GOVERNANCE AND CORPORATE SOCIAL RESPONSIBILITY RESEARCH UNIT, CURTIN BUSINESS SCHOOL, CURTIN UNIVERSITY OF TECHNOLOGY

13 February 2006

Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Department of the Senate
Parliament House
Canberra ACT 2600

Dear Sir/madam

Parliamentary Joint Committee Inquiry into Corporate Responsibility

Thank you for the opportunity to make a submission and appear before the Inquiry. A Submission from a group of members of the Governance and Corporate Social Responsibility Research Unit, Cutin University of Technology, is attached for your attention.

Yours Sincerely

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PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SEVICES: INQUIRY INTO CORPORATE RESPONSIBILITY.

Submission: Governance and Corporate Social Responsibility Research Unit, Curtin University of Technology, Perth, WA.

Introduction:

The Governance and Corporate Social Responsibility Research Unit comprises a cross-disciplinary group of researchers located within the Curtin Business School, Curtin University of Technology. Researchers are drawn from the disciplines of Accounting, Law, Economics and Management. Specific research programs have included research in Best Practice Corporate Governance, Comparative Governance, Executive Pay, Reporting and Business Disclosures (environmental, human resources and financial), Business and Community, Ethics Frameworks, Trust and Corporate Culture and Change.

Terms of Reference:

Terms of Reference a), b):
In this submission we acknowledge that, within Australian Business, there are excellent examples of decision makers who do have regard for the interests of stakeholders other than shareholders. In the best case examples, this regard is driven not only through consideration of identified corporate interests, but also by the strong ethical grounding of those organisations and the integrity of the decision making group. This is consistent with evidence from a study of Australian company directors (McCabe 2005, attached), which found that responding directors perceived that a commitment to 'integrity' is a critical ingredient of 'best practice' corporate governance.

We contend that the long-term sustainability of each and every corporation does require that corporate decision makers pay regard to broader stakeholder interests including the community. We do, however, argue that the current strong focus on the rights of and obligations to the shareholder in Australian Corporate Law, coupled with the short-term nature of both executive tenure and of some executive pay policies, has enabled to flourish within some Australian organisations, a culture and value system which has little regard for stakeholders. There are a number of current high profile examples where myopia in respect of damage to employees or community, or pursuit of short-term financial gains for special interests, have operated to the disadvantage of the property rights of other stakeholders such as employees, the community, customers/suppliers, or retail investors. In turn this has led to public questioning and concern about the corporate sector.

We lend our support to the need for executive compensation schemes to focus 'incentive pay' on indicators of the growth of long-term shareholder value such as Economic Value Added (EVA). We argue that an increase in the focus on equity in the organisation (with limitations on trading), as an element of executive compensation, provides a proven incentive for executives to focus on corporate sustainability.

Terms of Reference c), d):
We provide evidence from a study of Australian company directors (McCabe 2005, attached) which found that they perceived they did have a responsibility to stakeholders other than shareholders. The 'definition-in-use' of corporate governance which resulted from data from respondent company directors is reproduced below:

Corporate Governance is the ongoing independent exercising of professional judgment by the board as custodian of the company's assets, in the best interests of a variety of stakeholders, including shareholders, employees, customers, with a commitment to demonstrate integrity, responsibility and accountability. (McCabe2005, attached)

We argue that in the current framework of a Corporations Act focus on accountability to shareholders, coupled with the extensive but piecemeal legislative requirements outside the Corporations Act relating to stakeholder, does not serve the interests of the corporate sector well. The response to community anger which has followed from breaches of accountability to community, customers, the environment and retail shareholders, has seen continuing additions to the regulatory environment of business, much of it outside the Corporations Act framework. While we do not argue for the Corporations Act to 'gather up' this broader legislative framework, we do argue for inclusion of a generalised statement of responsibility to stakeholders within the corporate law framework. We argue that explicit recognition of the socially conferred 'licence to operate' will empower directors and the executive group to develop a culture which will give consideration to broader social interests and catalyse a shift in corporate values around long-term sustainability. We provide evidence from a case study of the Austrian governance climate to support our argument that such a cultural shift can ultimately reduce, rather than increase, community calls for regulatory intervention.

A minimum condition is to amend the Corporations Act to protect directors/boards, who make a 'socially responsible' decision, from facing a situation where they fear that they may be breaching their director's duties under the Corporations Act 2001 in doing so. This is in line with the call by Meredith Hellicar (Australian Financial Review-[AFR] 17/03/05, p3.) in response to the issues faced by James Hardie directors as they restructured the company. This submission argues that, further to that, 'director's duty' should explicitly include stakeholders.

Terms of reference e):
We do not consider that extensive addition to black letter regulation will, of itself, be effective in advancing stakeholder interests in the absence of corporate cultures that value integrity, sustainability, and responsibility. We advocate a combination of 'push for change' from government and other agents of influence, incentives for change through recognition of the long-run 'pay-offs' for all stakeholders, and reduction in barriers to change through legislative recognition of stakeholders. We argue that there is a place for catalysing change through a concerted 'public health' type approach from government and other key representative organisations, identifying

acceptable and healthy corporate practice relating to both shareholders and stakeholders.

An element in this relates to **clear pronouncements from government,** in addition to any existing penalties, to stigmatise within the corporate community unacceptable practice. A range of individual corporate behaviours have, in recent years, enraged the general community. These include ‘money-for-influence, so-called ‘facilitation payments’, ‘cover-up’ tactics including failure to disclose or account for health and environmental risks, the use of legal artefacts to delay or avoid accepting accountability to community/customers/employees, use of tax havens, and failure to respect clearly expressed community values/wishes.

In addition to a strong government position, there is a continuing role in advancing sustainability and professional integrity for professional and financial associations such as The Australian Institute of Company Directors (AICD), The Australian Council of Superannuation Investors (ACSI), the Investment and Financial Services Association (IFSA) and the Accounting bodies; (all are acknowledged to be currently involved in standards development and relevant continuing education). University courses and management training programs must necessarily play a part as well.

In the stigmatisation of these practices the unincorporated sector will not be immune, and a ‘business health’ campaign encompassing all forms of business and quasi-business organisation including the not-for-profit sector, small business and government corporations/instrumentalities is appropriate. This should allay concerns that the target is only the most visible group, incorporated firms.

Terms of Reference f):

Information is an essential for the achievement of transparency and accountability. A reporting framework is required to enable this accountability. Valuable work is being done internationally through groups such as Transparency International, the International Organisation for Standardisation (ISO), the Global Reporting Initiative (GRI) and the Institute of Social and Ethical AccountAbility (AccountAbility AA1000) to develop measures and reporting guidelines relevant to corporate sustainability. The Australian Accounting profession has also been actively exploring triple-bottom-line reporting and researching the incidence of reporting by Australian corporations. The GRI Sustainability Reporting Guidelines provide a voluntary framework which is being used by a number of major listed Australian companies. However, the proportion of firms involved is still disappointingly low. These reporting frameworks remain a ‘work-in-progress’, and mandating one without exploration of the particular issues for Australian companies may be premature. We recommend, however, that ‘best practice’ principles incorporate the use of an appropriate framework with the eventual objective of adoption and mandating of a reporting code suited to Australian conditions. This may be achieved in the short run by an ‘if not why not?’ requirement in ASX Listing Rules.

Terms of Reference g):

This submission discusses some of the perceived advantages of the inclusion of stakeholders in the corporations law mix in a case study using Austrian data (Bickley and Nowak 2005, attached).

Supporting Discussion:
Supporting argument for this submission is detailed below and further evidence may be read in a selection of research papers prepared by researchers of the Curtin University Governance and Corporate Social Responsibility Research Unit and attached to this submission. The submission is organised in the following sections:

Section 1 discusses some of the influences which mediate the short-term focus of many Australian companies and argues that, where this is the driving force, it becomes difficult for corporate sustainability issues to appear on the radar.
Section 2 discusses property rights and the issue that incomplete specification of the property rights of 'stakeholders' other than shareholders is an impediment to achieving sustainability.
Section 3 is a discussion of the 'values' framework of the marketplace and the argument that a move from the amoral values of the rational economic market to a moral frame of reference internal to the corporation is required for the achievement of corporate sustainability.

Three research papers are appended to support the submission:
McCabe, M. (2005), Australian directors define corporate governance.
Bickley, M. and Nowak, M. (2005), The Austrian Way: director conduct in the context of legal and cultural frameworks of Corporate Governance.
Evans, J., Evans, R. and Todesco, D. (2000), An examination of Economic Value Added and Executive Compensation.

Section 1: Focus on the Short-Term

The argument that the corporate sector focus on sustainability and stakeholder issues can reliably be left to the judgment of executives, on the basis that they will understand that this is good-for-business, assumes that there is consistency between the time horizon of the executive decision-making group and that required for the financial returns to pursuing sustainability to become apparent. Financial commentators and academic analysis, however, have supported public perceptions that the focus of many corporations, and of the financial market, is short-term.

Short-term value considerations focus on immediate profitability (often the most recent quarter), forecasts and announcements, and related current share price movements. This focus may be exacerbated by the current 'fashion' for relatively short executive level contracts (three years and seldom in excess of five years). Given that to achieve real culture change within organisations requires a long-term commitment, short contracts encourage executive management to focus on the quick profitability gains and related share price impacts (achieved often through cost-cutting). Issues which 'get in the way' of short-term profits or which promise only longer term returns; community opposition to a specific decision; loss of corporate knowledge capital through redundancy; environmental interventions which have long-term payback horizons; may be evaded or even dismissed.

Executive pay policies may also result in a culture and value system within corporations that may have little regard for stakeholders other than shareholders, and even at times, for the interests of the bulk of shareholders. It is not surprising, given the tenure issue, that incentives in remuneration packages have often been short-term or poorly specified in relation to what does indeed progress the long-term interests of shareholders. Cash bonuses relating to current-year profit and/or current share price and share options with a short time horizon are short-term. In addition, their specification does, at times, confuse market trends with individual performance. There is evidence, however, that superior performance on a long-term measure of corporate performance, such as Economic Value Added (EVA), is positively related to the percentage of equity held by the CEO and to the ratio of equity to cash-based pay, including bonuses (Evans, Evans and Todesco, 2000, attached). This supports the need for boards' remuneration committees to focus on planning longer term incentive packages, with a significant role for equity (with specified limitations around trading), to support an ethos of corporate sustainability and concern for stakeholders.

The financial management industry and, in particular, superannuation trustees/pension funds have an important role to play in scrutinising remuneration policy which some have exercised in the most recent reporting season. Some in this market, however, still prefer to exit the shares rather than seek change. Accountability within this sector for their approach to corporate reporting of executive remuneration can be strengthened through an industry code.

Failure to adopt strategies which facilitate accounting for broader stakeholder interests, while sometimes maximising short-term financial gains for senior executives and influential major shareholders, has **the potential to damage long-term shareholder value as well as broader stakeholder interests**. Current examples playing out in the Australian corporate scene include James Hardie, AWB.

Section 2 : Governance, sustainability and property rights.

The principle which underlies corporate governance traditions in Australia is the agency relationship of the principal (shareholder or owner) who engages an agent (management, the chief executive/executive group) to perform some service on their behalf. The power to perform this service is delegated to the agent.

In this framework, governance systems are required to 'align goals' of the principals/owners or shareholders and the agents/management. A range of internal accountability and incentive mechanisms under the authority of the board of directors (the focus of governance activities) seek to ensure the agents – management - ***do*** operate in the shareholder's interest and not in their own. Corporations Law is explicit in affirming the 'director's duty' to shareholders.

The focus of the Corporations Act in Australia follows the Anglo/US tradition of specifying the contracts between the various capital providers to the corporation and the corporation (Berglöf, 1997, p.105).This is the agency model. Corporate law is specific about the obligations and accountability of the corporation to the shareholder group as owners, and confers on that group specific powers, such as voting at the annual general meeting. Within this tradition the only property rights which are closely specified in corporate law are the property rights of the shareholder as 'owner'/ finance provider.

However, this represents a narrow view of the firm and the responsibilities which arise from the privileges endowed through incorporation and limited liability. Clarkson (1994) argues for recognition that the context of the firm is society. He proposes the firm should be viewed from a systems perspective, with each firm a system of stakeholders within the host society system. The host society provides the infrastructure for the firm's operations. The firm's purpose is to convert the 'stakes' of **all** those stakeholders into goods and services, thus creating wealth for stakeholders. The term 'company' originally was used for "a community of interest, a mutually beneficial partnership of employers, employees and investors."(Albert 1993). This supports the broader view of accountabilities, recognising the property rights of participants other than shareholders/owners.

The assumption of optimisation of resource use claimed for the competitive markets is based on completely specified property rights. Where property rights are incomplete (e.g. for water) the market is unable to achieve this optimisation. One of the problems for those 'non-shareholders' who contribute value or have a stake in the outcomes of corporate activities (communities, employees and the natural environment), is that their property rights are legally underspecified and lacking in recognition in Anglo/US corporations law. The problem of underspecified property rights for the environment has long been recognised by economists, but it is now recognised that community property rights, stemming from the provision of social capital and infrastructure, are also inadequately specified.

In the Anglo/US paradigm the interests of employees, customers, suppliers, and the environment of corporations, require separate legal intervention outside corporation law (e.g. employment law or environmental law). One result is that the 'director's duty' to shareholders specified in the Corporate Law prioritises shareholder financial interests over decisions which may be morally necessary in relation to employee, community or environmental considerations . Meredith Hellicar (AFR 17/03/05, p3.) drew attention to one aspect of this in relation to the James Hardie decision on restructuring. This separation has the effect of bringing any legal protection for stakeholders into the adversarial legal system.

Turnbull (1995) has proposed new institutional protections for stakeholders. His 1995 position was for independently appointed stakeholder councils to advise non-affiliated independent directors on corporate boards. This would be a cumbersome addition to the corporate governance process, though it does have some parallels with the two-board system of some European countries.

However, the European legal system (Berglöf, 1997) has a corporate law tradition that is based on multiple property rights and which provides specifically for corporate accountability to multiple stakeholders. This tradition of 'company' as institution and 'enterprise' is deeply rooted in the German/ Austrian systems and the Netherlands

In this tradition, management is responsible for conducting the affairs of the corporation with specific recognition of their responsibilities to multiple stakeholders. It is interesting to note that corporations in this tradition have in the past made little use of *market related* executive incentive pay schemes. It is also interesting to note that executive pay in these European corporations still remains many multiples below that which now seems to characterise the companies of the Anglo/US model.

The behavioural principles underlying this model align with the idea of Stewardship. This idea depicts organisational participants as potentially collectivists, pro-organisation and trustworthy (Davis et al., 1997). It proposes that the interests of stakeholders and management may be able to be aligned through empowerment and trust rather than through monitoring and control. In such a setting, performance pay may be more broadly specified to reflect performance in spheres which include, but are wider than, shareholder value.

A case study undertaken by researchers of the Governance and Corporate Social Responsibility Research Unit, (Nowak and Bickley, 1995 [see attached]), found that within the EU, Austria provides an example of where accountability to stakeholders is internalised to the organisation through corporate law rather than externally mediated either through the adversarial legal system or through additional institutional arrangements as proposed by Turnbull.

We were able to explore the perceptions of Austrian corporate board members and concluded that this example of the European enterprise-based model, with its recognition of stakeholder rights, is more able to encompass the range of societal sustaining property rights than one where corporate law and corporate rhetoric give primacy to recognition of the property rights of the capital provider. By giving recognition to stakeholders within the corporate governance system, this study suggests that the need for regulatory intervention to protect property rights of other stakeholders is reduced, while a culture more conducive to corporate sustainability is developed.

The data and discussion which supported this position are outlined in the attached article by Bickley and Nowak which was published by Elsevier in 2005 in Advances in Public Interest Accounting Vol.11.

Section 3: Moving from Amoral to Moral.

Agency theory, and the supporting philosophical framework of economic rationalism, treats companies as amoral instruments of commerce, charged with the single responsibility to maximise investor value. This proposition is consistent with Milton Friedman's position (1970), often quoted in support, that "there is one and only one social responsibility of business: to use its resources and engage in activities designed to increase its profits". In this stark model the question of ethics is outside the arena of companies' responsibilities.

Compliance-based culture, concerned with black letter legal requirements over issues of moral responsibility, can tend to dominate as companies focus on the quest for maximum profitability. However, increasingly companies are viewed by the community as having responsibilities for their impacts on others. In corporate surveys (see Paine, 2003, p.119 for an analysis of Asian Business, Fortune, Financial Times and other surveys), company performance is defined by multiple criteria including their appeal to investors, employees, customers and communities. Publicity about the impact of companies on ‘others’ has had an effect on many major corporations. Recent examples in Australia include James Hardie, AWB, and Woolworths.

Shareholder and activist voices have forced more companies to adopt a voluntary quasi-stakeholder approach as ‘good-for-business’. The debate on sustainability and triple-bottom-line reporting has moved to the mainstream in forums for corporate directors and executives internationally and in Australia (e.g. World Economic Forum, AICD). Some managers and directors find this broadened accountability hard to accept because it adds significantly to the range of issues that demand their attention. Furthermore, accepting wider impacts on ‘others’, moves them from an amoral instrument role to the moral actor role.

There is a groundswell of comment from corporate players in Australia about the onerous nature of regulation. However, the Anglo/US model logically leads to the need for an enforceable and structured regulatory environment which creates protection for property rights of stakeholders outside of the corporate law, while at the same time enforcing strict requirements for monitoring and reporting to shareholders within the corporate law. ‘External’ enforcement processes are required for stakeholder interests because, while property rights of the investor are contractually complete (and subject to continued strengthening), the important social and environmental property rights for sustainability are incomplete and not able to be contractually specified in this tight way. Primacy to the shareholder, which is the hallmark of this system, means that the argument for sustainability is seen to depend on the ‘good-for-business’ imperative, which can be sidelined by the short-term culture and adherence to the Friedman view that the sole business of business is to increase profits.

We have put the case that this contrasts with the stakeholder approach which produces, via the legal recognition of a range of property rights (even though not fully specified), an ‘internal’ frame of reference, relying on stewardship, judgement and trust. The Australian company directors interviewed in our research implicitly accepted this role, and the centrality of the integrity of decision makers required to fulfil it. There is an opportunity to move in the long-run to a less regulated and less adversarial system that considers a range of stakeholders including employees and the community. The Austrian case study demonstrates this alternative despite the pressure now exerted there for conformance with the Anglo/US model. With the stakeholder approach the focus switches to choosing management who will act responsibly as stewards for these multiple interests. This requirement for gaining consensus among multiple interests provides internal control requiring an underlying climate of trust. Managers and directors are then charged with accepting the complexity of these multiple claims as moral actors. We argue this provides a more sustainable corporate and social future.

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