerformingPublicInterest09D.doc

My conclusions from a recent review of governance standards, being completed as part of a PhD in Governance, may be of interest.

Governance standards issued by OECD countries including the UK Combined Code were reviewed and compared to over 80 studies into the governance practices of high performing organisations and/or corporate failures.

My conclusion is that most governance standards may assist in improving directing effectiveness but are generally not sufficient to provide guidance that motivates, creates or sustains high performance or failure avoidance. Most governance standards focus on structure and process whilst the factors that create high performance or avoid failure are more correlated to culture, competency and systems.

Governance standards need to move from 'trust me, we are experts' to 'prove to me' that the recommended principles and practice are statistically proven to achieve performance and/or compliance outcomes in the long term interests of shareholders and public (if public sector).

Attached is an unpublished draft which provides further detail. Although it is written from an Australian perspective I think the basic conclusions remain valid for any country.

I am happy to provide further information, if required, including my evidence based performance focused governance standard.

regards

David White
PhD Researcher
Principal Audit Manager (Housing)
Risk Management and Internal Audit
Department for Families and Communities
Phone 812 44034
Level 12 Terrace Towers
178 North Terrace Adelaide South Australia 5000

Performing in the Shareholder/Public Interest

David White

1. OVERVIEW

Governance standards issued by OECD countries including Australia were reviewed and compared to over 80 studies into the governance practices of high performing organisations and/or corporate failures.

My conclusion is that most governance standards may assist in improving directing effectiveness but are generally not sufficient to provide guidance that motivates, creates or sustains high performance or failure avoidance. Most governance standards focus on structure and process whilst the factors that create high performance or avoid failure are more correlated to culture, competency and systems.

Governance standards need to move from ‘trust me, we are experts’ to ‘prove to me’ that the recommended principles and practice are statistically proven to achieve performance and/or compliance outcomes in the long term interests of shareholders and public (if public sector).

An evidence based performance focused governance standard designed to overcome these limitations is overviewed and its use to date in making assessments. The governance standard has been used as a benchmark to analyse the results of studies into the state of governance in Australia. My conclusion is that there is a high residual risk of mediocrity and underperformance in the private and public sectors which may be compromising shareholder/public interests and the standard of living of every Australian.

The Australian Government needs to adopt a nationally integrated approach to governance using evidence based performance focused standards if international competiveness and societal wellbeing is to be sustained and improved.

2. WORK CONDUCTED

The following work has been conducted:

- reviewed all major governance standards issued by OECD countries including those issued in the private and public sectors in Australia;
- analysed studies in all major countries into the governance practices of high performing organisations;
- conducted my own research into high performing organisations in Australia and Middle East;
- analysed the results of studies into the state of governance, productivity, innovation and international competiveness in Australia;
- facilitated over 100 workshops on governance and corporate control system self assessment for boards, executives, internal auditors, risk managers and human resource specialists in both the public and private sectors;
- internal auditor, governance adviser and change agent for over 25 years including withdrawing services for a major airline that subsequently collapsed, investigating major performance issues and frauds at all levels of responsibilities in the public and private sectors;
- provided internal audit opinions on the effectiveness of corporate control systems for performance and compliance for large complex and/or high risk organisations, designed control frameworks and/or provided training in controls/system design and operation internally with organisations and as part of a university management qualification.

Over 80 studies into high performing organisations or those that failed have been reviewed including research evidence on board / executive practices, behaviours, personality types, decision-making, stakeholder relationships, corporate culture, CEO maturity, corporate support functions, internal auditing, risk management, change management, leadership styles, employee engagement and innovation.

The research and analysis work has been conducted under supervision as part of completing a PhD.

3. ANALYSIS OF GOVERNANCE STANDARDS

The analysis indicates many of the governance standards issued in the public and private sectors are based on oversight activities including reviewing directions, performance management of the CEO, approving key decisions and monitoring performance, risks and integrity of financial and other information.

Private sector examples include the Australian ASX Corporate Governance Principles and Recommendations (2007). Public sector examples include OECD (2005), Australian Public Service Commission (2007-08) State Service Authority Victoria (2006) and Audit Office of NSW (1999). Examples of overseas governance standards can be seen in the Independent Commission for Good Governance in Public Services UK (2004).

Most standards primarily focus on roles, structure and processes with oversight based on control systems that require imposed controls such as plans, policies, procedures, performance and risk monitoring. A typical outcome is increased paperwork for directors and managers. Little guidance is provided on cultures and competencies required for effective governance.

Governance standards issued by OECD countries, including Australia have generally not provided research based evidence to objectively support the recommended principles or practices. Governance standards appear to be derived from unsubstantiated opinions/theories as the basis for directing and managing organisations. Not surprisingly difficulties have been experienced by researchers in finding strong correlations between recommended governance practices and performance.

Overall the research results are mixed with some researchers able to correlate governance to performance and some researchers finding inconclusive or negative correlations. For example, studies by:

- Larcker et al (2004), involving over 2000 firms and analysing many structural measures of corporate governance, found that when corporate governance is measured by the above "hard" but easy to verify variables (such as the proportion of independent directors), these factors only account for between 1.4 and 9.1 per cent of the variance in the financial performance of companies;
- Gold (2006) into Australian companies found a representative sample of "poor" governance firms (non compliance with Australian Stock Exchange (2007) Corporate Governance Principles) reported superior investment characteristics (higher returns, higher persistence of performance, less downside risk and lower beta risk) including outperforming the S&P/ASX200 by between 5-13 percent per annum and when compared to the financial performance of a large sample of listed firms;

- Brown and Gorgens (2009) tested corporate governance and company performance (EPS, ROA and one year sales growth) for the ASX 300, between the years 2004 to 2006, using the Australian Stock Exchange (2007) Corporate Governance Principles. The researchers found that companies with better corporate governance outperformed those companies that were less compliant. In particular, companies that were fully compliant with the ASX Corporate Governance Principles significantly outperformed companies that were not in the areas of EPS and ROA over the sample period;
- Travlos et al (2005) and Weir et al (2001) who sampled 312 (148) UK listed companies to review the adoption of the Cadbury Code of Governance on financial performance. Travlos et al (2005) found generally improved performance form adoption whereas Weir et al (2001) found little relationship between internal governance mechanisms and performance.

One of the few notable global exceptions at creating evidence based guidance is the publication *Enterprise Governance: Getting the Balance Right* issued by the International Federation of Accountants (2004).

The guidance was developed based on a case study analysis of organisational successes and failures drawn from Australia, Canada, France, Hong Kong, Italy, Malaysia, the Netherlands, Thailand, UK and US. The guidance highlighted the importance of strategic management in corporate success and avoiding failure. A subsequent publication *Evaluating and Improving Governance in Organisations* (IFAC 2009) provides governance principles for performance and compliance.

In Australia the Commonwealth Australian Public Service Commission document *Agency Health: Monitoring Agency Health and Improving Performance* is commended because it is one the few documents found that supports an evidence based approach to governance and reporting. The publication draws upon articles from both research and management literature as well as specific examples of public sector agencies where governance weaknesses have contributed to performance issues.

4. GOVERNANCE STANDARDS FOR PERFORMANCE AND COMPLIANCE

An evidence based approach to developing governance standards is now possible because it has only been in the last two years that more reliable methods have been used to statistically correlate governance factors and performance and some consensus reached about the contributing factors. There are still gaps and more research is required.

I have developed a performance focused evidence based governance standard *Governance for Performance and Compliance: Evidence Based Principles and Controls.* (GPC*).*

GPC is intended to complement rather than replace existing governance standards. As discussed in Section 3 most governance standards focus on structure and process. However the research indicates the factors that create high performance or avoid failure are more correlated to culture, competency and systems. GCP primarily provides guidance on these high performance factors.

The governance standard is applicable to both public and private sectors. The six Principles provide broad concepts or intent that underpin sound governance. Controls provide guidance on how the Principles might be achieved.

GPC includes the following features:

- guidance on addressing the challenge of move the organisation forward (improving performance) whilst making sure things are operating efficiently effectively, ethically and legally in compliance with plans and other guidance (compliance);
- summary of over 80 studies provided as evidence of achieving performance/ compliance outcomes from implementing each of the principles/controls;
- requires boards/ministers to take into account corporate control competencies/systems exercised by a CEO, executive team and corporate services function in determining their performance/compliance focus;
- outlines alternative governing roles, cultures and competencies/control systems aligned with the need to focus on various performance/compliance options;
- integrates board/ministerial governance with internal auditing of strategy and corporate control system audits where there is high risk operating environments;
- provides guidance on forming a professional judgment on the residual risk after controls of acting and performing in the long term shareholders/public interests.

5. ASSESSING RESIDUAL RISK

Governance standards are not an end in themselves. Shareholders, investors or the public (if public sector) just want a simple straight answer to the question - are boards, executives and/or elected and public officials (public sector) behaving and performing in the shareholder/public interest and, if not, what is the residual risk after corporate controls/treatments.

With regard to behaviours, a practical example of assessing the residual risk and controls of not behaving in the public interest was provided in an article in 2008 (White).

With regard to performance, GPC provides a traffic light rating system and a framework for making professional judgments for assessing corporate control effectiveness taking into the account complexity and dynamics of future challenges.

The GPC residual risk rating comprises high performance with compliance, performance/compliance, mediocrity, potential performance/compliance issues and performance/compliance failures.

Over 100 self assessment workshops using a governance maturity framework of corporate controls (included in GPC) were conducted in Australia. My experiences from conducting self assessments, supervising management self assessments of controls and/or providing audit assurance indicates there are typically three residual risks after corporate controls in areas including strategy, risk management, culture and internal audit. Three residual risks are discussed in the following which relate to system issues for performance/compliance and professionalism.

5.1 Residual risk of not creating high performance

GPC is based on research into high performing organisation which highlights that high performance can only be created by putting together a combination of cultures, competencies and processes as a system.

The research that validates the high performance system combination includes:

- Research including by Bailom et al (2007) found that 50 percent of the success of 1100 European organisations could be attributed to an interrelated system combination of factors including market orientation, culture of entrepreneurship, innovation orientation of top management, strength of corporate culture, core competencies, competency based management, innovation success and market position;
- Research by Hubbard et al (2007) into 11 ‘winning’ organisations in Australia found a combination of factors integrated as a system including external focus on customers and relationships, adapting rapidly, effective execution, leadership not leaders, right people and risk taking.

My work to date indicates few executives and/or boards know the high performance combination and how to design these characteristics as a high performance corporate control system. Hence there is a residual risk of underperformance and mediocrity.

5.2 Residual risk of non compliance with plans, policies and legal requirements

Guidance on risk management and compliance systems such as Australian Standards 4360 and 3806 exist nationally which require plans, policies and procedures to manage risks.

However greater insight in strategy design and reducing time spent on compliance requires a corporate/operational control maturity moving;

- from imposed controls such as plans, policies and procedures;
- to supporting self control at the lowest practical level as a culture of stewardship and a competency to set goals, assess risks and design controls.

GCP provides guidance on control systems that support self control. My experiences to date indicate few executives have the competencies to move from imposed control to supporting self control as part of designing corporate compliance control systems. Cost effective compliance through self control should prevent problems and issues arising (which would otherwise require intervention) and enable executives and others to focus on future performance and organisational development.

5.3 Residual risk of professionalism

Even after controls there may be still an inherently high residual risk after controls of not behaving and performing in the shareholder/public interest. Societies have generally not yet come up with a solution that rewards rather than penalises those who act with professional integrity and speak out regardless of personal consequences. For example:

- board directors or elected officials who are forced to resign due to concerns about governance;
- external auditors in the private sector who are forced to lose a client due to concerns about financial reporting and accounting;
- company secretaries, governance advisers and internal auditors who are forced to resign due to concerns about unacceptable risks, control and governance.

My experiences to date indicate few rewards exist in organisations for those that speak out in the shareholder or public interests regardless of personal consequences. Promotion within organisations based on subservience, compliance and low risk behaviours may act as incentives to compromise professional judgments.

6. STATE OF GOVERNANCE IN AUSTRALIA

What are the available studies showing about the state of governance in Australia to behave and perform in the shareholder/public interest? GPC has been used as the basis for making a strategic assessment based on the following studies into the private and/or public sectors:

- Sarros et al (2005) survey of 2 400 executives in the Australian public and private sectors and found only moderate levels of articulating vision (rated mean 4.63 out of a possible 7), innovative culture (rated mean 3.45 out of 5), and making resources available for innovation (rated mean 3.14 out of 5). Very low levels of culture and innovation were found in the public sector;
- Gourley (2004) surveyed 9,400 senior executives in more than 900 organisations across Australia and New Zealand indicated a preference for a constructive style culture which is needed for a performance/innovation orientation. This result was then contrasted with 132,500 employees across those same organisations who rated their actual culture as aggressive and defensive cultures. The key finding was that too many organisations reinforce cultures which promote conflict, risk avoidance and people playing politics to gain influence (ie politicalisation rather than professionalism in governance).
  Playing politics to gain influence may compromise performance. For example research including by Luthans et al (1988) that shows successful managers (ie those rapidly promoted) may not necessarily be effective managers but politically astute. Successful managers may spend more time and effort on socialising, politicking and networking at the expense of planning, decision-making and people management;
- a major survey by Nicholson et al (2007) who found the involvement of non-executive directors in governance rated as relatively low by boards and management with the CEO more likely than even the chair to initiate and champion governance;
- a survey by Insync (2009) of 625 directors that sit on 79 Australian or New Zealand private/public sector boards found that only half agree that their board encourages a strong culture of organisational performance with less than half (49%) agreeing that their board takes appropriate action when performance measures are not met;
- research by Cutler (2008) into Australia's national system of innovation found that the productivity success of the 1990's was built on successful innovation occurring in agriculture and service industries particularly in wholesale trade, communications and finance. However innovation/productivity has subsequently stalled in the last five years with indications that growth in average real income was based more on terms of trade rather than innovation;
- During the decade of the 1990's, research shows Australian companies were unsuccessful in international markets. For example a 2003 BRW survey reported by Ferguson and James (2003) revealed that twenty firms had lost almost $40 billion in ill-timed or poorly managed overseas investments. Profitability measures reported by the Australian Bureau of Statistics (ABS) and Templeton global Performance index (Rugman 2001) show that the firms return of foreign assets were significantly lower than for domestic assets. According to ABS, in 2001-02 three of the biggest markets for Australian foreign investment (ie US, UK and Japan) failed to produce returns above the bond rate of 4.75%.

A study by Zalan and Lewis (2006) of eleven large Australian owned firms in four industries concluded that, apart from one firm (BRL Hardy), there was little reliance on strategic capabilities including leveraging resources and transferring/building skills/culture to create a competitive advantage;

- the GLOBE project (Javidan 2007), a study now in its 15th year, which surveys over 17,000 middle managers in 61 societies, has found that the greater a society's future orientation the higher its average GDP per capita and its level of innovativeness, happiness, confidence and competitiveness. Australia is regarded as in the middle societal position–ie neither strongly future orientated or having a comparatively low level future orientation;
- Australian Public Service Commission (2008) survey of 9000 employees in the Commonwealth public sector which identified less than:
  - 40 percent of employees were satisfied with senior leaders, innovation and agency culture;
  - 60 percent who rated their immediate supervisor as 'high' on shaping strategic thinking and communicating with influence;
- In 2006 a global survey by the Institute of Internal Auditors (IIA) was conducted in 91 countries and completed by over 9000 respondents including Australia found only 49 percent of chief audit executives were prepared to report unacceptable risks to management and board for resolution. As a result of non compliance with professional standards IIA Australia has warned that the "quality and reliability of information boards are receiving from their internal auditors is patchy".

7. CONCLUSION

Overall the available studies show that, nationally, there is a high residual risk of both private and public sector organisations achieving mediocrity and underperformance due to ineffective competencies, systems and behaviours. In other words ineffective governance may be directly or indirectly compromising shareholder/public interests and the standard of living of every Australian. It should be of major national concern that research shows:

- management rather than independent directors are primarily driving governance;
- cultures which promotes conflict, risk avoidance and people playing politics rather than professionalism in governance;
- internal auditors unwilling or unable to report on unacceptable risks.

Mediocrity and underperformance is reflected in studies that have shown:

- innovation/productivity has stalled in the last five years with indications that growth in average real income was based more on terms of trade rather than innovation;
- an inability for a significant number of Australian organisations to achieve long term financial success in breaking into international markets;
- Australia in the middle position with a comparatively low level future orientation when compared to other countries.

One would expect to find these results because:

- directing, managing, advising and governance auditing is yet to be recognised as competency based professions requiring evidence based proof of competence;

- governments globally typically adjust governance standards and regulations in reaction to rather than in anticipation of corporate failures and crisis's rather than as part of nationally integrated approaches to create high performing organisations in the private and public sectors for overall societal wellbeing;
- existing governance, risk and control standards typically reinforce a bureaucratic orientation focusing on structure and process rather than providing direction on values and competencies critical for an innovation, performance and productivity focus;
- if boards and executives do not understand what are the key elements that must be combined as a system to motivate, create and sustain high performance, then there is a high residual risk of underperformance and mediocrity;
- underperformance/insufficient competencies may be disguised by impression management and powers/positions retained by subservience, not rocking the boat and playing politics;
- board effectiveness and internal audit reviews of management control may be resisted or weakened.

The organisation is the fundamental means for creating well being in our society. Products and services from organisations influence how we are born, the food we eat, education, health, law and order we receive, employment, career, housing, retirement and death.   How organisations are directed and managed is critical to performance and societal wellbeing This means governance standards for directing and managing are of concern to everyone and not just shareholders and investors. There is a need to move the mindsets of governments that governance is more than investor protection and accountability to taxpayers (public sector).

It is therefore unacceptable to rely on governance standards in both the private and public sector derived from unsubstantiated opinions/theories as the basis for directing and managing organisations.

There can only be confidence in governance standards when they are based on evidence of what is proven to work. A proactive integrated national and/or global approach to governance would focus on evidence based performance focused standards relating to how:

- governments govern/regulate for society well being and respect for human rights;
- companies are governed for growth, viability and responsible behaviour;
- public services are governed for delivery efficiency/effectiveness and appropriateness/responsiveness to future needs.

Whilst governments can create the environment for economic and social well being through macro-economic and other associated policy levers, it's at the micro-level focusing on how organisations are directed and controlled that matter as much, if not more. Few governments appear to understand the importance of governance standards and the link to societal well being. As a UK commentator Caulkin (2007) observed: *"It's not the economy: its management, stupid"*

ABOUT THE AUTHOR

David has more than 30 years experience in risk, control and governance gained in roles including internal auditing, change management, governance advising and corporate services in the public and private sectors.

As part of completing a PhD, David White is currently conducting research into the governance of high performing organisations and providing directions for evidence based governance standards objectively linked to proven factors influencing performance, lessons learnt from corporate failures and legal due diligence principles. He can be contacted on (08) 8124 4034 or email whitedr@bigpond.net.au.

This article provides advice of a general nature and is not intended to reflect the actual situation or recommended direction for any particular organisation or environment.

REFERENCES

Audit Office of NSW (1999) Better Practice Guide: *Public Sector Governance Ready Reckoner for Public Sector Governing and Advisory Boards* www.audit.nsw.gov.au/publications/better_practice/1999/gov_chklist.pdf accessed August 08

Australian Public Service Commission 2007/08 *Monitoring Agency Health and Improving Performance, State of the Service Report 2007/08* www.apsc.gov.au publications accessed Mar 08

Australian Stock Exchange 2007 *Corporate Governance Principles and Recommendations* Corporate Governance Council Second Edition, www.asx.com.au

Bailom F, Matzler K and Tschemernjak D 2007 *Enduring Success: What Top Companies do Differently* Palgrave Macmillan

Brown R and Gorgens T 2009 Australian Treasury Working Paper 2009 — 02 March http://www.treasury.gov.au/contentlist.asp?year=2009&ContentID=703&abstract=%2D1&classification=179&businessArea=%2D1&titl=Working+Paper+Series accessed Mar 09

Caulkin S. 2007 Quote in *The Observer Newspaper* (UK) July 22

Cutler T, 2008 'Venturous Australia' a review of the national innovation system August www.innovation.gov.au/innovationreview/Documents/NIS-review-web.pdf access Dec 08

Ferguson and James 2003, 'Secrets and Traps of Overseas Expansion' *Business Review Weekly* 5-11 June

Gold M.L 2005 'One eye on the rules the other on performance' *Australian Financial Review* article 2 December

Gourley M 2004 *Organisational Culture* Australian and New Zealand Survey http://www.human-synergistics.com.au/content/articles/papers/zb-campaign-michael-gourley-apr-04/organisational-culture.asp accessed December 2008

Hubbard, G. Samuel D, Cocks G and Heap S 2007 *The First XI: Winning Organisations in Australia* Second Edition Wiley; Sydney.

Independent Commission for Good Governance in Public Services UK (2004) *The Good Governance Standard for Public Services* www.cipfa.org.uk/pt/download/governance.standard.pdf

Insync 2009 *Organisational Performance: A Boardroom Perspective* available at www.insyncsurveys.com.au accessed May 09

Institute of Internal Auditors 2007 Global Survey as reported in The Board Room Report: *Drive to lift Internal Auditing Standards* Australian Institute of Company Directors Vol 5 Issue 15 August

Institute of Internal Auditors 2006 IIA Australia and IIA New Zealand *Trends in Australian and New Zealand Internal Auditing: Third Annual Audit Benchmarking Survey* in conjunction with Ernst and Young

International Federation of Accountants (IFAC) 2004/2009 *Enterprise Governance: Getting the Balance Right* and *Evaluating and Improving Governance in Organisations* February www.ifac.org accessed Feb 09

Javidan 2007 'Forward Thinking Cultures' *Harvard Business Review* July-August page 20 Journal of Economic Perspectives Vol 21 No 1 Winter 2007 Pages 117-140

Larcker, D, Richardson S and Tuna I 2004 'Does Corporate Governance Really Matter', *Wharton School Paper,* [online http://knowledge.wharton.upenn.edu/papers/1281.pdf accessed May, 2008]

Luthans, Hodgetts and Rosenkrantz, 1988 *Real Managers* Cambridge, MA: Ballinger, extract article *Successful vs Effective Real Managers* http://pages.stern.nyu.edu/~wstarbuc/mob/luthans.html access August 2008

Nicholson G, Hendry K, Newton C 2007 *Managers Silent Obligations: A report on the perceptions of the respective roles of managers and directors in corporate governance in Australian Companies* http://www.aim.com.au/research/aimags.html accessed Dec 08

Rugman *2001 The End of Globalisation* Random House Business Books London

Sarros J C, Gray J, Densten I, Parry K, Hartican A Cooper B 2005 The Australian Business leadership Survey No 3 Australian Institute of Management/Monash University Research Project http://www.aim.com.au/research/abls.html accessed Dec 08

State Services Authority Victoria (2006) *Welcome to the Board: Your Introduction to the Good Practice Guide on Governance for Victorian Public Sector Entities* http://www.ssa.vic.gov.au/CA2571410025903D/0/D51221C39776FD86CA2571500039B80A?OpenDocument accessed Aug 08

Travlos, N G., Weir, C, Milonas, NT. and McKnight, P J., 2005 'The Cadbury Code Reforms and Corporate Performance' January. EFA 2005 Moscow Meetings. Available at SSRN: http://ssrn.com/abstract=675627

White D S 2008 'Acting in the Public Interest ' *Keeping Good Companies* August Journal issued by Chartered Secretaries Australia pages 401 -407

Zalan and Lewis 2006 'Administrative Heritage: An Exploratory Study of Large Australian Firms' *Australian Journal of Management* December

