



Address given by

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**“CORPORATE GOVERNANCE AND ITS APPLICATION, IN PARTICULAR THE DIFFERENCE
BETWEEN MANAGEMENT AND GOVERNANCE”**

Thank you for the opportunity to speak to you. I am honoured to be here in such distinguished company.

Thank you for your kind introduction. As a director of Genesis Energy I attended one of the Parliamentary Study Programmes run by the Trust last year and not only had a great day with some excellent and interesting speakers but I also learnt a huge amount about how government is exercised through Parliament.

For those of you who are not sure what the Institute of Directors does, let me briefly tell you that its mission is to *“enable and encourage New Zealand boards and board members to add value to their organisations and adopt the highest standards of corporate governance.”* It does this through, amongst other things, professional development programmes, networking functions, publishing guidelines for best practice and a Code of Practice and a director accreditation scheme. Our aim is to be recognised nationally and internationally as a pre-eminent professional body for boards and board members.

I am going to talk this evening about corporate governance and, in particular, the roles of management and the board of directors and what makes an effective board. I have drawn on my experience in business both as a CEO reporting to a board and as a director, as well as discussions with other directors and senior managers.

Never before has corporate governance received as much attention as it now does. Recent corporate

scandals and questionable business ethics have forced companies and their leadership under the microscope. To deal with the problems - legislation, codes of conduct and guidelines for corporate governance practices have proliferated.

Directors are under pressure. In the early 20th century, Lord Boothby described his board meetings as resembling a series of pleasant hot baths followed by food and money. The water temperature has risen a lot since then!

Most of the prescriptions for improving corporate governance (including the infamous Sarbanes-Oxley Act) have focused on the structure of boards including their size, composition, independence of directors and so on. But what is the role of the board and is there a relationship between board structure and corporate performance? I will consider the answers to these questions.

I will start by looking at the definition of corporate governance and what better place to look for a definition than the web encyclopaedia!

The definition I found is:

“Corporate governance is the set of processes, customs, policies, laws and institutions affecting the way a corporation is directed, administered or controlled.”

It includes the relationships among the many players or stakeholders involved. Of course there are numerous players and stakeholders in any business but in the context of governance there are

three key ones which are:

- shareholders
- management
- the board of directors.

In an organisation with multiple shareholders (for example a listed company) the concept of the separation of ownership and control is important in understanding how corporate governance works.

Shareholders invest but usually they do not want to run the company – they provide the capital and the risk appetite but they want people with specialised knowledge to manage the business – so they appoint an agent - the board of directors - to oversee their investment on their behalf. The board in effect acts as an agent for all shareholders and stakeholders.

The board of directors is the interface between the shareholders and the company and the board is accountable to the shareholders who appoint the directors. But in law the directors must act in what they consider to be the best interests of the company. This is not necessarily the same thing as acting in the best interests of shareholders. This is a critical point which I find is often not that well understood and once it is understood then other aspects of corporate governance and how the board works fall into place.

There are many well documented cases of pressure being exerted on boards of directors to act in the interests of one or other of the shareholders, particularly if they are a majority shareholder. One example is Carter Holt

Harvey where the independent directors refused to resign when asked to by Graham Hart but stayed in order to look after the interests of minority shareholders until the takeover was complete. Of course in this case the majority shareholder could have simply called a meeting of the shareholders and voted the directors off the board. Mr Hart chose not to do that and thus respected the role of the independent directors to act in the best interests of the company and represent all shareholders not just the majority.

The exception of course is where a shareholder owns 100% of a company and then it can obviously instruct the board to carry out its wishes. The directors may choose to resign if they are put in a position of doing what a 100% or majority shareholder wants if they do not believe it is also in the interests of the company. Equally the shareholder may decide that a board is not necessary and run the company directly with one executive director.

It is interesting here to also consider Crown Entities and SOEs. The Crown is a 100% shareholder of these companies and shareholding ministers, as representative of the Crown, could, if they so wished, instruct their wholly owned entities on particular subjects or issues. Of course, I do not need to tell you that ministers are very careful as to how they use this power and if they do exert it they should expect to get significant push back from boards!

However the situation with Air New Zealand is a little different as the Crown has a significant but not a 100% shareholding. In this situation the board cannot in law take instruction from a minister to act, unless, in the board's view, it is also in the best interests of the company.

It is worth noting that the concept of shareholders ceding control to the board works both ways. As a shareholder of a widely held company you are forced to let the board of directors oversee your

investment. You can appoint or remove directors if you have sufficient support from other shareholders, but if this proves impossible and you do not like what the board is doing you have no choice but to sell your shares, or simply continue as a passive investor.

The board governs and directs the company and has ultimate control, but it does not manage the organisation on a day to day basis. Management provides the necessary specialised skills to run the company.

The role of the board is to oversee and to set the direction for the company (taking into account the views of an often diverse shareholding but, as previously stated, always acting in the best interests of the company). Management's role is to implement the strategic direction set by the board. Then the board must monitor performance and report back to shareholders.

As the board is an agent of shareholders, so management is an employee of the board. To a large degree, they exist at the board's leisure. However, the board will not exercise its ability to dismiss management or the CEO lightly. The implications could be substantial - for example a lack of confidence in the company and, if it is listed, a resulting drop in share value, and of course, employment legislation must be adhered to.

A board could manage the company directly if it was so inclined, and boards do tend to manage directly on some occasions, for example in instances of corporate failure, but it is very unusual.

So to summarise:

- the board oversees and directs, management manages day to day and implements
- the board is accountable to the shareholders, management is accountable to the board.

Having set out the different roles of

board and management I will briefly outline some of the fundamental functions of the board. Then I will talk about the link between board structure and corporate performance.

There are many ways to explain the functions of a board and many models have been used. I have chosen to use *“The Four Pillars of Effective Corporate Governance”* originally formulated in the Institute's best practice statement entitled *“The Role of the Board in Adding Value”*.

These pillars are:

- Determination of Purpose
- Holding to Account
- Governance Culture
- Compliance

First, Determination of Purpose

The board must have ultimate accountability and 'ownership' of the company purpose and strategy.

Management will provide analysis, operational and business knowledge, research and thinking. Probably they will make recommendations to the board but it is the board that must approve the company purpose, philosophy and strategy.

Secondly, Accountability:

An effective board must ensure that it holds management to account. Few companies fail overnight. More frequently failure is the result of ongoing under performance that accumulates over time. An example here is the recent spate of finance company collapses – you have to wonder if the boards of these companies really challenged management and understood the risks their companies were taking.

As an aside it is interesting to note the media commentary on the role of the trustees for these companies, regulation and rating agencies – little if anything is being written about the boards.

Effective boards will make sure management has an implementation plan for the strategy and that the plan is realistic. Then they will ensure that progress against the plan is measured and monitored regularly.

The relationship between the board, particularly the chairman and the CEO is critical, as he or she is the primary portal into the organisation. The CEO is also the primary mechanism for influencing the organisation, and is generally the chief educator of the board on company matters.

The board needs to be able to challenge the CEO but directors must also work as a team with management. The CEO must see the board as there to help, not just criticise, or else, for example, he or she may be slow to tell of bad news.

Thirdly, Governance Culture

Culture is critical in the performance of the board and the organisation as a whole. Trust is important around the board table but obviously it needs to be earned. Challenge is also important. Discussion and debate need to be robust. Above all there can be no compromise on ethics and integrity. This sounds like a simple aspiration but it should be shared by both the board and management.

Boards should assess their own performance regularly and should consider issues such as the balance of skills around the table, succession planning, professional development and, crucially, whether they add value to the company.

Director evaluation can take the form of a facilitated discussion with an independent third party with all the board present. Alternatively a one on one discussion can take place between the chairman and each director, perhaps following a questionnaire completed by both parties. The Institute of Directors offers a simple online evaluation tool that many companies

use as it enables “all of board” or one-on-one evaluation with minimal administrative hassle. I recommend it to you.

I am pleased to say that director evaluation is becoming much more commonplace and most boards undertake regular assessments. Although it may seem a somewhat self-serving process, we find that self-evaluation by directors is highly effective. In reality, good boards have very low tolerance for underperformance amongst their members.

A board that shows no interest in a process of evaluation may well be confirming the first signs of ineffectiveness. Although boards will never face the level of public scrutiny that politicians do, the days of directors and boards not being accountable for their performance are rapidly coming to an end.

Finally, Compliance

Boards of directors need to ensure that a company’s financial position is adequate and that other financial matters including audit, both internal and external are properly and effectively undertaken. As part of this process the board must also ensure that risk is managed and that a formal process is put in place for assessing, managing and reporting on risk.

Directors must also be aware of other compliance issues such as regulations, delegated authorities, confidentiality, safety guidelines and many others. Some of these are common to all organisations and others will depend on the operating environment of the company.

Effective processes and regular reporting is important as it gives boards a regular opportunity to review compliance matters and gain assurance that compliance is effective whilst not dominating proceedings. Board sub-committees such as audit and risk

committees can play an important part here and allow greater scrutiny whilst not detracting from the board’s agenda.

Board Structure and Corporate Performance

I mentioned earlier that most of the prescriptions for improving corporate governance (including the infamous Sarbanes-Oxley Act) have focused on the structure of boards – their size, composition, independence of directors and so on but academic research is not able to demonstrate a definitive relationship between the structural characteristics of a board and corporate performance.

A number of studies have attempted to define what it is that makes a board successful. I read an article a few months ago that said that companies that had a woman on their board were more successful. As much as I might like to believe this is true I have to say that I am sceptical about such claims!

A study carried out recently by Richard Leblanc and James Gillies and published in their book “*Inside the Boardroom*” takes a slightly different approach. They led some research which considered how boards make decisions and determined an instinctively sensible conclusion that decision making is greatly influenced by behavioural characteristics.

Many factors impact on organisational performance, governance is just one of them, but common sense would suggest that a positive relationship should exist between performance and decision making capability.

At the Institute of Directors we so strongly believe that it is behaviour around the board table that matters that we have recently changed our training courses to emphasise behaviour away from a more academic approach to teaching governance. We have introduced a board simulation exercise into our Company Directors’ Course

which gives participants an opportunity to feel what it is like to put theory into practice. It is interesting to note that in discussions with sister institutes around the world this is starting to be a trend. The Institute of Directors in the United Kingdom and the Institute of Corporate Directors in Canada in particular have - quite separately from us - made a significant shift in emphasis towards behavioural skills.

The study by Leblanc and Gillies led the authors to a classification of types of directors based on behaviour. They also identified that certain types were common to functional boards and other to dysfunctional boards.

The five functional or positive director behaviour types are:

- change agent
- consensus builder
- challenger
- counsellor
- conductor (for the chairman)

The five dysfunctional or negative director behavioural types are:

- controller
- conformist
- critic
- cheerleader
- caretaker (for the chairman)

Often, the dysfunctional types are mistaken for the functional. For example, the critic at the board table is a well-known type, sniping at management proposals and questioning their credibility. On the other hand, a director who is a challenger will act to strengthen the board's understanding through debate, then move on to a decision they can support.

Time does not allow me to explain all of these behavioural types in detail and their names provide some explanation, but it is worth noting that the functional

directors rank high on the “persuasiveness” scale and dysfunctional directors rank low on this scale.

However, functional boards are not just about persuasiveness. An effective board, like a cabinet in government, speaks as a single unit although it makes decisions collectively. Individuals will often have strong differences of opinion and it is important to have a mix of views and behavioural styles around the table in order to have a full discussion on issues to ensure effective decisions are reached.

For boards to be functional they must show some respect to structure. For example, they need a chair that facilitates debate, they need to adhere to time constraints and monitor conflicts of interest etc, but they must also have the required competencies to assist in the solution of specific problems and they must also be able to work together effectively as a team. But beyond these basic functions, what Le Blanc and Gillies suggest is that behaviour matters.

They conclude that board effectiveness depends on a combination of structure, membership and process and that director effectiveness depends on independence of mind, competence and behaviour. Boards must continually strive to achieve the right balance of competence and behaviour, through recruiting, retaining, educating and replacing directors to suit the changing needs of the company.

I would like to finish with a famous quote from “*The Way we Live Now*”, a satirical novel by Anthony Trollope written in the 1800s:

“At the regular meeting of the board, which never sat for above half an hour, two or three papers were read by Miles Grendall. Melmotte himself would speak a few slow words, intended to be cheery, and

always indicative of triumph, and then every body would agree to everything, somebody would sign something, and the board for that day would be over.”

No doubt followed by food and money!

Thank you for listening.

Dr Nicki Crauford



Dr Nicola Crauford has been the Chief Executive of the Institute of Directors for the last three years, the first woman to assume this position.

She is a senior executive with over 20 years' experience in both the UK and in New Zealand, including nine years with Transpower New Zealand. She has experience in the oil, gas, electricity and the banking sectors.

Nicki is a director Genesis Power Ltd, a director of the Centre for Advanced Engineering, a trust formed by the University of Canterbury, director and minority shareholder of iYomu Limited, a director of the Global Development Circle, and she is trustee and a member of the National Committee for UNICEF.

She holds a PhD in engineering, a bachelor of science in chemical engineering and in 2005 was made a fellow of the Institute of Professional Engineers for her contribution to leadership in the profession of engineering, specifically her contributions to the recognition of engineering in the business sector.