GOVERNANCE IN NEW ZEALAND: RETROSPECT AND PROSPECT

Dr Brent Wheeler,
Executive Chairman,
The Boardroom Practice

INTRODUCTION

This year marks the 10th anniversary of the establishment of governance advisory and training company The Boardroom Practice Limited (TBPL). This provides a company vantage point to look back at the development of governance in New Zealand over the last decade, to sketch work in progress and to consider prospects for the coming decade.

These remarks reflect the personal views of the Chairman garnered over the decades practice and delivered from the perspective of one individual operating as Chair, Director and professional colleague within TBPL. Obviously the views are those of the author.

SUMMARISED JUDGEMENT ON THE DECADE

Looking back to 2003 in New Zealand and considering the development of governance thought and practice over that time, at least four distinctive points emerge.

Profile

It seems incontestable that the profile of governance as a concern and activity has grown and grown substantially from its origins as the somewhat arcane and niche concern of the legal and accounting professions with occasional visits from financial economists. Such growth has been accompanied by an expansion in expectations about what it might achieve, the organisations to which governance activity and concerns might apply and, unsurprisingly, the number of individuals having aspirations to deliver in one form or another in the governance space.

This growth in popularity has both useful and somewhat less useful characteristics. In the first place – and selfishly from the perspective of a company such as TBPL – growing awareness has been helpful because it has promoted at least some ability to address governance issues and raised awareness amongst shareholders, investors and others in the virtues of improving if not perfecting their governance. That would seem to be a cause for applause. Neither does it show any signs of lessening.

Somewhat less helpful has been the tendency, particularly amongst the media and other populist constituencies to blame and look to governance as both cause and solution to an increasing number of problems. Thus with the onset of the GFC and subsequent recession numerous journalists pointed uncritically at governance mechanisms as "cause", worthy of "blame", and ripe for a series of unspecified changes which would drag various economies out of an increasing number of dark valleys[1]. Such expectations are typically unrealistic. That is not surprising.

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[1] The Wharton School, operating in the serious rather than populist area, held a two day Conference entitled "Corporate Governance & the Global Financial Crisis" in 2010. Wikipedia speaks of "the dramatic breakdown of corporate governance." http://en.wikipedia.org/wiki/Financial_crisis_of_2007%E2%80%932008 .

When the term "governance" becomes common parlance amongst politicians and journalists a clear signal is emerging that the term is in danger of becoming conceptually vacuous. It is to be hoped then that the coming decade sees rather more precision in the use of the term, depth of understanding about the substance of governance thought and practice, along with more realistic expectations of what might be delivered[2].

Appreciation of the governance challenge

My second observation concerns the enhanced appreciation of the nature and extent of the governance challenge a decade on. Far from its origins, at least in the minds of some, as some sort of parent-teachers or service club meeting run to a fairly crisp agenda, the appreciation of the governance task has emerged as one involving significant philosophical questions, competing ideas, and increasingly sophisticated nuance. The task is increasingly seen as requiring at least some rigorous analytical input[3].

The last ten years have surely seen a growing appreciation of the extent and nature of the governance task faced both by directors as individuals and by boards. Increasingly the role of the chair has been identified as a separate, critical and hitherto poorly understood element in successful governance.

In another obvious instance the content of what comprises governance has been fleshed out. That process has largely occurred through identifying and codifying explicitly what had been existing practice for probably more than a century. Such codification has focused on the significance of strategy and the means for effectively hiring, monitoring and mentoring chief executives. Other attendant matters have also been codified.

Most recent work proceeding at pace in behavioural economics at present, suggests that the role of policy in general, including its development and consistent implementation, may come to be seen as being of equal significance. The reason is simply that decisionmaking which, devoid of policy, proceeds on a case-by-case or one-off basis exhibits quirks such as overreaction to risk, undue sensitivity to "home grown ideas" and an inability to abandon sunk costs with optimal timing. Consistent application of policy in guiding decisionmaking has the capacity to overcome the weaknesses[4].

Finally amongst the advances has been the recognition that the governance task stretches well beyond mere compliance. Perhaps the most appalling indictment of regulatory driven compliance approaches is the fact that Enron as that company stood prior to its downfall would have complied in all respects with the Sarbanes Oxley legislation introduced after and as a direct result of the downfall of Enron. The episode demonstrates the futility of seeking resolution to governance issues through compliance and the dangers of relying on regulatory solutions to substantive problems[5].

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[2] Tourani-Rad, A. has noted that linking the GFC to universal failure of governance is difficult. See "Corporate governance and risk-taking in New Zealand", accepted and forthcoming," Australian Journal of Management" 2013 (with H. Koerniadi and C. Krishnamurti).

[3] Even the number of Universities (and thus tertiary education offerings) offering governance courses or papers at both graduate and undergraduate level is ample testament to this.

[4] Originally explained in the seminal "Choices, Values and Frames" Kahneman, D. and Tversky, A. American Psychological Assoc.(conference proceedings) 1983.

[5] Allen, F.E. "Sarbanes-Oxley 10 Years Later: Boards Are Still the Problem", Forbes, July 2012.

Diversity

With the growth in profile and appreciation of the governance task an awareness of the diversity to be found in governance structure and process has emerged. In broad terms the governance field remains split between the U.S. and European models. The former tends to be a shareholder driven model and commonly espouses structures which feature joint directorship and management roles coupled with legally driven shareholder rights[6].

Standing in contrast is the European top-down “stewardship model” in which something of a more pastoral approach is adopted with a heavy stress on separation of management and governance roles coupled with an emphasis on trustee or trustee-like duties and obligations.

Neither theory nor evidence is decisive at this point on the virtues of either approach. It is however increasingly possible to enumerate the costs and benefits of each and to place those costs and benefits in a variety of contexts such that relatively rational choices amongst models on offer is possible.

The message is that both the governance structure and process involve a good deal more nuance than might have been originally supposed[7]. Part of recognising this has been the development of realistic expectations as to what governance, regardless of its diverse form, is able to deliver.

State owned enterprise governance models

In commenting on governance in New Zealand some assessment of the state-owned enterprise (SOE) model forms a central part of the picture. That model, first established in the mid ‘80’s has formed a template for numerous attempts to improve the performance of public sector organisations both profit and non-profit seeking in nature[8].

My view, and it is a personal and arguably biased one, is that amongst developed nations adopting the SOE model New Zealand began with the clearest statement of principle and understanding of issues to be addressed in developing and implementing its original state owned enterprises. While the profile of the few failures which have occurred in SOE’s has been high, the record on average has been outstanding.

Two caveats might be added. The first is that memories being short – too short at present – it is important to register the low base from which the SOE model was launched. Given the mixed and confused objectives of the government departments which spawned the first state owned enterprises, the costs imposed by them in fiscal and broader terms and the uneven policy environment in which those organisations operated, it was hardly surprising that a reasonably well-governed state owned enterprise should soar. Many did. Moreover the goodwill of the private sector in promoting the model and investing support time and energy in promulgation of the model was likely a fortunate one-off.

On a darker note the model and its capabilities seem currently to be under threat in part because the corporate memory seems not to extend back to the ‘80’s, but more importantly because the

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[6] See for example Mendez, M. “Corporate Governance: A US/EU Comparison”, Univ of Washington, Global Business Center, undated.

[7] See for example, Shaw, S. “Mapping Outdoor Recreation Sector Governance: Models, capability, Vision” Report to Sport NZ, December 2012.

[8] An overview is provided on the NZ Treasury website at http://www.treasury.govt.nz/statesector/soes.

fundamental characteristics of state ownership have been lost sight of in the thick smoke of politics and the fond but misguided belief in rhetoric as a substitute for sound policy. Conceptual rigour regarding fundamentals is not a feature of current debates[9].

One such fundamental is that governments have been, remain and will for the foreseeable future be poor stewards of assets. A second fundamental is that governments are poor monitors of such assets as they own. These two factors are critical and inalterable[10]. Operating the SOE model without daily awareness of the risks these factors pose leads, sooner or later but surely to unintended cost and harm.

GOVERNANCE FOR THE NEXT DECADE

The face of governance in 2013 then looks remarkably different to what it did when TBPL commenced operations. I turn now to what the future might hold and rather than speculate on what outcomes will be observed ten years hence, I identify instead four major areas in which outstanding work remains.

Tying board behaviour to company outcomes

Regardless of the considerable ink which has been spilt in developing ideas of governance principle and practice there is little in the way of solid evidence which links the nature and extent of governance practice to outcomes experienced and observed in enterprises. It remains the case that there is no reliable indicative link between the type and quality of board decisions and company outcomes in respect of measures such as shareholder value, shareholder wealth increase or reduction in shareholder risk[11].

It remains intuitively plausible – and indeed commonsensically obvious – that better governance ought to lead to better company outcomes. The link however remains one of intuition, possibly even one of logic but empirical elaboration or confirmation continues to elude us.

Consequently it is still possible to measure board performance and to undertake evaluations of board performance in which both the board and the evaluator reports good health in board process, significant confidence amongst directors, compliance with regulatory regimes and various other meretricious characteristics while at the same time commercial company performance particularly as noted in shareholder value remains dismal and in some cases disastrous.

Clearly Enron is the prime example where compliance with a variety of auditing standards were met and yet the company failed. In the case of less extreme examples, issues such as board performance evaluation remain detached from company performance and explicit links have yet to be built. This is a challenging task because of the influence of at least two factors.

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[9] Similar points are raised by Cameron, R. "Governance of SOEs: Is the current design of the SOE Model a Recipe for Failure?", Presentation to The Centre of Accounting Governance and Taxation Research Conference November 2008.

[10] The recent performances of the SOE Solid Energy provides examples of both problems, see http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=10873612 for a relatively standard media treatment.

[11] An example of research in the NZ family business context is, "Board Characteristics and Firm Performance: Evidence from New Zealand", Bathula, H. Ph.D dissertation, AUT 2008.

First a number of company outcomes arise as a result of random factors. The work of numerous authors most notably Taleb[12], Kahneman[13] , Watts[14] continues to show that we underestimate the importance of randomness in accounting for outcomes and our ability to tie those factors explicitly to board practices is close to negligible. Second, there are a number of factors (a good example is the exchange rate) which are simply well beyond the control of any board no matter how good or bad, and in terms of their influence on shareholder value the board is simply irrelevant – except to the extent of creating the illusion that we have greater control over outcomes than is in fact the case.

Useful advances in the assessment of board performance awaits development of better understandings of the link between board behaviour and outcomes for shareholders.

Independence versus skin in the game – unresolved tensions

In this area too in spite of considerable debate and much writing both formal and informal it remains the case that a series of strong arguments can be mounted in favour of two at opposing positions.

One holds that populating boards with independent directors (see the "Lord Cadbury" literature and all that flows from it) is effective, highly desirable and a cornerstone of sound governance. At the same time strong arguments can readily be developed by those who promote the beneficial effects of directors having significant investment and "skin in the game" as a means for promoting effective governance (see the "Jensen" financial economics literature[15]).

Neither is there necessarily some form of workable "middle ground" which is conceptually robust or empirically verified.

Better means are needed to isolate the circumstances in which superior governance performance is likely to emerge given the two differing approaches. Even such isolation is complicated by the fact that certain structures (independent versus investment committed) may produce better results in respect of some cases or types of decisionmaking than others even within the same company.

Thus for example in seeking to appoint a chief executive the unbiased views of independent directors might produce better outcomes than the perhaps more slanted views which invested directors bring to the issue. In contrast when considering risky investments independent directors with only the vaguest of reputational risk and no tangible dollar stake in the decision may bring less muscular debate to decisions than committed investors who stand to lose material financial wealth if the decision is a poor one.

Following from this point it is not necessarily clear what balance of committed versus independents might be best, whether or not board structures ought to alter over time, how the use of committees

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[12] Taleb Nassim Nicholas, Fooled by Randomness: The Hidden Role of Life and in the Markets; Random House, NY 2001

[13] Kahneman, D. Thinking Fast and Slow, Penguin (Australia), 2012.

[14] Watts, D.J. Everything is Obvious: How Common Sense Fails, Atlantic books, London 2011

[15] See Jensen, M.C. and Chew, D. "Us Corporate Governance: Lessons from the 1980's", in Michael C. Jensen, A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS AND ORGANIZATIONAL FORMS, Harvard University Press, December 2000.

and subgroups within boards might improve matters and what principles might be used in judging performance[16].

Outside of conventional board settings the problems can become more difficult. Public sector ownership in particular creates difficulties where the risks involved in appointing politicians to boards (where the exposure is to votes rather than financial loss) are well established. On the other hand the value of independents can be blurred through aspirants seeking social status rather than commitment to sound decisionmaking through their appointments to a publicly owned enterprise.

The not-for-profit sector and its governance is equally riddled with difficulties in this area. Perhaps what may be possible and would be productive in future is to move beyond bold assertions and rhetoric regarding one or another position and the adoption instead of a more nuanced approach which seeks to highlight the pros and cons of different levels of commitment versus independents in differing situations.

SME governance

It remains the case that throughout the western world some 80% or more of economies are dominated by small-to-medium enterprises rather than high profile listed companies[17]. Their contribution to GDP and GDP growth is also of this order of magnitude and in respect of the latter growth rates are typically stronger amongst SME's than in the often moribund publicly listed sector[18].

In spite of this governance amongst SME's remains at best skeletal, in a number of cases risk prone and can lead to less than optimal growth, limited expansion and sophistication in goods and services offered along with significant liquidity problems which stymie exit.

My 2012 paper on this subject "The Unique Governance Issues of Small to Medium Enterprises" dealt with these issues in depth and highlighted the particular issues facing SME's.

In sum those issues concern myopic narrow strategy outlooks, the mixing of commercial and non-commercial objectives, decision making which fails to meet commercial criteria and absence of liquidity generated through poor or non-existent succession planning.

I argue in that paper that governance issues for SME's do not involve some miniature form of PLC governance but instead should be seen as governance concerns in their own right. A separate conceptual apparatus is required such that principles may be derived and applied in developing a better framework for SME governance.

Moreover that framework needs to embrace the fact that what might be a conflict of interest in a publicly listed company may be the competitive strength and advantage of an SME. At the same time the proximity of relationships evident in SME's which helpfully drives down agency costs may at the

[16] See Baghat, S. and Black, B "Board Independence and Long-Term Performance", Univ of Colorado and Stanford Law School, www.leeds-faculty.colorado.edu/bhagat/b-black.ppt for a general discussion plus some evidence.
[17] The NZ statistics are summarised by the Ministry of Economic Development, now Ministry of Business, Innovation and Enterprise at http://www.med.govt.nz/business/business-growth-internationalisation/small-and-medium-sized-enterprises.
[18] See Wilkinson, B. "A Management Scandal? Interpreting Measures of Shareholder Value", NZBR April 2001. http://www.nzbr.org.nz/site/nzbr/files/publications/publications-2001/management_scandal.doc.htm.

same time preclude optimal levels of innovation because of the introverted nature of such relationships. There are other examples. The point is that a good deal of work is required in this area and it has much greater potential to contribute to value enhancement than does further "polishing" of the OECD, Cadbury[19] or Jensen mantras.

Finally and not least amongst the challenges with SME's is the stubborn fact that the level of fees charged by the advisory firms involved in developing PLC governance are completely inappropriate for SME's and a much more resource-slim approach will need to be developed if the advantages of better forms of governance are to be delivered in this sector.

Distractions

A final and arguably more controversial area in which the study in development of governance might be improved involves resistance to various tempting but potentially dangerous distractions. A significant conclusion of the work of Kahneman[20] in behavioural economics is that policy which is able to generate consistent behaviour over time along with adherence to principle has a significant place in producing better outcomes through the rejection of ad hoc, reactive responses to issues de jour.

The past decade has seen governance succumb to various fads in much the same way as management can be inclined to. An unfortunate consequence of this is that such elements of virtue as may inhere in various fads are typically lost as the more frivolous and populist aspects of various movements and themes come under attack.

Three examples suffice to make the point.

The move to incorporate ideas regarding sustainable development and the "green" movement[21] have generated mixed blessings for those involved. Superficially appealing and "up to the minute" these ideas have been adopted with varying levels of enthusiasm amongst enterprises throughout the economy in almost every case without addressing two fundamental governance issues.

The first is simply that if an enterprise is to become involved in green issues and if governance principle and practice is to reflect those issues then some mandate which goes beyond the whim and view of the management and the personal views of the directors needs to be obtained from those owners whose wealth is being put at risk by the endeavour. Unless and until there is a significant commitment by owners to placing their wealth at risk in the pursuit of sustainability then its pursuit should be eschewed. Secondly some identifiable competitive advantage in improving matters in respect of sustainability should also be a sine qua non for the pursuit of investment in these areas.

While currently an unfashionable author to quote, it was in fact Friedman who pointed this out as long ago as 1970[22]. The wisdom remains as strong today as it was then. The argument is not "against" the adoption of sustainable development or various other green mandates. The argument is that as with

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[19] Cadbury, A. "Financial Aspects of Corporate Governance", UK, 1992.
[20] Kahneman, ibid.
[21] The concept and relationship to governance is discussed at http://www.gbb.org/news/green-corporate-social-responsibility.
[22] Friedman, M. "The Social Responsibility of Business is to Increase Its Profits" The New York Times Magazine, September 13, 1970.

any other investment an owners mandate is required and at least an even likelihood of success is expected prior to the commitment of owners' resource.

A second example is in the area of gender[23]. Again the temptation to succumb to policies favouring various numerically based, mechanistic definitions of equity in respect of gender has been for some jurisdictions overwhelming. The extent to which numerical definitions of gender and balance contribute to shareholder value let alone the improvement of equity objectives such as elevating the contribution of women to corporate decisionmaking is debatable in the extreme.

The heat rather than light generated through rhetoric around the subject tends to obscure the fundamental importance of improving the way governance deals with this issue. In a commercial environment in which women are responsible for 70% of all retailing decisions for example, it is simply commercially risky and naïve not to involve female input into decisionmaking at all levels of corporate activity[24].

Indeed given that half the population is female no serious understanding of the markets can proceed without much improved input from women including in governance. Thus ideological mutterings notwithstanding, the growth of shareholders wealth and its protection from risk demands a higher level of involvement of women in governance.

A focus then on training, developing experience, identifying crucial traits and like processes is a critical priority in addressing these issues. It is likely that the public sector has some leadership role in this area. It is likely that the imposition of regulatory targets will be counterproductive.

Finally it is worth noting that the yet to be developed links between board performance and company outcome identified above have important links to both the motivation for and the manner in which the place of women in governance is improved.

A final example rehearses each of the arguments related to gender and sustainability set out above. This relates to the politically appealing and ever tempting notion of seeking ethnic "balance" on boards and in governance activities again predominantly through the pursuit of quotas, numerical benchmarks and other like mechanistic devices[25]. As in the case of gender, a serious understanding of markets on any sophisticated level increasingly demands input from all of those participants (customers, employees and other stakeholders) from the increasingly ethnically diverse populations which make up these markets.

Ideologically driven means to involve such communities create two difficulties.

In the first place they confuse strong board performance and high quality decisionmaking with "representation" as if boards and governance involved some sort of "parliament for companies". It is

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[23] See discussion in "Gender Diversity and Corporate Performance", Credit Suisse, 2012. On gender versus other factors see Ramsinghani, M. "On startup boards, laziness and bias trounces gender diversity" Forbes, http://www.forbes.com/sites/mahendraramsinghani/2013/01/21/on-startup-boards-laziness-trounces-gender-diversity.

[24] See Peres, T. "Re-Imagine!: Business Excellence in a Disruptive Age", DK, 2006, NY.

[25] See Maramuthu, M. "Ethnic Diversity on Boards of Directors and Its Implications on Firm Financial Performance" for an example of empirical research in this area http://www.sosyalarastirmalar.com/cilt1/sayi4/sayi4pdf/marimuthu.pdf .

ability to perform and produce high quality decisions on a sustained basis which characterise strong governance rather than adherence to some form of Westminster-derived democratic framework applied to enterprise. It is the former rather than the latter which is sought.

Secondly ideologically driven attempts to produce ethnic input – most noticeably Maori in New Zealand – run the strong danger of descending into a form of tokenism the result of which can be bitterness amongst those targeted, a less than optimal level of involvement, continued failure to reap the benefits of diversity and failure to produce high quality decisions such that governance is improved.

CONCLUSION

The last ten years have seen governance come of age in profile and acceptance as a critical element in the corporate mix. Whether or not the analytical framework required to deliver all that is sought from governance has been established adequately is more doubtful.

Significant gaps remain while expectations run high. Moreover the temptation to blame governance arrangements and performance for a range of woes remains strong. Unjust attribution is frequently difficult to separate from reasonable assertion. The appeal of laying blame at the feet of governors also remains strong if only for its simplicity.

These frustrations aside the potential for improvements in the understanding of what makes for better governance along with the promise of what its delivery might bring make the prospect of resolving outstanding issues an exciting one.

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