OBJECTIVES, STRATEGY AND CORPORATE GOVERNANCE:

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ABSTRACT

Corporate governance is too often viewed as an objective in itself. This is wrong, and it should be thought of as one of the processes by which a business achieves its strategic objectives. A number of elements are required for good corporate governance, and this paper discusses four key elements: external compliance, internal compliance, reward and recognition structures and internal communication and feedback mechanisms.

INTRODUCTION

Corporate governance is often described in terms of a system by which companies are directed and controlled. Such definitions, however do not include the concept of why corporate governance systems and processes are needed. Experience from the 1980s and 1990s requires that the actions of boards and managers are brought to the account of shareholders. How do we do this? We must know the shareholders' objectives, namely what we are trying to achieve.

Finance literature defines corporate governance within the context of organisational objectives, concerned with the ways in which suppliers of finance assure themselves of getting an investment return, very often expressed as shareholder value. Value is defined in terms of the economic model which includes both tangible and intangible impacts, and is determined by future outcomes (not current or past performance). Shareholder value concepts can also be applied to the public/not for profit sectors.

Fundamentally, the need for corporate governance comes about because there is a mis-alignment in the objectives of the various players in an organisation, and especially between managers and shareholders in the private context. Corporate governance puts the onus on a firm's directors to ensure that mechanisms are in place to safeguard that management is working in the best interests of shareholders. This view requires many things of corporate governance, including compliance requirements (external monitoring); internal audit and other internal monitoring; reward and incentive structures, and internal communication and feedback mechanisms.

COMPLIANCE REQUIREMENTS – EXTERNAL MONITORING

Compliance requirements, namely rules set externally to an organisation, are readily cited in any discussion of corporate governance, possibly as they are the most easily defined, broad in focus covering a wide range disclosure issues. They usually represent monitoring, disclosure and external audit type functions.

Businesses often focus on external compliance and design internal procedures and practices which simply meet the compliance requirements. By doing so, there is a real danger that the needs of the organisation are not met as the requirements may not be sufficient to meet its strategic objectives. Further, if the focus

becomes compliance only, then this may override the strategic needs of the organisation, and may focus the organisation on meeting time schedules, form filling, preparation of returns and disclosure, etc, and not the main game of achieving the strategic objectives of the business. A focus on compliance as an objective in itself is likely to divert attention away from this, and may take management's "eye off the ball".

A further problem if compliance becomes the main focus of corporate governance is a tendency for management to "assume" a good corporate governance culture if the compliance is satisfied - a moral hazard problem, which creates a checklist approach to corporate governance. While checklists are useful, there is always a danger that the checklist becomes the prime focus rather that the reasons for having it. This point was reflected in the results of a recent Australian Fund Managers Association study, which finds that 80 percent of the 100 top companies indicated a "genuine effort" in addressing the listing rules of the ASX, and that only 10 percent were found to have a good understanding of the need for the requirements and the issues involved.

INTERNAL AUDIT AND OTHER INTERNAL MONITORING

The second component of corporate governance is internal audit and other internal monitoring processes. Internal audit teams are a very common example of this, and more recently, businesses are developing risk management units. All these internal activities are focussed on the achievement of better returns to investors through better work practices and risk management. To be effective, the internal monitoring devices need to be designed to enhance the achievement of the business objectives, and should be developed independently of external compliance requirements.

REWARD AND INCENTIVE STRUCTURES, AND PERFORMANCE MEASUREMENT

Reward and incentive structures which encompass the whole organisation can be a highly significant and underutilised part of corporate governance. Good monitoring devices (internal or external) can be undermined by poor or badly constructed reward and incentive systems.

It is critical for good corporate governance that incentive structures be consistent with the organisation's strategic objectives. If this is not the case, then the objectives will not be achieved, unless the business is lucky. While altruism does exist, the concept of self interest is entrenched in the Anglo/American corporate governance culture.

The reward and incentive structures need to also be consistent with the organisation's culture, employee morale as well as its strategic objectives, with the strategic objectives as the main focus. They cannot usually be borrowed from somewhere else – another organisation, or from the past. They must be relevant in time and place within any organisation, and should be developed to eliminate competition across the organisation in the use of scarce resources. They need to run throughout the organisation and not just reside at the top.

Any effective reward and recognition system requires appropriate methods of performance measurement, and the performance of the board is obviously no exception to this. The need to balance the skills and capabilities of the board members to ensue a high level of overall board performance is an important

ingredient, making, the structure of the board and the balance of independent and non-independent directors, relevant issues for performance.

INTERNAL COMMUNICATION AND FEEDBACK MECHANISMS

If an organisation is focussed on the achievement of its objectives and not on compliance and monitoring per se, and if its employees are rewarded for the behaviour and performance necessary to meet these objectives, then, less costly monitoring and compliance is likely to be needed.

However, to achieve this state requires effective communication and feedback mechanisms within the organisation. All employees need to be well informed about their roles and responsibilities, with suitable recognition. If only directors and senior managers are rewarded for performance, then morale problems may cause higher compliance costs. A risk management approach requires that all who need the information have it. Corporate governance cannot be effective unless there is a high level of trusting up, down and sideways. Further, the cost of corporate governance compliance is likely to fall if communication is effective.

Good communication along with performance planning systems can support the reward and recognition systems and the delegation and control structures that make up the operations of the organisation. However, all need to have as their focus the strategic objectives of the organisation.

CONCLUSION AND SUMMARY

In all this, there is a trade off. All the issues raised here represent a cost. For some businesses, compliance costs represent a tax, and are not necessarily helpful. Compliance is necessary in imperfect markets. However, it may be ineffective and too costly if it promotes a compliance culture and not a corporate governance or risk management culture. If a compliance culture develops, then it may protect the wrong firms, creating a barrier to further investment in the relevant businesses. Corporate governance in isolation of objectives is irrelevant. Consequently, the amount spent on corporate governance depends on the additional value created. There is no fixed or right price. The amount paid is justified as long as sufficient value is created to both cover this cost and provide additional returns to investors.

In conclusion, the approach in this discussion paper has been to highlight the need to ensure that corporate governance does not of itself become an issue in isolation of the activities and operation of a business. The discussion of corporate governance needs to be broadened. It needs to become a part of the way things are done within a business and should be one of the tools used to ensure that the objectives of the organisation are achieved. Corporate governance is not compliance and corporate governance is not an objective in itself. Corporate governance encompasses both internal and external monitoring and compliance requirements, in addition to appropriate reward and incentive structures which support the objectives of the firm. The need for communication and feedback in this process becomes paramount. The various corporate governance mechanisms are complex and do not work independently.