

Key governance report
SYNOPSIS

When does good governance lead to better performance?



PREPARED BY

Dr Robert Kay and Dr Chris Goldspink

Contents

Key Findings	3
Overview	5
An ecology of governance	6
Defining the team	9
Summary	10

Key findings

‘Good’ governance is a team activity, with its primary process being one of collective sense-making. This represents a significant departure from the way in which the topic has been researched in the past and arises from a reappraisal of the purpose of governance itself. Key to this finding is the recognition that the behaviour associated with ‘good’ governance is not a constant. It changes depending on the circumstances in which the organisation finds itself. The ability of the board to accurately read the environment is fundamental to effective governance and hence ‘good’ governance is a collective cognitive process, dependent on the effective functioning of the team.

- **‘The team’, as a single unit of analysis, should be conceived of as the board and the executive leadership team.** Whilst this may appear to conflict with the structural notions of independence, independence was overwhelmingly viewed as a mindset and characteristic of the individual by the Chairs and a basis for the next finding.
- **Within this ‘team’, the board provides the reflective capacity for the executive** in order to improve the

quality of decision-making. This is necessary in order to overcome failures of decision-making arising from issues of cognitive bias and the demands of senior executive roles, where the opportunity to critically reflect on decisions can be limited by time.

- **The nature of the decision-making challenge varies by circumstance.** In this research, circumstance has been conceptualised through four main phases involving processes of renewal, growth, stability and disruption. The Holling Cycle was used to explore these processes and found to be consistent with the experiences of the Chairs interviewed.
- **The greatest governance challenge existed when the organisation, or the environment in which it operated, was moving from one phase of the cycle into another.** This required the board and executive to not only accurately identify where they were in the cycle, but also predict the range of potential outcomes that could arise from alternative courses of action during the subsequent phases of the cycle.

Within ‘the team’, the Board provides the reflective capacity for the executive in order to improve the quality of decision-making.

“ Good governance is a team activity...taken seriously and deeply, it represents a significant change in direction from the literature and the general approach adopted in exploring the topic in the past, particularly as this ‘team’ is generally taken to include the executive.”

Three key factors impacted ‘the team’s’ ability to achieve successful outcomes:

- **Perspective** — an ability to question and debate the assumptions informing the board’s assessment of the organisation’s situation, given its complexity and ambiguity
- **Scale** — the ability to appropriately frame or understand the implications of decisions across time and different levels of scale, i.e. division, organisation, market, economy

- **Prediction** — the ability of the team to use information and experience as a basis for predicting plausible future circumstances and their implications for the organisation and its stakeholders

Whilst each of these factors present different challenges, the Chairs perceived the best path to addressing them lay in the selection, development and maintenance of an effective team (as described above).

The key attributes of an effective ‘governance’ team were:

- **Diversity of view and experience**
- **Independence of mind (as distinct from structural independence)**
- **Openness to alternatives**
- **Trust**

Of these attributes, trust between members of the board and the executive was seen as the most important factor. It enabled the other attributes.

The concept of performance varied significantly depending on the sector and the organisation’s stakeholders. This made a study of the causal relationship between governance and performance impossible with this data set. Indeed, many Chairs linked the concept of performance to the strategic objectives of the organisation, which in many cases are not generalisable. Furthermore, data showed that any discussion of this point must first address the difference between ‘outputs’ and ‘outcomes’.

Overview

This report is the first in a series of research studies to be supported by the Australian Institute of Company Directors (AICD). It marks the beginning of what will become an ongoing research program into the nature and practice of good governance.

The key finding of this current research, that 'good' governance is a team activity, may initially appear almost too obvious to warrant a mention. However, this presents a significant departure from the way in which the topic has been viewed in the past.

The board as a unit of study has largely remained a 'black box' to researchers, with very few studies gaining first-hand access to the dynamics of board decision-making. These limitations have obscured discussions about the role of the board and its relationship to the executive. Performance too has been narrowly defined, being largely limited to publicly available financial data. In combination, these factors have frustrated attempts to establish a clear link between the quality of governance and organisational performance, particularly for unlisted organisations.

By contrast, the findings in this study are based on interviews with 100 Chairs, covering organisations in the Publically Listed, Private, Not-for-profit and Public Sectors. These interviews illustrate that the challenge of 'good' governance is a not a constant one; it changes depending on the circumstances in which the organisation finds itself. This led to a reframing of the research question - away from a one size fits all approach - to ask instead:

“ Under what circumstances does good governance lead to better performance? ”

This reframing highlighted the considerable complexity involved in understanding the drivers of 'good' governance. Four hundred and eleven vignettes or short stories of governance were collected through the interviews. To make sense of the data, a conceptual framework was required to both categorise the different circumstances boards faced; and also illustrate the characteristics associated with these different circumstances.

An ecology of governance

The Holling Cycle, developed by Canadian ecologist C.S. Holling, provided a useful metaphor for this purpose. The Holling Cycle¹ (see Figure 1) is divided into four phases or states through which a system is continuously travelling. Holling refers to the most stable of these phases as Conservation. During the Conservation phase the focus is on consolidating the organisation's position in the market and aligning organisational investments and processes to service it in an increasingly efficient manner. This is typically the longest lasting of the four phases and, in terms of responding to and harvesting a market opportunity, could span many decades.

At some point a market disruption will trigger a shift to the next phase in the cycle - in Holling's words a Release. This may be due to a change in consumer preferences; a technical innovation rendering existing products or services obsolete; or just simply the result of poor management. Holling links this phase to Schumpeter's (1945)'creative destruction' stage of a business cycle.

The Release phase is followed by the need for Reorganisation. During Reorganisation existing assets and systems are abandoned or sold, thereby freeing up capital for re-investment. This phase is associated with high levels of innovation, uncertainty and instability. The old business models, destroyed during the Release phase, are yet to be replaced by a new, dominant approach. Many small and minimally connected organisations form in response to a perceived market opportunity and innovate, particularly

with regard to business models, in an attempt to colonise the new opportunities.

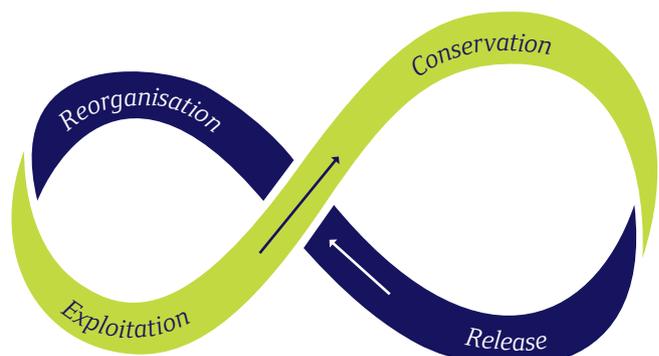


Figure 1: The Holling Cycle

It is then that activity moves to the fourth phase of Exploitation. Here the multitude of small activities that characterised the Reorganisation phase are reduced to a few dominant models that prove most effective at capturing the available resources and maximising value from the environment. Innovation is also prevalent in this phase, but more focused on finding increasingly effective and efficient production processes to underpin the new business models. And so the cycle continues back into Conservation.

To test the applicability of the Holling Cycle in understanding the interview data, the vignettes were reviewed and coded according to how well they matched a particular phase of the Holling Cycle. Figure 2 shows the results of this exercise.

¹ A detailed description of the Holling Cycle and associated research can be found in Gunderson and Holling (2002)

The highest proportion of stories (40%) described instances of governance characteristic of a Conservation phase. We would expect there to be more Conservation stories in the sample because, for the vast majority of the time, boards will be dealing with decisions involving the Conservation of business as usual.



Figure 2: Percentage of vignettes by phase of the Holling Cycle

Consequently, more of the Chairs’ experiences would be in this phase. It is important to note we are not claiming that these numbers are statistically valid or representative of the actual time board members spend dealing with issues of governance in each of the quadrants. Rather, because the stories could be easily and consistently categorised into each of the phases, the Holling Cycle presents a useful metaphor and explanatory framework for thinking about issues of governance.

Interestingly, when we split the sample in terms of those stories the Chairs considered to be positive and those that were negative, the Release phase was associated with a significantly higher percentage of negative stories (55%) compared with the others (ranging from 29–35%). Figure 3 shows the comparative breakdown of positive and negative stories across the four phases of the Holling Cycle.

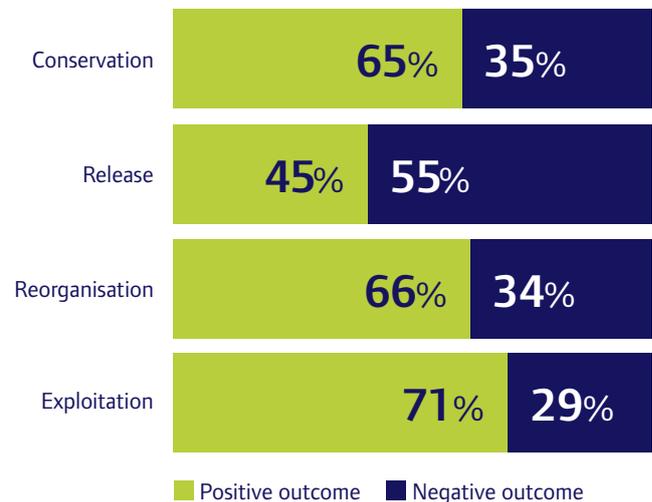


Figure 3: Breakdown of vignettes by positive and negative stories

This presents an interesting paradox and our first distinguishing characteristic of ‘good’ governance — as opposed to governance in general. The Release phase of the Holling Cycle is inevitable in all natural systems (in which we would include social systems like organisations). As such, while it may be within the power of the board to influence the timing and extent of a Release, it is not something that can be avoided altogether. Therefore it seems logical that the board’s capacity to pre-emptively and successfully ‘read’ the environment and guide the organisation through a Release phase is critical to the notion of ‘good’ governance. Furthermore, we could hypothesise that it is during the Release that the effect of ‘good’ governance is most easily discerned.

Interviewer: So, when does good governance lead to better performance?

[Chair 98]: Well it probably always does, but it's hard to show... But in the crisis... that's when you'll see it. And I would think there'd be lots of examples that you would gather from around the world that would show that.

The picture is not, however, as straight forward as this. Whilst a crisis may expose to the outside world the quality of governance present in an organisation, from the perspective of those involved, the more vexing governance problems were experienced when things were going well - when there was no particularly compelling reason to change what was being done.

[Chair 98]:...I think the trick is, when you are humming, to introduce new things...that's one of the hardest things for companies to do when things are going well.

It is from these observations that three critical factors emerge that are crucial to the ability of the board and executive team to deliver a superior outcome:

- **Perspective** — The ability to ensure an accurate assessment of the organisational situation given its complexity and ambiguity.
- **Scale** — The ability to appropriately frame or understand the implications of decisions taken at one level of the organisation (e.g. business unit or division) on activities and performance at a different level of the organisation (e.g. the overall enterprise or, as in the case of the GFC, on the economy as a whole).
- **Prediction** — The ability of the team to adequately predict changes in the environment of the organisation at a future point in time. In other words, judging the right time to make a change and the likely impact of any change on different stakeholders over both the short and long term.

In essence these factors represent human failings. The limitations of human psychology, in the form of personal bias, hubris and the simple fact that one cannot be good at everything, requires a team to overcome these difficulties. The notion that good governance is a team activity arises because, through an effective team, we can to some extent overcome these limitations - or at least minimise their impact.

Viewed as a decision-making unit the board provides the reflective capacity, often difficult to maintain in an executive role, that supports higher-level sense-making about the organisation's environment and the quality of decision-making overall. Whilst the Chairs recognised the importance of their monitoring and compliance responsibilities, in terms of contribution to performance, these took a back seat to the broader sense-making role they perceived.

[Chair 34]:...a really important aspect is actually the right relationship between the board and the senior management. And that, at its simplest, has two aspects to it. The first is supervision, under the old teacher/pupil type of...role. That's probably 20% of it or probably only 5% of it, actually. And...because the buck stops with the board there has to be that supervision aspect to it. But then there's the other 80% or 90% or 95%, which is actually...you know it's the mentoring; it's the guiding.

The quality of the team is a 'soft factor' for which there are no readily available measures, at least within the existing governance literature. Consequently, this variable never appears in the economic and econometric analysis of the relationship between governance and performance. For the Chairs, however, the quality of the team always emerged as 'an', if not 'the most', important factor supporting good governance and fundamental to the quality of decision-making.

Defining the team

Building and maintaining the right type of team is difficult, with many Chairs indicating a ‘sweet spot’ where the many variables involved came together...

A team is not just any group of people who are thrown together. The Chairs were very clear about the qualities that were required; and that these qualities must be held in combination in order to be effective. The key qualities that emerged were:

- A diversity of skill and experience
- An independent mindset and willingness to question and challenge respectfully
- Openness to alternatives
- Trust

Whilst many of these factors are discussed in relation to corporate governance, they tend to be treated in a piecemeal fashion rather than as a cohesive whole. Most commonly they are reduced to structural proxies that, while easy to measure, in the view of the Chairs are too

loosely related to ‘good’ governance. For the Chairs, these features of the ‘team’ were critical to their capacity to make sense of complexity and recognise the challenges - and the opportunities - associated with uncertainty. In this regard it is more accurate to view ‘good’ governance as a collective, cognitive process that is dependent on the effective functioning of the team.

Building and maintaining the right type of team is difficult, with many Chairs indicating a ‘sweet spot’ where the many variables involved came together to produce an effective decision-making unit. They also recognised that this was difficult to maintain over time and - whilst the need for skilled, experienced directors and increased diversity on boards is well documented - it was no guarantee of ‘good’ governance. It involves more than just different skills and diversity of perspective. It involves the creation of trust between members of the board and the executive. The power of bringing alternative perspectives to deal with problems and capturing opportunities in an authentic and respectful way will not occur in an environment of distrust. Independence of mindset (as opposed to the structural factors regularly discussed) was key - but again, often seen as inaccessible without trust.

These concepts - and the relationships between them - present some significant measurement issues if we are to get closer to understanding the relationship between ‘good’ governance and performance. They are measurement issues that cannot be ignored if we are to explore this question in a way that reflects the lived experience of directors and, therefore, that has relevance to practice.

Summary

In truth, this report has only scratched the surface of what good governance involves and how it is achieved. Perhaps of more significance to current debates on corporate governance is that this study presents the views of those involved, directors, rather than proxy measures of what might count. As a consequence, the findings are concerned with what directors actually think about governance and the concerns they deal with, not with assumptions.

A greater challenge exists when we turn our attention to what constitutes performance. Put simply, whose view of performance are we concerned with? The overwhelming focus on the shareholder that pervades the literature does not reflect the views presented by the Chairs in our sample. The nature and needs of the shareholder change considerably between sectors and the relationship the shareholder has with the organisation. Performance, seen through the eyes of a diffuse, often disengaged, shareholder base (like that of many publically listed companies) is vastly different to the single, highly engaged shareholder to whom public sector organisations respond. Furthermore, are we talking about 'outputs' or 'outcomes'?

For the public and not-for-profit sectors, traditional financial measures of performance are important for operational reasons, but are often irrelevant to their reason for being. There is limited value in a sound balance sheet if the stakeholders the organisation is supposed to help are left starving in the street.

The Chairs were overwhelmingly concerned with the views of a wide range of stakeholders in their considerations of governance. Not because they had a direct impact on financial measures of performance, but because they impacted the broader resilience of the organisation and the ongoing achievement of strategic objectives. Understanding the complex relationship between shareholding; the perception of outcomes; the definition of strategic objectives; and engagement between the shareholder and the organisation is an area that requires considerably more research and contemplation if we are to identify a more comprehensive notion of performance. It also suggests measures that are highly sensitive to the context. Does this mean it will not be possible to compare organisations? Obviously financial performance can be,

The past focus on structural aspects of governance has not helped us reduce the occurrence of corporate errors, omissions and malfeasance and, given the findings of this research, is unlikely ever to do so.

and needs to be, comparable so that organisations can be valued. Comparing ‘outcomes’ may be a different story. However, even here, the possibility for metrics that link strategic objectives, outcomes and probabilities are likely possible – if difficult. In both cases, however, the relationship between performance and governance remains oblique.

This leaves the not inconsiderable matter of causation. Identifying a relationship between these factors is one thing; understanding the complex sets of causation that influence them is another. The literature is itself undecided about how this should be approached. The problem of endogenous causation is central to these debates and, based on our data, is arguably a very real consideration. The contribution of this report is to identify some of the factors that need to be measured and built into a model of causation. To date, these factors have received relatively little attention within the governance literature, or been characterised through crude proxy measures. Taking these factors seriously poses some very significant challenges to what might constitute effective regulation. Regulatory regimes have also tended to focus on structural aspects of governance and compliance with more tangible (and therefore more readily measured) outputs. Governance is a quintessentially human activity and subject to all the imperfections and frailties that engenders. ‘Good’ governance provides a pathway to dealing with these limitations. The past focus on structural aspects of governance has not helped us reduce the occurrence of corporate errors, omissions and malfeasance and, given the findings of this research, is unlikely ever to do so. If we accept the Chairs’ views - that factors like trust; diversity of worldview; and independence of mindset are critical to ‘good’ governance then, based on the old adage that what gets measured is what gets done, we need to get serious about measuring these factors and building them into the way our organisations are governed.

The Australian Institute of Company Directors is the nation's leading organisation for directors, dedicated to making a positive impact on society and the economy by promoting professional director education and excellence in corporate governance. We have a significant and diverse membership of more than 35,000 from across a wide range of industries, commerce, government, the professions, private and not-for-profit sectors.

Disclaimer

© Copyright in this material is owned by AICD unless otherwise noted. All rights are strictly reserved under Australian copyright law and comparable law of other countries. You may not reproduce any part of the material without AICD's prior written consent.

The Material has been prepared for information purposes only and is not intended to embody any professional or legal standard. The Material does not constitute legal, accounting or other professional advice. While all reasonable care has been taken in its preparation, neither the Australian Institute of Company Directors nor any contributor makes any express or implied representations or warranties as to the completeness, currency, reliability or accuracy of the Material. The views and opinions expressed in the material are not necessarily the views or opinions of AICD, or its members, directors or employees.

The Material should not be used or relied upon as a substitute for professional advice or as a basis for formulating business decisions. To the extent permitted by law, both the Australian Institute of Company Directors and all contributors exclude all liability for any loss or damage arising out of the Material.

© 2015 Australian Institute of Company Directors. All rights reserved.

For further information

t: 1300 739 119

e: research@aicd.com.au

w: companydirectors.com.au
