

## Launch of UTS Centre for Corporate Governance – Tuesday, 18 March 2003



**Sir Adrian Cadbury**

I must first thank the University and the Commonwealth Bank very warmly for inviting me to take part in the launch of the University's Centre for Corporate Governance. The setting-up of this Centre is very apposite, given the early lead which this country established in publicising and advocating the principles of good governance. I have no doubt that the Centre will make a valuable contribution to corporate Australia, and to Australian society more widely, by promoting high standards both of governance and of performance. The Centre will also become an important link in the worldwide chain of governance research communities.

This is an appropriate moment to reflect on how corporate governance has developed and where it stands today. It is just over ten years since the UK Committee which I chaired published its Report and Code of Best Practice and the only similar study at the time was **Corporate Practices and Conduct** published by Henry Bosch's Working Group here in 1991.

### UK Code 1992

The object of our Code of Best Practice was to provide boards with a checklist to enable them to assess where they stood in relation to best practice and, at the same time, to provide investors with an agenda for their dialogues with boards and to encourage such dialogues. The Code was neither mandatory nor prescriptive, given that companies and boards all have their differences and that their circumstances change. The Code aimed to assist boards in clarifying their responsibilities, in introducing appropriate checks and balances in their governance structures, and above all in encouraging disclosure. Provided boards were open about the way in which they directed and controlled their companies - our definition of corporate governance - then those with responsibilities towards boards could exercise them constructively and effectively.

The shorthand for this approach was, "comply or explain". To be listed on the London Stock Exchange companies had to state in their annual reports how far they complied with the Code and to explain areas of non-compliance. I recognise how important the Stock Exchange's backing was for ensuring that boards took the Code seriously. But why should companies comply with what was in essence a voluntary code?

First, the Code recommendations were based on best practice and on the evidence presented to us; they were not abstracted from textbooks. They were guidelines to assist boards to direct their companies more professionally, to help them to do a better job as directors. Second, being seen to comply with best practice could logically be expected to enhance the market standing of companies, in their own interests and in those of their shareholders. By the same token, shareholders had an incentive to use their influence to encourage the companies in which they had invested to comply. We left compliance itself, where it belonged, as a matter between boards and their shareholders. We referred to this discipline as market-regulation, rather than simply as self-regulation. Its effectiveness depended on the degree to which boards and investors responded to the challenge of the Code, because they saw it as to their advantage and in their interests to do so.

## Accountability and Performance

Companies operate within boundaries set by law, by regulations, by those who own and fund them and by the expectations of those they serve. There needs to be an appropriate statutory framework, on which companies and those with whom they are dealing can rely. Within that, as much as possible should be left to voluntary regulation, partly because it is better suited to those aspects of governance which require judgement and also because it is capable of setting higher standards than statutes. In addition, it can react more speedily to new issues as they arise. We are all dependent on the enterprise, willingness to take risks, and efficiency of the corporate sector. Companies must, therefore, be free to drive their businesses forward, but to exercise that freedom within a framework of effective accountability. Accountability and performance are the governance watchwords.

The issue is achieving the right balance between statutory and voluntary regulation. Arguably, the United States pre-Enron put its faith wholly in the market to enforce accountability and performance. They relied on investors, analysts, rating agencies and the financial media to act as the watchdogs of corporate conduct. But all concerned were carried away by the euphoria of rising share prices and by their interest in maintaining their rise. When disaster struck, faith in the market was shattered and trust is now having to be rebuilt. This will take time and carries with it the danger of tipping the balance too far in the statutory direction.

The role of codes of best practice is to assist market forces to work more effectively, not to supplant them. They form part of the framework within which companies operate and in practice their guidelines may well be as relevant to public sector and not-for-profit organisations. Once the code approach was widely seen to have an impact, more countries brought out their own codes which addressed their particular corporate situations.

How far, however, did code recommendations bring about real change? First, they put governance issues firmly on the agendas of boards. All directors had to sign off in their annual reports on the way in which their companies were directed and controlled. This concentrated their attention on the division between direction, which is the task of the board, and management, which is the task of the executive, a division which too often in the past had been blurred. Code recommendations highlighted the responsibilities of directors in relation to risk and internal control. They also provided a means for drawing investors into issues of governance. For example, the 1992 UK Report said that in principle the posts of chairman and of chief executive should be separate, but the Code at that stage simply provided for appropriate checks and balances should the positions be combined. The pressure on companies to split the posts has come from the investing institutions. As a last point, codes have drawn attention to the importance of the way in which board members are selected and they have unquestionably changed the nomination process for the better. There can be little doubt that in most countries the board scene has changed significantly over the last ten years and that codes of best practice have acted as agents of change. What needs to be watched is that the guidelines or principles, on which codes are based, do not get transmuted into rigid rules.

## The Governance Agenda

But now looking ahead, what issues are likely to appear on the future governance agenda? I would expect attention to shift from board structure to the way in which boards work, that is to say to people and to process. How should board members be selected? What should directors be expected to know when they take up their posts,

and what form of continuous professional development is needed to keep them up-to-date? Most important of all in terms of board effectiveness, how should boards appraise themselves, in order to improve?

Externally, there are a further set of questions which relate to the changing corporate environment. How realistically can companies reflect the increasing importance of intangible assets, such as intellectual property, a trained workforce, and reputation, in their reports and accounts? This leads on to the whole issue of the role of companies in society, at a time when society's expectations of business are changing. What does the phrase "corporate social responsibility" really imply and how might it be expressed in practice? What about the impact of technological change? How will and should companies react to a world in which published corporate information will be instantly available on their websites? Websites which will be open to shareholders and the public to interrogate.

The agenda is not limited to boards, it naturally takes in shareholders as well, especially the institutions as investors. They are being pressed in Britain to be more active and to engage with boards, where it could be to the advantage of those whose money they are investing. This raises questions about their competence to intervene in this way, about their conflicts of interest in so doing, and about their accountability. To whom are they accountable and to whom should they be?

These are the kind of matters on which chairmen and boards may well turn to the Corporate Governance Centre for advice and for a studied, objective view. Close collaboration between researchers at the Centre and corporate and professional practitioners is capable of yielding significant benefits to both partners. It could provide opportunities to gain a greater understanding of the way in which boards work as a collective to arrive at their decisions; this would prove particularly illuminating.

### Growth of Interest

After national codes, the next step was for international organisations to take an interest in this approach as well. The result was that the OECD published its **Principles of Corporate Governance**, as did the Commonwealth Association for Corporate Governance. The World Bank in its turn saw the importance of raising governance standards especially in the developing world. The President of the World Bank, James Wolfensohn, said in 1999: *"The proper governance of companies will become as crucial to the world economy as the proper governance of countries."*

This brings us to the basic issue of why corporate governance has risen from comparative obscurity to featuring prominently on the agenda of the G8 Summit in less than ten years?

During that period the world has continued to shrink. Capital markets are now truly global, as is investment and share ownership has become increasingly concentrated in institutional hands. As the World Bank has recognised, private capital is now far more important as the stimulus for economic growth than state, World Bank or IMF loans, therefore the standards of governance of companies have become a focus of national and international attention. On top of this, there is now a far wider public interest in corporate affairs in the developed world. Many more people now see themselves as directly affected by business decisions, as pension fund members, as employees, and as shareholders, and indirectly affected by the impact of companies on society. Consciousness of the importance of corporate governance is now far more widely recognised along the lines of James Wolfensohn's prediction. But what does this imply nationally and internationally?

## Governance and Performance

At the national level, the objective of codes of best practice is clear. They are in place to help raise standards of corporate governance and thereby to improve board effectiveness. More effective boards will in their turn direct and control their businesses better and thereby achieve higher standards of performance. The overriding aim of governance codes is to encourage higher standards of corporate performance. They provide a degree of insurance against fraud and failure as well, but I would suggest that, on balance, underperforming boards are more of a drain on the economy than dishonest ones.

Be that as it may, the proposition that good governance is linked to good performance becomes the test against which to measure the value of compliance with codes. It is not, of course, a linkage that can be proved in some scientific sense. There are a number of obvious problems in attempting to estimate the influence of governance on performance. First, governance is only one of the complex network of factors accounting for the comparative success or failure of companies. Second, people are more important than structures. As a result, early research which looked for straightforward links between structure and performance were largely inconclusive.

Research, however, based on the way in which the market rates corporate governance has proved positive. Studies by McKinsey into the premium which investors said they would pay for good governance, all else being equal, concluded that belief in the economic value of high standards of corporate governance was no longer a matter of faith. Further studies into the factors which investors take into consideration in allocating their funds have shown that the majority claim to take standards of corporate governance into account in coming to their investment decisions. The emergence of agencies which publish corporate governance ratings demonstrates that this interest has generated a market response. The fact that the market takes corporate governance seriously in investment decisions is the most compelling evidence that there are links between governance and performance, even if causation can never be proved.

## The Wider Role

At the international level, other considerations come into play. A prime reason for the World Bank's preoccupation with corporate governance is the overriding need for capital to flow where it can be put to use most effectively. In particular, if the gap between the developed and the developing world is not to continue to widen, emerging markets have to be able to attract the capital which they so desperately need. In a global financial world, they can only achieve this, if their standards of corporate governance are acceptable to the international providers of capital. In the words again of the World Bank: *"Because effective corporate governance can promote enterprise and ensure accountability, it is an essential foundation of the global financial architecture and central to the World Bank Group's mission to fight poverty."*

In relation to economic growth, therefore, high standards of corporate governance play a twofold role. In terms of companies, they lead to the better use of resources and add to the creation of the wealth on which the maintenance and improvement of the fabric of society depends. In national terms, capital will flow to those commercial centres which command confidence in their systems of corporate governance.

While the economic importance of corporate governance remains a primary consideration, the debate has broadened to include its social dimension. The issue is one of the role of business in society. The way in which companies are governed and the factors which boards take into account in coming to their decisions have their impact on the communities of which they are a part. Companies are being encouraged to widen their reporting to include ethical, social and environmental policies and investors are increasingly interested in these aspects of governance.

In the end, corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society. This is a worthy aim and one which matches the mission of the University's new Centre for Corporate Governance, to which we all wish every success on this its launch.

**Centre for Corporate Governance: [www.ccg.uts.edu.au](http://www.ccg.uts.edu.au)**