

GOVERNANCE FOR PERFORMANCE

Précis

This paper discusses fundamental governance theory and explores the components of effective governance – performance, assurance, and conformance. It is argued that performance, assurance and conformance are indivisible and inter-dependant ingredients of “effective governance”.

The paper then reviews the three key elements of “agency risk” – malfeasance, misfeasance and underperformance – by those entrusted with the governance, direction and management of an organisation.

The paper discusses the relatively recent emergence of regulatory compliance responsibility towards self-regulation. It refers to the costs (direct and indirect) to corporate Australia associated with developing a “culture of regulatory compliance”.

It is postulated that organisational “under” performance has greater significance and resultant societal cost than organisational “under” conformance, with its underlying ethical and regulatory compliance focus.

The paper invites consideration to be given as to whether society may derive greater economic and social benefit by re-directing some of its current resource expenditure from conformance and regulatory compliance to organisational performance outcomes.

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1 Fundamental Governance Theory

Organisations are formed to better serve the needs and desires of their members or societal constituents in accordance with their stated objectives. Control of organisations is entrusted to appointed directors. That entrustment is on the basis that those directors can better achieve the intended or desired outcomes for the organisation than can the organisation's members or societal constituents acting collectively themselves.

Governance is an organisational construct designed to facilitate:

- Performance – by better assuring delivery of outcomes consistent with the organisation's objectives, including appropriately managing organisational risk;
- Conformance – by better assuring the control and accountability of organisations including, importantly, by helping to manage “agency risk”. This refers to the behaviours, actions and conduct (or lack thereof) of those entrusted with the governance, direction and management of the organisation proving to be otherwise than in the best interests of the organisation and its members or constituents.

In relation to directors of organisations, agency risk includes:

- (i) malfeasance – the risk of illegal and wrongful behaviour by the organisation's directors giving rise to criminality e.g. dishonest dealing;
- (ii) misfeasance – the risk of culpable behaviour by the organisation's directors falling short of accepted standards and giving rise to civil liability claims e.g. negligence;
- (iii) underperformance – mere ineptness or failure by the organisation's directors to govern in a manner that realises organisational potential, but without malfeasance or misfeasance.

“Effective governance” commonly includes a third element of *assurance*. This is represented by policies, systems, standards and protocols designed to assist in the more reliable delivery of both the *performance* and the *conformance* objectives of governance.

These components of effective governance (performance, conformance and assurance) work symbiotically to deliver outcomes which are consistent with organisational objectives, and where agency risk is effectively managed. Although theoretically capable of separate categorisation, they work indivisibly and inter-dependently with one another to support a holistic “effective governance” framework.

Governance is the domain of an organisation's board of directors. It is they who must hold themselves accountable for the organisation's governance and the delivery of outcomes consistent with the organisation's objectives. It is they who must deliberate and make decisions having regard to the best interests of the organisation. It is also they who must appoint and, through ongoing oversight, hold accountable managers of the organisation to execute and implement board decisions and to administer and manage the day-to-day operations of the organisation.

2 Analysing the components of effective governance

(a) Performance

For an organisation to sustainably deliver outcomes consistent with its stated objectives there must be at least appropriate:

- decision making by the organisation's board of directors;
- execution and implementation of those decisions by management;
- oversight, monitoring and review of the decisions taken as well as their execution and implementation.

Performance related decisions by boards of directors typically relate to: strategic direction; risk appetite and oversight; resourcing allocation and prioritisation – financial, human and asset (tangible and intangible); business planning; budgetary approval; and significant capital and acquisition proposals.

(b) Conformance

An organisation's governance must also protect against the downside of adverse outcomes. This includes behaviour, actions or conduct (or lack thereof) by appointed directors and officers which is contrary to the organisation's objectives, policies and/or the law.

Accountability to members, societal constituents and regulators is a key element of conformance. This includes concepts of transparency (subject to legal and commercial constraints), access to relevant organisational personnel and reporting of relevant organisational information. In this manner, those to whom accountability is owed can be reasonably informed and make proper assessments of the progress towards delivery of organisational outcomes. They may also assess the performance of those appointed to the organisation to govern, direct and manage it.

Importantly, an organisation's governance must also align with a strong ethical framework which is principles-based and rooted in values and integrity. This goes well beyond legal and regulatory compliance, although that too is absolutely vital. It must be designed to underpin an ethos that whatever is done by the organisation and its people in the name of the organisation, not only must lawfully be able to be done, but is also "right" to be done.

(c) Assurance

Assurance is akin to the glue that holds an organisation's governance intact and holistically coalesces the "yin and yang" of the performance and conformance functions of governance.

It is a function that embraces both formal and informal elements.

On the formal side are the written policies, systems, standards and protocols that proscribe, prescribe or describe how operations and processes within the organisation, or by the organisation with the external world, are to be conducted.

On the informal side is the culture of the organisation. Having a sound culture is vital for an organisation in developing normative behaviour based on principles which can be interpreted and applied by the organisation and its people. It facilitates appropriate decision making and action even if a prescribed process as to what should be done has not been formally documented, or cannot readily be accessed.

Increasingly at law, even where an organisation or one of its people strays from set legal or regulatory compliance, the presence of a demonstrable culture of compliance with the law can be a possible defence, or at least an element in mitigation of the penalty that might otherwise be imposed.

Table "A" seeks to present these concepts in diagrammatic form.

Table “A” – COMPONENTS OF EFFECTIVE GOVERNANCE



3 Governance focus and agency risk

(a) Conformance by managing agency risk

The evolution of organisational governance, both philosophically and in practice, has been significant over recent decades. Applied governance is generally recognised as being both an art and a science.

Importantly, much of its evolution has focused on the conformance aspect of governance. Laws and regulations are passed prescribing and proscribing the behaviour of organisations and their directors and officers. Courts also pass judgment on compliance with these laws and regulations, and the observance (or not) of fiduciary duties by directors and officers. In turn, the media is keen to report on such matters.

In the context of agency risk, this legislative, regulatory and judicial focus primarily has been on “malfeasance” and “misfeasance”. This is where fault or culpability, criminal or civil, is sought to be ascribed, and penalties and compensatory damages awarded, including as a deterrent to others as to how not to behave in the future.

Stakeholders of organisations whose directors or officers have breached legal and regulatory rules have been keen to attribute blame for the breach. It has been suggested that they seek “a soul to damn and a body to kick” for the loss or harm suffered.¹ The blame may be fairly ascribed to the organisation’s directors or officers, depending on the circumstances. But, at all times, it must be remembered that business and corporate performance is invariably concerned with managing risk to derive operational returns and strategic outcomes. By its very nature, risk is steeped in uncertainty.

Our regulators and our judiciary prosecute and pass judgment on malfeasance or misfeasance of directors and officers. It is their job to do just that. It is an important job, and nothing in this paper suggests otherwise.

In support of society’s legislative, regulatory and judicial system, the government and its agencies spend billions of dollars each year in passing legislation and resourcing regulators, prosecutors and the judiciary to monitor and enforce compliance, and to bring miscreant corporations and their directors and officers to justice.

Governance academics and practitioners then seek to respond to the ever changing legislative, regulatory and judicial landscape. In doing so they may create increasingly detailed and prescriptive governance guidelines, rules and standards which seek to define policies, systems and processes. These are designed to ensure that these legislative, regulatory and judicial requirements are not offended.

(b) Self-regulatory trends and costs

Interestingly, and especially since the 1990s, government political theory and practice has promoted the devolution of regulatory compliance responsibility towards self-regulation.² This practice is evident in the jurisdictions overseen by the Australian Securities and Investments Commission (that is, corporate and financial product/service regulation) and the Australian Competition and Consumer Commission (that is, trade practices, competition and consumer law).

¹ “Did you ever expect a corporation to have a conscience when it has no soul to be damned and no body to be kicked” – Edward, First Baron Thurlow 1731 – 1806 as also alluded to by Neil Young QC in ASIC Summer School February 2008 “Corporate liability versus directors’ personal liability – have we gone too far or not far enough” – www.asic.gov.au

² “Managing Regulatory Compliance” Prof Peter Carroll and Prof Myles McGregor – Lowndes – September 2002 – Australian Institute of Criminology

This trend towards self-regulation is accompanied by a corresponding shift of regulatory cost from the government sector to the private sector. It obliges those who are the subject of regulatory intent to establish their own internal codes and compliance regimes to ensure that the organisation and its people meet the regulatory compliance objectives. In part it does this by holding the senior decision makers of organisations (that is, their directors and officers) to account should the organisation or its people default in compliance with regulation. Increasingly it is accompanied by a further obligation upon the organisation to “self report” compliance breaches to the regulator. The risk of culpability is heightened if the organisation does not have in place a reasonably effective compliance assurance protocol designed to ensure that compliance is maintained.

The proven efficacy of this “carrot” (that is, an element of protection if sound compliance protocols are implemented) and “stick” (that is, strong penalties for compliance default especially if sound compliance protocols are not implemented) approach is still in its relative infancy, although its principles appear to be sound.

As mentioned above, a consequence of this approach is the shift of a large measure of the regulatory compliance cost from the public to the private sector. The regulator is no longer the “policeman on the beat” closely watching every step of organisational endeavour. Rather, the regulator is the overseer of compliance reports and certifications issued by the regulated organisation, as well as the initiator of periodic compliance audits. The “policeman on the beat” has now been deputised to within the regulated organisation. Interestingly, the compliance function within organisations is now one of the largest growth areas in terms of employment expansion, not necessarily productivity.³ This “deputisation” is to the cost of the organisation itself and, ultimately, to the cost of the organisation’s members and broader stakeholders as yet another cost of doing business.

As a consequence, when looking at the cost to business and society of regulating governance conformance and compliance risks (including the agency risks of malfeasance and misfeasance) it is necessary to consider:

- the public cost; that is, the cost to the government of resourcing our legislative, regulatory and judicial systems to deal with default risks and alleged defaulters; and
- the private cost; that is, the cost to businesses and organisations in developing, maintaining and operating the necessary internal compliance systems and protocols.

Survey results from Deloitte Access Economics³ seek to provide an estimate of what might be the costs of compliance “red tape” across Australia from both a public purse and an industry cost perspective. Based on those survey results the cost to the public purse is estimated at around \$27 billion annually with the cost to industry being around a further \$67 billion annually. It should be noted that these are gross numbers with respect to regulatory compliance costs as a whole, with governance related conformance and compliance costs a subset of that.

4 Is there a better view of the situation?

It is not disputed that there are important moral issues, having both economic and social relevance, that need to be controlled and managed to effectively address agency risk. After all, our entire capital markets system is founded on principles of integrity; equal access to information; transparency; and the rule of law.

But the question that needs to be asked is whether society is gaining optimal return for its overall investment in resources that seek to mitigate governance risks? This is especially

³ Deloitte Access Economics “Get out of your own way – Unleashing productivity” – October 2014 – www2.deloitte.com/au/en

so given that the primary focus is on *conformance* and *compliance* to address the “agency risks” of malfeasance and misfeasance, rather than addressing the cost and expense to society of organisational *underperformance*.

Questions that need to be asked in this context include:

- Could there be a risk of *unintended consequences* arising from the current increasingly detailed and prescriptive focus on legislative, regulatory and judicial compliance?
- Could there be a greater *moral hazard* to society – that is, the cost to society of organisational underperformance – which is either being masked or not appropriately resourced relative to the considerable focus being applied to managing *conformance* related risks?

(a) Unintended Consequences

The concept of “unintended consequences”⁴ has particular application where regulation, designed to manage or control particular behaviour or circumstances, in fact also has impacts and effects (often negative or unduly intrusive or burdensome) well beyond the intended scope of influence of the regulation.

At times, the “unintended consequences” have proven to be more costly or have greater adverse economic or societal impact than the original egregious behaviour or circumstance sought to be managed or controlled by the regulatory intervention.

In a governance context, the question to be asked is whether the current attention given to regulating the behaviour of directors and officers of organisations is creating an environment where:

- too many aspects of such behaviour are being prescriptively regulated;
- the amount of regulation has become burdensome and virtually impossible for most to fully understand, have knowledge of and therefore comply with;
- the penalties for regulatory breach are excessive, given the ability of a director or officer reasonably to control the behaviour or circumstances sought to be regulated;
- too much valuable time and effort of the corporate and organisational leaders of our society are being consumed on legal and regulatory compliance functions;
- entrepreneurial business spirit and endeavour is being suppressed or, at least, not fostered.⁵

If these responses are in the affirmative, and if Australia is comparatively out of step with its global trading partners, then Australia may be at a strategic competitive disadvantage relative to those international trading partners. This may be to the detriment of the social and economic welfare of Australia and its citizens generally. In this regard, the contributions to society that Australian corporations would deliver to the nation and its people may be reduced (for example, employment opportunities, taxes, the delivery of goods/services, and improvement in the standard of living).

⁴ The Concise Encyclopaedia of Economics – [www.econlib.org/library/ENC/Unintended Consequences.html](http://www.econlib.org/library/ENC/Unintended%20Consequences.html)

⁵ refer Australian Institute of Directors “Impact of Legislation on Directors” (Director Liability Survey Results – Nov 2010) – www.companymdirectors.com.au

The perception of this conformance focus has also given rise to a secondary unintended consequence which risks impugning the “governance” movement as a whole, notwithstanding the broader benefits than can be derived from it.

(b) Moral Hazard

Could the costs to society of the agency risk of underperformance exceed the risk of regulatory non-compliance?

*Moral hazard*⁶, in economic theory, is where a party (for example, a director or officer) is more likely to behave (or not behave) in a manner where the resultant cost or consequences of the behaviour (or lack of behaviour) will be borne by another (for example, a member or shareholder of the organisation, or society generally) or at least not by the party him or herself.

In essence, if the primary focus on the behaviour and performance of a director or officer is through a legal or regulatory compliance lens (where sanctions against the director or officer for failure to conform or comply are significant), with only a secondary focus on the contribution of the director or officer in adding value to the *performance* of the organisation and achievement of organisational objectives (where formal sanctions against the director or officer for failure to perform are minimal, especially in relative terms compared with malfeasance and misfeasance), then the *moral hazard* needs to be considered.

If the propensity and/or the prospective cost and expense to society of this outcome is high, then steps need to be taken to mitigate and address the moral hazard arising.

5 The risk of malfeasance and misfeasance compared with the prospective cost and expense to society of underperformance

- (a) Attachment “A” to this paper contains some statistics drawn from the Australian Securities and Investments Commission (ASIC) and the Australian Charities and Not-for-profit Commission (ACNC) – sources that are worthy of reflection in considering these issues. It is provided for general illustrative purposes only.

From this information the following general observations and inferences might be drawn:

- The number of enforcement investigations and court actions by ASIC is a very small percentage (less than 0.01%) of the total number of directors and incorporated organisations in Australia.
- Assuming ASIC is effective in its regulatory mandate, corporate Australia and its directors and officers appears to have a high level of regulatory compliance.
- ASIC appears to measure and report on its performance in regulating the corporate sector by referencing the number of prosecutions and actions it successfully brings against miscreant corporations, directors and officers. It takes this negative measurement and reporting approach, rather than measuring and reporting on the apparent low percentage of available prosecutions and actions, relative to the size and activity of the corporate sector.

- (b) Other public sector regulatory and judicial agencies

Based on research by the Australian Institute of Company Directors (AICD), there were around 700 pieces of legislation in Australia (Federal and State) which

⁶ Economics Help – www.economicshelp.org/blog/105/economics/what-is-moral-hazard

demand regulatory compliance by corporate Australia and in respect of which directors and officers of incorporated organisations may be held liable for failure to comply with their legislative and regulatory requirements.

Many of these legislative enactments come with a supporting regulatory (or quasi-regulatory) body or agency to oversee and enforce legislative compliance. Some of the more significant ones amongst these include (whether at State or Federal level) the Australian Competition and Consumer Commission (ACCC), Australian Prudential Regulation Authority (APRA), Australian Stock Exchange (ASX), Australian Taxation Office (ATO), occupational safety and health agencies, crime and corruption agencies, environmental protection agencies, fair work agencies, State revenue and public sector management agencies and privacy agencies.

In addition, corporate regulatory compliance, and related disputes, are assessed through the judicial system.

It is the aggregate of the legislative, regulatory and judicial functions dedicated to corporate regulation and compliance by directors and officers that must be considered when assessing the cost to the public purse of “governance for conformance” and regulatory compliance.

Based on research by Deloitte Access Economics titled “Get out of your own way; unleashing productivity”, and released by the Federal Treasurer in October 2014⁷, the cost to the public purse of corporate compliance, including governance related conformance and regulatory compliance, is \$27 billion annually to administer, with a further \$67 billion imposed annually in expenses to businesses by way of management of compliance obligations. Governance related conformance and regulatory compliance is a sub-set of this significant sum.

(c) Private sector conformance and regulatory compliance costs

Based on the Deloitte Access Economic research findings referred to above, the cost of corporate legislative and regulatory compliance is but the tip of the iceberg, especially having regard to the devolution of regulatory compliance responsibility towards self-regulation with the associated shift of regulatory compliance costs from the public to the private sector.⁸

The Deloitte Access Economics research findings were that the Australian corporate sector was spending a mammoth \$155 billion annually (proportionately split between development/administration and compliance components around 1:6) on self-imposed rules to meet corporate initiated conformance and compliance requirements.

This shift of the regulatory compliance burden from the public to the private sector has seen “compliance workers” within the Australian workforce now exceeding one million people and constituting in excess of 9% of the total workforce, despite technology related productivity gains which have seen “back office” personnel reduce over the last 2 decades from around 8% of the total workforce to now only 4%.⁹

(d) Australian director sentiment

Based on the Australian Institute of Company Director Sentiment Index 2014¹⁰, and with respect to regulatory and legal issues:

⁷ Refer note 3

⁸ Refer note 2

⁹ Refer note 3

¹⁰ Australian Institute of Company Directors “Directors Sentiment Index 2014” – www.companydirectors.com.au

- around 25% of directors surveyed believed that regulatory compliance issues were negatively impacting their decision making as a board member;
- around 40% of directors surveyed believed regulatory compliance risks were negatively affecting their willingness to be a director.

6 Observations

Certainly the overall cost of regulatory conformance and compliance, be it from the public or the private sector perspective, is significant.

But what the foregoing financial and other information fail to reveal is the other side of the equation; that is, what is the benefit to the economic and social well-being of Australia and its citizens of these costs and expenses and the strong regulatory focus on the compliance and conformance aspects of corporate governance?

Without knowing the value of the benefit derived, it is difficult to make an informed judgement as to whether or not the overall costs and expenses of regulatory conformance and compliance is money well spent.

Certainly a risk weighted analysis of the cost:benefit equation for each regulatory imposition might better inform such a judgement.

Suffice to say, though, that the costs and expenses are significant, and the value to society of the benefit derived from this current approach does not appear to have been quantified. In economic and business parlance, a detailed business case analysis appears not to have been undertaken. That said, the importance of the rule of law and the value to society of a just and fair system of government, which has integrity, may well be immeasurable or at least unquantifiable.

However, what is apparent is that this cost and expense is primarily focused on “defensive” or compliance aspects of governance rather than “offensive” or performance aspects of governance. If that is so, then at least the economic value to society of the benefit derived from the current approach is not one measurable against an enlarged economy. Rather it is one measurable against “how much the size of the economy would diminish” if it were not for the current approach.

On the other hand, if greater focus was given to governance for *performance*, then the social and economic value to be derived by society (in the form of employment, taxes, dividends, the delivery of goods/services of utility to society and improvements to the standard of living), could be measured by the relative uplift in performance, or the extent of the value add, to the existing economy and its resultant social dividend.

7 Consequential questions

It is submitted that the following questions should be asked:

- What are the areas of governance that society should apply its resources and attention to in order to deliver its desired economic and societal objectives?
- To what extent and at what cost should society apply its resources and attention to each of these areas of governance?
- How should society prioritise the application of its limited resources and attention to each of these areas of governance to optimise the prospect of society’s desired economic and societal objectives?
- Is the current cost to society of initiatives to address the risk of malfeasance and misfeasance of directors and officers disproportionate to the benefit currently being derived, especially if the existing relatively high level of corporate compliance could be maintained at a reduced level (and cost) of regulatory control and oversight?
- Would greater investment and social dividend be gained if some of the resources currently deployed towards governance for compliance and conformance were

redeployed to governance initiatives designed to enhance the performance of the nation's organisations and their directors and officers?

8 Conclusion

Governance is an organisational construct designed to better enable organisations to achieve their objectives. Governance has at its core "agency risk". It seeks to address aspects of both corporate performance and regulatory conformance.

Effective governance includes a third element of assurance, embracing formal policies, systems, standards and processes, as well as informal cultural practices. Assurance is seen as an enabler of enhanced performance outcomes and reduced conformance failure.

Considerable legislative, regulatory and judicial resources are deployed seeking to ensure legal and regulatory compliance by directors and officers. The resources expended or deployed on the agency risks of malfeasance and misfeasance by directors and officers appears to far exceed that expended or deployed to address the agency risk of underperformance of directors and officers.

The burden of the regulatory focus on director and officer malfeasance and misfeasance is having the unintended consequence of exacerbating the risk of organisational underperformance. A rebalancing of resource expenditure to address the risk of underperformance may have significant economic upside potential, with associated social benefit.

Attachment “A”

This information is largely drawn from analysis of publicly available data sourced from the Australian Securities and Investments Commission (ASIC) and the Australian Charities and Not-for-profit Commission (ACNC) websites, especially the 2012/2013 ASIC Annual Report.¹¹

1. No. of incorporated organisations in Australia (approximations only)
 - ASX Listed 2,000
 - Public unlisted companies 20,000
 - Other public/proprietary/commercial 2,000,000
 - NFP/charitable 200,000
 - Public sector 10,000
2. No. of directors in Australia (approximations only)
 - ASX Listed 10,000(*)
 - Other public/proprietary/commercial 2,000,000(*)
 - NFP/charitable 800,000(‡)
 - Public sector 40,000(‡)

(*) estimated unique directors (i.e. multiple board positions excluded)

(‡) estimates only with an assumed 4 unique board members per organisation on average
3. No. of ASIC generated major enforcement investigations and court actions for 2012/2013 under its 2 priority outcome strategic area of “Confident and informed investors and financial consumers” and “Fair and efficient financial markets”
 - (a) No. of misconduct reports received by ASIC (12,000 total)
 - referred for further action/review 3,000
 - relating to solvency 300
 - relating to directors’ duties/governance 350

[i.e. around 70% did not warrant further ASIC attention]
 - (b) No. of investigations 186
 - (c) No. of legal actions 40
 - criminal (including 8 insider trading convictions) - 25
 - civil - 15

¹¹ ASIC website www.asx.gov.au

(d)	No. of criminal convictions	22
	• fines	- 13
	• jail	- 9
(e)	No. of illegal schemes shut down/action taken	39
(f)	No. of persons disqualified/removed from directorship	22
(g)	No. of enforceable undertakings given	20
(h)	No. of negotiated outcomes achieved	17
4.	ASIC aggregate annual financial resource allocation to “enforcement”	\$133 million (39% of ASIC’s \$340 million total budget)
5.	Additional compensation secured by ASIC for Storm Financial investors	\$136 million