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Geoff Nunn & Associates
Governance and Board Specialists

Governance Under the Spotlight: Corporate Credibility in Question

Shareholder Primacy—Is it an Issue?

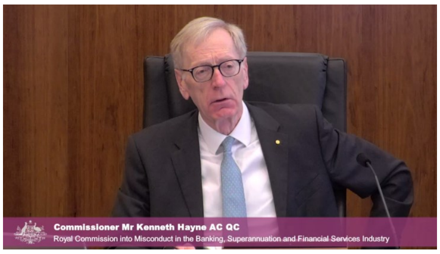
Sometimes the look on Commissioner Hayne's face says it all. As yet another failure of corporate social responsibility is revealed by Banking Royal Commission the community is shocked at the length to which some of our corporations will go in the pursuit of profits. Even when it involves decisions which, by any moderate ethical standard, most of us would find highly questionable.

Sections 180-184 *Corporations Act 2001 (Cth)* enshrine in legislation that directors should act in the interests of the corporation (meaning shareholders). In an interesting report by the Governance Institute in 2014, Shareholder primacy: Is there a need for change, Judith Cox presented an agruement for a broader perspective on the purpose of the corporation:

"Concern has been expressed over decades with the shareholder primacy view. The argument against it stems from Professor Dodd's thesis that the proper purpose of the corporation (and the proper goal of corporate managers) is not confined to making money for shareholders, but also includes more secure jobs for employees, better quality products for consumers, and greater contributions to the welfare of the community as a whole." Page 11

This view would seem run counter to what we generally experience with some of our listed and private corporations in Australia where the balance favours financial returns.

As mentioned in our last issue share ownership carries risk and a fair return is a reasonable expectation. Most boards and executive teams work very hard to achieve this. However all to often it's our government owned corporations and statutory bodies which lead when it comes to articulating core purpose.



Corporations play a vital role in our society by providing the everyday goods and services we all need to function effectively and participate in the modern, global world. Boards of all persuasions need to set the tone and ensure the organisations they govern act in accordance with community expectations.

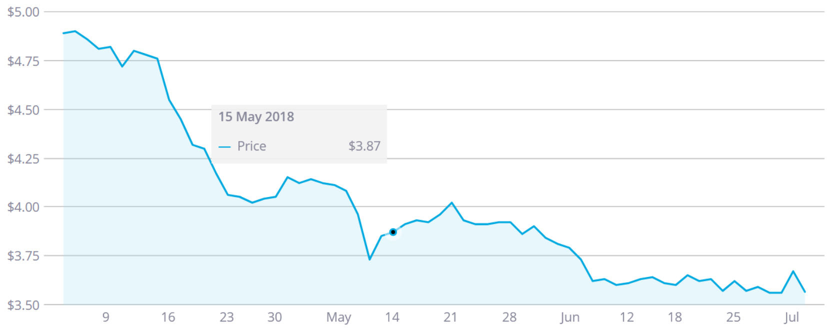
What are the Key Concerns for Boards and Directors in 2018-2019?

Reputation Risk

Issues emerging from the Banking Industry Royal Commission highlight the very real risks to an organisation's reputation if its conduct dips below good governance standards and community expectations.

Reputation is a fragile asset. Some commentators assert that up to 25% of a company's market value is tied up in its reputation.

In today's world of social media, incidents that might previously have gone unnoticed very quickly spread throughout the world. Just think of the damage a rogue trader or shonky financial planner can do to a financial institution's reputation. Consider the AMP's share price graph in the light of recent revelations about fee for no-service, interference with independent legal advice and misleading the regulator:



All organisations need to understand the reputational risk they confront. It's a key item for inclusion in the risk register and a question for regular review by the Audit and Risk Committee.

Source AMP Website 5.7.2018

What are the Key Issues for Boards and Directors in 2018-2019 (continued)?

Board Renewal is Not Just About Finding New Directors!

If any of us stay in the one job for too long we can become stale. This holds true for directors as well as employees. We all need fresh challenges to revitalise the spirit. Learn and development is a priority for directors. Sometimes a board needs to find the time to review its own dynamics, decision making capabilities and approach to conflict resolution.

Like all human groups behaviour in the boardroom is shaped by a range of conscious and unconscious process. What gets said at board meetings is only the tip of the iceberg. There's a lot more going on beneath the surface.

Sometime we need to be brave and peel back the cover to see what's really going on. And bring it into the room. This is confronting. Boardroom dynamics can be positive and enhance functioning. But they can also be negative. The elephant in the room might be hindering open and authentic discussion.

When New Directors Are Required

This is can be a tricky issue for boards. Where the board is appointed by an external body, as in the case of state owned corporations, the task is relatively straight forward. The relevant minister and advisors make a judgement call as to when it's the right time for a new board (in full or in part). In 2015 the Victorian Andrews Labor Government spilled the boards of its 17 state owned water authorities. 170 director positions were declared vacant and a large scale recruitment initiative was undertaken. Cynics argued that this was politically motivated move and the previous Liberal Government had stacked these boards with its cronies. No doubt this has an element of truth but the objective of board renewal was achieved with new gender diversity targets.

When it comes to listed corporations the process is somewhat different. Directors are appointed by the shareholders and must be confirmed by shareholders at the AGM. In practice candidates are usually nominated by the Board or its Nomination Committee. Shareholders have a very limited choice.

But the underlying issue of when a board knows that it's time for complete or partial change of its make-up is complex. Keeping the board skills matrix up to date is a good starting point. When the skills mix starts to show significant gaps it might be time to start thinking about selective replacement and skills enhancement.

Sometimes the need for complete or partial replacement is brought about by changes in the organisation's operating environment. For instance digital disruption and the redundancy of an organisation's traditional operating model may necessitate bringing on new directors with different skill sets to chart the future.

Director Independence and Groupthink

When we think about director independence we usually mean that the individual director should, at all times, act in the best interests of the corporation, its shareholders, members and other stakeholders. This is no doubt correct and the *Corporations Act 2001* makes this clear.

But there is another element. When a board has been working together for sometime directors develop a shared understanding of the reality they find themselves in. It is a construct. And a pervasive one that develops over time much like socialisation into an organisation.

Groupthink occurs in the boardroom when directors make unsound decisions for the sake of harmony and coherence. When individual directors refrain from speaking out, raising concerns and ignore the ethical or moral consequences of any board decision then problems inevitably occur.

In some cases, directors may engage in groupthink if they believe their objections might jeopardize the harmony of the board or feel that their views might cause other directors to reject them.

This is major issue and stifles authentic debate and informed decision making.

Corporate Credibility Under Siege!

By any measure public trust in our corporations and government organisations is at an all time low. The Edelman Trust Barometer 2018 shows Australia now ranks below many of its peers—most of which are not looking to good either. See back page. Currently only a relatively low percentage of the general population have confidence in our businesses, government, the media and NGOs.

There is a growing sense across the community. Many believe our institutions are failing us. They are not living up to expectations when it comes to ethics, honesty and integrity. The Banking Industry Royal Commission has confirmed what many of us already knew: the pursuit of shareholder returns is being prioritised above the interests of other stakeholder groups, particularly customers.

In an informative report by the AICD and KPMG Maintaining the Social Licence to Operate 2018 Richard Boele is quoted:

"Vulnerable stakeholders are the ones we have difficultly hearing because their voices are filtered out by layers of management that are using a business only lens to prioritise their biggest risks"

What are the Key Issues for Boards and Directors in 2018-2019 (continued)?

Corporate Credibility Under Siege (Continued)

The AICD Report identified the three key stakeholder group in which the organisation needed to maintain trust:

- Customers or clients;
- Employees
- The local or regional community

Unfortunately some of the Banks and other financial institutions are not looking too good in respect to these stakeholders.

Although there appears to be one stand-out. The Bendigo and Adelaide provides the infrastructure for the establishment of "Community Banks" across the country. These banks return part of their profits to the community in which they operate. Although recent revelations at the Banking Industry Royal Commission have even called this community icon into question.

How Have we Lost Trust In our Institutions?

It's difficult to say exactly when we began to lose trust in our institutions in Australia. It's happened progressively over the last 20 years. Some of the contributing factors might be:

1. Various inquiries into institutional conduct over the past few years have found that a number breached the trust of those that they were meant to serve. Some of these failures have shocked the community. This includes failures by the banks, corporates, churches, government institutions and even NGOs. These breaches have called into question some organizations' social license to operate.

2. The pursuit of profit and shareholder returns has become the dominant mantra for our listed and private corporations. It's a competitive landscape and shareholders are demanding. Particularly institutional shareholders. But profit by pushing products that the customer doesn't want, don't fit well or can't afford is unethical at best. Charging for services not delivered is downright dishonest.

3. The GFC left a bad taste for many. It was seen to be driven by corporate greed. Many individuals lost large sums of money, including for some, their retirement savings. Sub-prime lending practices in the US were predatory. The commodification of low quality mortgages, to be sold as parcels of debt, was seen by many analysts as the creation of just another high risk financial product. With the exception of Lehman Brothers the companies and individuals largely responsible were bailed out by various governments and continued to enjoy considerable power, wealth and influence.

4. The outsourcing and off-shoring of call centres and customer service in a number of our industries does not sit well with many people. Not only have we lost lower skilled jobs in Australia but many feel that the quality of service they receive is substandard. We've all been stuck in phone queues for long periods, been confronted by progressive multiple choice phone menus only to find that our enquiry doesn't quite fit the categories available.

5. CEOs are often the public face of our corporations. Some come across as self-serving, arrogant and egotistical. A healthy ego is a pre-requisite for a CEO. But recent cases where arrogance has spilled over into psychopathological behaviour is of great concern.

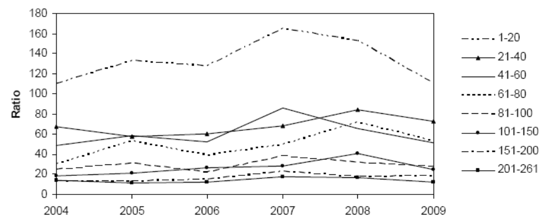
   "A psychopathic diagnosis requires a lot of boxes to be ticked, such as ruthlessness, narcissism, persuasiveness, the inability to feel guilt, or the inability to see things from another person's perspective."

   Lindsay Dodgson, Business Insider, July, 2017

   Some of these characteristics sound disturbingly familiar.

6. Remuneration differentials have grown. Over the past 25 years the gap between pay for the lowest paid employee and the CEO has grown progressively to the point where the CEO remuneration in some of our larger listed companies sits well over 100 times average weekly earnings. The following graph from 2009 illustrates:

Figure 3.5 Ratio of CEO remuneration to AWE varies by company size, 2003-04 to 2008-09[a, b]



Executive Remuneration in Australia. Productivity Commission 2009

The level of growth appears to have tapered off since the GFC. But many argue it remains to great. Remuneration advisors and directors will assert that this phenomena is market driven as competitive pressures force boards to seek out the best executive talent, locally and internationally, which comes at a price. This is no doubt true in some cases but represents only part of the story. Pitching high in the market creates inflationary pressures and benchmarking against like companies can have a ratchet effect.

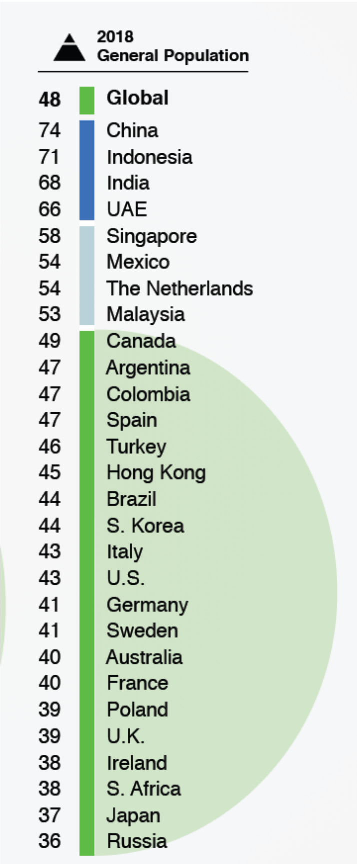
7. Board visibility is an issue. In many of our corporations the board is perceived as a shadowy group who meet monthly to discuss strategic issues.

   "Not much is known of what boards do from month to month, and in most organisations you would be hard pressed if you asked a staff member who was on the board to get a response beyond one or maybe two people (and usually only the name of the Chair)."

The Faceless Board—Reconnecting to Your NFP Community. Better Boards David Bartlett August 2012

Commentary on Trust (Continued)

Considering the above, combined with the very intense media scrutiny to which every institutional activity is subject, is it any wonder that confidence in institutions is low? The Edelman Barometer puts Australia in the lower third of the countries surveyed. See figure below.



Edelman Trust Barometer 2018

"Trust is clearly a top board priority. Let's not sugar-coat it: Australian business is still not performing well on trust. There's been some improvement in trust in our CEO and board directors, but I would not read too much into that. As leaders, we're still ranked poorly on trust by the community and Australia is going backwards on trust, overall, according to Edelman."

How Boards Can Help Australia Recover From Its Trust Crisis
Dr Nora Scheinkestel AICD Feb. 2018

CEOs play a critical role in ensuring that the public have trust in our organisations. They are usually the public face. We need our CEOs to lead with vision, wisdom, equanimity and above all, to articulate their organisation's core purpose with respect to the communities in which it operates. The days when our CEOs reflect the warrior archetype are coming to an end. We need them, along with their boards, to be present in our communities in a positive way.

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, the Prudential Inquiry into the Commonwealth Bank of Australia (CBA) prepared for APRA, the ACCC Report of Retail Electricity Prices and various other reports and enquiries have all raised serious issues of corporate governance. In particular issues around that centre around Core Purpose, Credibility, Reputation, Visibility, Board Renewal and Structure.

The findings in these reports, whilst very confronting, also provide boards with a unique opportunity to examine their own processes and dynamics.

Our service offering aims to counter these risks through working at the board level with these pivotal concerns.

About Geoff Nunn and Associates:
Geoff Nunn & Associates was established in 1993 as an independent provider of remuneration and organisation consulting services to the government and corporate sectors. We now specialise in working with Boards and CEOs in the areas of corporate governance, board dynamics and renewal, governance structures, board and executive remuneration strategy. Projects have been completed in over 1000 organisations across Australia, New Zealand and Singapore.

Our Services

- Board Governance Advice;
- Board & Committee Charter Drafting;
- Business Advisory Services;
- Board and Executive Remuneration Strategy Advice;
- Remuneration Governance Advice.

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