Enhancing Firm Sustainability Through Governance
The Relational Corporate Governance Approach

Explanatory Memorandum

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for

Enhancing Firm Sustainability Through Governance
The Relational Corporate Governance Approach

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CONTENTS

A.   SYNOPSIS OF BOOK

1.   Overview

The following overview is taken from the back cover of the Book:

Enhancing Firm Sustainability Through Governance presents a fresh perspective into corporate governance and how the relationship between governance mechanisms, processes and variables should be understood through ***a new unifying theory: the relational corporate governance approach.***

Francesco de Zwart examines significant areas of governance study and practice to illustrate how the most established governance mechanisms, processes and variables affect each other and the governance and management structures within a company. The relational corporate governance approach acts as a tool for analysing the governance health of individual companies and suggests the actions required to remedy sub-optimal governance and management arrangements. A wide selection of articles, empirical studies and literature have been translated into an original and understandable theory which complements and enhances the explanatory power of existing law and economics models of the firm.

This interdisciplinary book will interest scholars and researchers in the fields of corporate law, economics, accounting, management and, more specifically, governance and regulation. Policymakers and practitioners involved in corporate governance will benefit from the discerning insight into managerial design and adoption, decision-making, monitoring and reporting structures and other processes within the corporation.

2.   Scope and Aims of the Book

The **relational corporate governance approach** presented in this Book is a tool which complements and enhances the explanatory power of the existing principal 'law and economics' theories and models of the firm. It maps the effectiveness of corporate Governance Variables in use in corporate Governance Codes and laws around the world and assesses reform proposals in the field. The approach can be used by centres of corporate governance, academics, researchers, students, governments, securities and exchange regulators, policy-makers, law reformers and corporate actors as a diagnostic tool to analyse the governance health of individual companies and the governance actions required to remedy sub-optimal governance and management arrangements.

The **principal aim of the relational approach** is to describe and evaluate the *interrelationships* between the most significant fields of corporate governance study and practice and the Governance Variables to which these fields give rise. The relational approach can be used to make predictions in relation to the relative importance of Governance Variables *inter se* in reducing (or increasing) agency costs and enhancing (or reducing) the long-term efficiency and survival/sustainability of the for-profit firm. Classic agency cost theory posits that the bestowal of discretion on managers and directors will lead them as 'rational' self-wealth maximisers to engage in value-reducing behaviour - 'shirking' responsibilities (such as sitting on committees), 'empire building', over compensation and engaging in less transparent benefits in the form of perks. Thus 'Governance Variables' are used to counter these actions – these are the management and governance structures, mechanisms, processes and protocols in a corporation which seek to punish or deter management misconduct or which seek to align the interests of 'insiders' with 'outside' shareholders and are contained in Governance Codes such as those operated by the NYSE and ASX. Often, these Governance Variables are applied in a 'checklist' manner without understanding that these Variables have a 'field' or 'zone' of operation/effect that affects other Governance Variables and other management and governance structures within the company.

To remedy this, the **relational approach is a completely novel approach** to understanding the interrelationships between these Governance Variables. To do so, the Book introduces a new field of corporate governance analysis and a new unifying theory **– relational corporate governance.** The whole Book is a detailed identification, development and justification for the theoretical and operational components of the new approach.   Instead of mathematical formulae and statistical equations which alienate many academics, researchers, students, corporate actors and their advisors alike, the relational approach comprises detailed theory and explanation drawn from hundreds of articles, empirical studies and other works and a range of comparative tables and instructional diagrams. The approach culminates in two operational tables

displaying the predicted relative importance of 39 of the best-known Governance Variables in enhancing (or reducing) the long-term efficiency and sustainability of the corporation measured on a **new governance rating scale.**

The unique virtue of the relational approach is that it *translates* hundreds of theoretical and economic articles, empirical statistical studies, international/cross-border and national Governance Codes and corporate collapse literature into an approach that can be understood and used by academics, researchers, students, governments, securities and exchange regulators and corporate actors and their advisors who are not versed in those fields. The approach is thus intentionally interdisciplinary representing ground-breaking research in modelling complex corporate governance systems to the widest possible audience.

The relational approach examines four Key Fields which together comprise the artificial or simulated 'world' of corporate governance:

(1) the application of the principal theoretical models of the firm to the new relational approach;

(2) Enron and Hastie corporate collapse literature/case studies;

(3) international/cross-border and national Governance Codes and

(4) empirical studies of the effectiveness of Governance Variables in reducing (or increasing) agency costs and enhancing (or reducing) the survival/sustainability of the firm measured by firm cost of capital, firm operating performance, firm value/share price and likelihood of earnings manipulation.

Each of these Fields is examined extensively for academics, researchers and centres of corporate governance with a vast range of works examined. For academics, directors, CEOs, management, government, securities and exchange regulators and reform bodies, these works are then translated into the relational approach's components. These components translate the approach's 'world' into the internal workings of the company to demonstrate how the Governance Variables affect each other and other management and decision-making structures within the company. Thus, the Book introduces an approach which can be used to enhance the long-term efficiency and survival/sustainability of for-profit public companies and to evaluate reform proposals in the field.

3.   Important Features – New Material and Approaches

Based on the underlying interrelationships, themes and tensions in the approach's simulated world of corporate governance, the approach proposed for academics, researchers, students, governments, securities and exchange regulators, policy-makers, law reformers and corporate actors and their advisors is known as the **relational corporate governance approach**. It is based on identifying, describing and predicting the nature, behaviour and interrelationships between corporate Governance Variables. It is critical to the understanding of Governance Variables that they do not operate in isolation but have a significant 'zone of effect'. They affect the operation of other Governance Variables as well as other managerial and governance structures within the corporation.

The **overarching purpose** of the new approach is to increase understanding of the interactive balancing processes of insiders and outsiders of the for-profit corporation.   To do so, the approach evaluates and in turn predicts the behaviour of 39 individual Governance Variables for the purpose of making hypotheses in relation to their relative importance in affecting agency costs and the long-term efficiency and sustainability of the corporation.

To do so, the **key goals or aims** of relational corporate governance are to:

(1)   Introduce a ***new definition of relational corporate governance;***

(2)   ***Create a simulated corporate governance environment*** which represents the 'real world' sphere of corporate governance;

(3)   ***Identify, describe and map diagrammatically the interrelationships***, themes and factors underpinning this environment;

(4)   ***Create a comparative table or scheme system*** upon which to compare across sectors and over time the Governance Variables utilised in the ***major global, US, UK and Australian Governance Variable Codes*** and schemes; and

(5)   As an over-arching aim, to propose an approach or tool for academics, researchers, students, governments, securities and exchange regulators, policy-makers, law reformers and corporate actors and their advisors ***to predict and measure the relative importance of Governance Variables in reducing (or increasing) agency costs and enhancing (or reducing) the long-term efficiency and sustainability of the for-profit firm***.

The Book reviews these key elements of the relational approach and how they can be used in future to advance the understanding of corporate governance.

Each of the key questions is introduced in the following sections of this Explanatory Memorandum with the new features and components of the new approach. Many of the following descriptions are taken from the original manuscript itself:

3.1 To introduce a new definition of *relational* corporate governance

This is the **Three Relational Axes of Good Governance** examined in chapter 2. The Three Relational Axes are:

1. **Objectives Axis**

   On one axis, the freedom of a company's management to pursue (profit-maximising) objectives (value enhancement) at one end is balanced against the interests of the shareholders (owners) in monitoring management's performance (performance assessment and reporting) and seeing that a company's resources are not dissipated (value preservation).

2. **Behaviours Axis**

   On another axis, "entrepreneurism" and "innovation" (risk-taking) are balanced against risk management, "control" and "accountability" (responsibility).

3. **Positional Conflict Axis**

   Lastly, the interests of those 'within' the company such as the board, CEO and executives/management (internal stakeholders) are balanced against the interests of those 'outside' the company such as shareholders/investors, employees, lenders, suppliers, government legislators and regulators and social interests including the environment and the general public (external stakeholders).

These Three Relational Axes are the theoretical set of scales which weigh the objectives, behaviours and positional conflict of insiders such as the directors, CEO and management with traditional outsiders such as shareholders and other wider stakeholders. Reflecting the increasing influence of stakeholder theory - in the same way as Australia's ASX 2007-14 Revised Principles - the Three Relational Axes represent the competing claims on the governance framework of the national corporate governance or shareholder protection regime and, in turn, the governance systems of individual companies.

Governance Factors and Interrelationship Schemes

The recurring themes and tensions underpinning corporate governance discourse – comprising eight (8) **Governance Factors** described below – are weighed in this set of scales. Using empirical studies examined in chapters 7 – 10 as a springboard, the results of the weighing process are calculated and presented for the reader. These are the two **Interrelationship Scheme** diagrams reflecting first the shareholder primacy environment and, second, reflecting stakeholder theory. These Interrelationship Schemes depict the interrelationships between the eight Governance Factors drawn from the four **Key Fields** and, therefore, the 39 Governance Variables to which the Key Fields give rise. The Interrelationship Schemes act as maps to guide the decision-making processes of the board to enhance the firm's long-term efficiency and sustainability.

3.2   **To create a simulated corporate governance environment which represents the 'real world' sphere of corporate governance**

These are the four **Key Fields** introduced above and comprising the largest components of the new approach:

Key Field No. 1:   **Application of the Principal Theories of the Firm to the Relational Approach (chapter 4)**

The Book explains and demonstrates the application of the 'nexus of contracts', 'agency' (costs) theory, the 'shareholder' (primacy) model (and its associated shareholder wealth-maximisation principle), the 'stakeholder' model and the 'director primacy' model to the new approach. The **weighing mechanism** of the relational approach (which is comprised of the Three Relational Axes of Good Governance, the eight Governance Factors and the two Interrelationship Schemes) is shown to be a ***theoretical representation of nexus of contracts theory.***

Key Field No. 2:   **'Autopsies' of the Enron and Hastie Corporate Collapses (chapter 5)**

Comprised of literature and studies relating to the Enron corporate collapse, the new approach catalogues and analyses relevant Governance Variable failings surrounding that collapse as a pre-GFC phenomenon. The Enron

corporate collapse is demonstrated, by its comparison to the post-GFC collapse of the Hastie Group in Australia, to be still very relevant today in predicting areas of potentially fatal governance problems in real corporations. The new approach thus demonstrates that this collapse should continue to inform the construction, operation and development of Governance Codes across the world and, therefore, the new relational approach itself.

Key Field No. 3: **Comparative Corporate Governance Codes (chapter 6)**

These are the ***international (OECD, ICGN and CACG) and national (US, UK and Australian) corporate Governance Codes, statutes, schemes and directives of best practice.*** The new approach demonstrates the sphere of operation of the major national Governance Codes including the OECD Principles, NYSE Final Rules, the FRC UK Corporate Governance Code 2010-12 and the ASX 2007-14 Revised Principles. Using the process of recurrence or 'commonality' of Governance Variables, these Governance Codes give rise to a 'core' set of Governance Variables which are used for the identification and articulation of the new approach's Three Relational Axes of Good Governance and the eight Governance Factors.

Key Field No. 4: **Empirical Studies on the Effectiveness of Governance Variables (chapters 7 – 10)**

This, the largest Key Field, ***examines and translates empirical and statistical studies of the effectiveness of Governance Variables in reducing (increasing) agency costs and enhancing (reducing) the long-term efficiency and survival/sustainability of the for-profit corporation.*** These aims are measured by proxies for shareholder wealth including the firm cost of capital, firm value/share price, firm operating performance and the likelihood of earnings manipulation. This Field includes studies of the strength of the national shareholder protection regime which continue to show common-law-origin regimes as leading the others. Importantly, the new approach demonstrates that these empirical studies can be used as a springboard to determine the starting point(s) of the **relational effect paths** of the Governance Variables –

> *pathway diagrams depicting the number and identity of each Governance Factor affected by a Governance Variable and the direction of the effect* described below.

In this way, the relational approach creates a simulated corporate governance environment which represents the 'real world' sphere of corporate governance. This is represented by the four Key Fields and 39 Governance Variables to which the Fields give rise. The four Key Fields were selected on the basis of the number of works on the Social Science Research Network (SSRN) platform as a measure of impact. Thus, of immediate value for academics, researchers, students, governments, securities and exchange regulators, policy-makers, law-reformers and corporate actors and their advisors, the relational approach's simulated environment is very topical and current - in effect the 39 most-often considered Governance Variables in corporate governance discourse.

3.3   To identify, describe and map diagrammatically the interrelationships, themes and factors underpinning this environment

This is the **weighing mechanism** of the relational approach introduced above. This mechanism is comprised of three components - the Three Relational Axes of Good Governance, the eight Governance Factors and the two Interrelationship Scheme diagrams of the interrelationships between these Factors. These three components are combined to create a **relational effect path** for each Governance Variable – the pathway diagrams depicting the number and identity of each Governance Factor affected by a Governance Variable and the direction of the effect. The starting point(s) of each relational effect path is demonstrated by the new approach to be the empirical and statistical studies of the effectiveness of Governance Variables in Key Field No. 4 (chapters 7 – 10).

The relational approach demonstrates that the **Governance Factors** are the *eight most significant or principal recurring aims, themes and tensions* underlying or arising from the collective 'sphere' of corporate governance discourse:

Reporting Factor No. 1   Transparency, Timing and Integrity of Financial and Other Reports

Compliance Factor No. 2   Corporate Governance and Legal Compliance

Alignment Factor No. 3   Alignment of Management and Shareholder Interests

Compensation Factor No. 4	Board, CEO and Management Compensation and Incentives
Monitoring & Audit Factor No. 5	Internal and External/Audit Monitoring Quality
Stakeholders Factor No. 6	Identification, Participation and Protection of Stakeholder Interests
Decision-making Factor No. 7	Quality of Board, CEO and Management Decision-making
Responsibility Factor No. 8	Delineation and Disclosure of Powers, Duties and Lines of Responsibility

The weighing mechanism undertakes a theoretical or hypothetical 'weighing' exercise to depict – descriptively and diagrammatically – the themes and considerations relevant to the competing or opposing interests of 'insiders' and 'outsiders' of the corporation. In short, the eight Governance Factors are 'weighed' in the Three Relational Axes of Good Governance which act like a set of scales to weigh the often competing aims or objectives (Objectives Axis No. 1), behaviours (Behaviours Axis No. 2) and interests (Positional Conflict Axis No. 3) of 'insiders' and 'outsiders' of the corporation.

As noted above, the results of this weighing process are already calculated and presented for the reader – these are the two **Interrelationship Scheme diagrams** first for the shareholder primacy model and, second, for the stakeholder model. These Interrelationship Schemes are the two diagrams of hypothesised or predicted interrelationships between the eight Governance Factors. Thus, in turn, the Interrelationship Schemes represent the hypothesised or predicted interrelationships between the four Key Fields and the 39 Governance Variables to which the Fields give rise.

3.4 To create a comparative table or scheme system upon which to compare across sectors and over time the Governance Variables utilised in the major US, UK, Australian and global Governance Codes and schemes

These are the relational approach's **Governance Code Tables** and **Commonality Tables** presented in chapter 6.

Like the Three Relational Axes of Good Governance, the **Governance Code Tables** again reflect the influence of the OECD Principles. The new approach demonstrates that a comprehensive Governance Code Table can be constructed from elements of each of the global, US, UK and Australian sectors. The Tables compare the Governance Variables utilised in the major global and

Anglo-American Governance Codes in operation today - including the **OECD Principles**, the **NYSE Final Rules**, the FRC's **UK Corporate Governance Code 2010-12** and the **ASX 2007-14 Revised Principles**. Such a Table can be applied to determine the scope and nature of any Governance Code including, in the future, non-common-law origin countries.

On account of it's comprehensive listing of Governance Variables, the Governance Code Table will be a useful comparative tool for academics, researchers, students, governments, securities and exchange regulators, policy-makers, law reformers and corporate actors and their advisors in the area. In this respect, the new approach demonstrates that a Governance Code Table such as that presented in chapter 6 can be used to track the degree of harmonisation or convergence in Governance Codes including, again, those of non-common-law origin countries. In this way, refinements or additions to Governance Codes over time can be assessed.

Flowing from the convergence aspect of the Governance Code Tables are the **Commonality Tables**. The relational approach presents a Commonality Table to list the ***recurring Governance Variables within a sector and across sectors.*** Thus, the new approach has produced a Commonality Table for the global sector and several national sectors. Again to display the convergence aspect, the relational approach presents a Commonality Table to compare the US, UK and Australian listed corporate Governance Codes – those Codes currently in operation and backed with an enforcement or disclosure regime stemming from the listing rules of the relevant stock or securities exchanges. Again, refinements and additions to Governance Codes can be tracked and assessed.

The new approach concludes the examination of the commonality or convergence of Governance Codes by presenting a ***'core' set of Governance Variables from the global and national listed sectors combined.*** These are:

- Questions and voting in meetings;

- Interested or conflicted director disclosure;

- Employee/management/director incentive and participation schemes;

- Timely disclosure of material information including remuneration policies;

- Independent/external audit;

- Board functions and independence - compliance with statutory and legal duties on organisation/directors;

- Principal board responsibilities - corporate governance compliance;

- Principal board responsibilities - interested director or management conflicts or transactions;

- Independence from management - non-executive/independent directors; and

- Independence from management - responsibilities of board sub-committees delineated and disclosed.

The new approach demonstrates through commonality and convergence the significance of these Governance Variables in for-profit Governance Code discourse and for the relational approach itself in the identification, design and articulation of the Three Relational Axes of Good Governance and the Governance Factors.

3.5 **As an over-arching aim, to propose an approach or tool for academics, researchers, students, governments, securities and exchange regulators, policy-makers, law reformers and corporate actors to predict and measure the relative importance of Governance Variables in reducing (or increasing) agency costs and enhancing (or reducing) the long-term efficiency and sustainability of the for-profit firm.**

The Relational Approach and the Weighing Mechanism

This is the relational approach itself. Introduced above, it is defined as the examination and evaluation of the interrelationships between individual governance structures, mechanisms, processes and protocols (i.e., Governance Variables) that seek to minimise or avoid (or, contrastingly, increase) agency costs between economic actors 'inside' and 'outside' the for-profit corporation. The new approach explains that this gives rise to the theoretical weighing mechanism of the approach - the **Three Relational Axes of Good Governance, the eight Governance Factors and the two Interrelationship Scheme diagrams**. The Interrelationship Schemes identify the number of Governance Factors affected by a Governance Variable and the direction of effect. The Interrelationship Schemes are used in conjunction with the empirical studies in chapters 7 - 10 to construct a **relational effect path** for that Governance Variable. These empirical and statistical studies provide the starting point for the relational effect paths.

The **rationale** of relational corporate governance is that the interrelationships between Governance Variables and their effects (whether positive or negative) on such agency costs affect the long-term efficiency and survival/sustainability of the firm. If these interrelationships can be better understood, then the new approach hypothesises or predicts that the relative importance of Governance

Variables *inter se* in reducing (or increasing) these agency costs and enhancing (or reducing) shareholder welfare (measured by proxies for shareholder wealth such as firm cost of capital, firm value/share price, firm operating performance and the likelihood of earnings manipulation) can be determined or predicted with better confidence. ***The hypothesised or predicted effects on these agency cost and shareholder welfare measures, in turn, permit determinations and predictions to be made in relation to the long-term efficiency and survival/sustainability of the corporation.***

The Operational Tables

The **Coverage Table** is the first of two **operational tables** of the new approach presented in this Book. The relational effect path of each Governance Variable describes a predicted or hypothesised interrelationship directly or indirectly between each Governance Variable and one or more of the eight Governance Factors (the recurring themes and tensions underlying corporate governance). The description of, and results displayed for, each relational effect path are summarised in this Coverage Table. The summarised results are known as that Governance Variable's **Coverage.** This Coverage is the number of Governance Factors affected, and the direction of effect (positive or negative), by each Governance Variable. The maximum Coverage is +/- 8 units (the maximum number of Governance Factors). The results of the Coverage of a Governance Variable are set out in the Coverage Table.

The **Relational Proximity Table** is the ultimate operational table of the Book and represents the results of the new approach. The Coverage measure above is converted into the **relational proximity rating** of that Governance Variable in the Relational Proximity Table. This rating is a proportion expressed as a number on a scale from 0 to a maximum of +/- 100.00 units abbreviated as ***rprox.*** The Relational Proximity Table 'groups' Governance Variables in descending order of relative importance in reducing (or increasing) agency costs and enhancing (or reducing) the long-term efficiency and survival/sustainability of the firm. In short, the greater the number of Governance Factors affected by a Governance Variable in either direction, the greater is the relative importance (relational proximity rating) of that Variable in affecting agency costs and the survival/sustainability of the for-profit corporation.

4.   Contents of Book Chapters

Chapter 1   Introduction and challenges of corporate governance

Chapter 1 consists of an introduction to the challenges of corporate governance and the phenomenon of the separation of ownership from management of the modern dispersed-shareholding public company.   Flowing from this, the following questions are posed by Chapter 1:

- What behaviours of corporate actors such as the individual directors, the CEO and management were present in corporate collapses and what are the consequences of these behaviours for firm survival or (in today's parlance) sustainability?

- What is the regulatory corporate governance environment which applies to these companies and how do individual corporate governance measures, mechanisms and processes (called Governance Variables) operate in the real world to enhance or reduce the effects of these behaviours?   In other words, what are the effects of Governance Variables such as independent directors, disclosure regimes, internal controls, external audit and performance-based compensation for directors, CEO and executives such as equity and option pay?

- What are the 'core' or 'central' failures in Governance Variables that arise in corporate collapses?

- How do these Governance Variables interact with each other, i.e., what are the relationships between Governance Variables?

- And which corporate Governance Variables are relatively more important – again, in the real world – in determining the survival or sustainability of the publicly-traded for-profit corporation?

These key questions also stem from the phenomenon of the separation of ownership from management in the widely-dispersed shareholding public company.   A number of theories have sought to explain this phenomenon including the 'nexus of contracts', agency theory, the shareholder (primacy) model, the stakeholder model and the director primacy model. The approach in the Book adds explanatory power to these theories by providing a tool analysing how these theories - and the Governance Variables which flow from them - interact with corporate actors in the real world.

Chapter 2 Framework of the relational corporate governance approach

Chapter 2 constructs the principal components of the new approach and introduces the **39 Governance Variables**. It begins with an overview of the argued micro- and macro-economic benefits of 'good' corporate governance. Then follows detailed analysis and justification for the four components. The **Three Relational Axes of Good Governance** – the theoretical weighing mechanism - are presented in descriptive and diagram form. These act as a set of scales to weigh the objectives, behaviours and positional conflict of insiders versus outsiders. The eight **Governance Factors** are the 'backbone' of the relational approach. They represent the most significant and recurring themes or aims underpinning the four **Key Fields** and, therefore, the 39 Governance Variables drawn from those Fields. The third component - the two **Interrelationship Schemes** in Figures 2.6 and 2.7 – represents the hypothesized interrelationships between the eight Governance Factors. These Schemes are used later in the Book to construct the fourth component - a **relational effect path** for each Governance Variable. This path depicts the number and identity of Governance Factors affected by each Governance Variable and the direction of the effect. The chapter culminates with a diagram of the overall relational corporate governance approach in Figure 2.8.

Chapter 3 Governance variables in practice and operational tables

The hypothesized interrelationships between the Governance Variables and Governance Factors depicted in the relational effect paths are summarised early in the Book in Chapter 3. This is so that examples, analysis and interpretation of the results can be undertaken throughout the later chapters depicting the four Key Fields. The results are presented in two operational tables. The **Coverage Table (Table 3.1)** depicts the **'Coverage'** of a Governance Factor - a summary of the relational effect path for each of the 39 Governance Variables. This table displays the number and identity of each Governance Factor affected by a Governance Variable and the direction of the effect. The Coverage of the 39 Governance Variables is then summarised in the **Relational Proximity Table (Table 3.2)**. This Table arranges the 39 Governance Variables in order or groups of descending relative importance (known as **relational proximity**) in affecting agency costs and the long-term efficiency and sustainability of the firm.

Chapter 4
Key Field No. 1 - Application of principal theories of the firm to the relational approach

Chapters 4 – 10 cover a vast territory. They examine the four significant areas that simulate 'real-world' corporate governance discourse – the four **Key Fields**. Chapter 4 contains an analysis and application of the principal theories

and models of the firm explained in terms of the new approach. The chapter shows that the relational approach adds explanatory power, components and examples to the currently pre-eminent theories of the firm - the 'nexus of contracts', agency theory, the shareholder (primacy) model, the stakeholder model and the director primacy model. Agency costs theory and the shareholder (primacy) model, on one view predominating current firm theory, receive particular focus with the chapter explaining how these are represented in the components of the new approach.

Chapter 5
Key Field No. 2 – 'Autopsies' of the Enron and Hastie corporate collapses

In Chapter 5, the theory in the preceding chapter is translated into a real world case study of the behaviour of Governance Variables in one of the largest corporate collapses ever – the pre-GFC corporate collapse of Enron. Juxtaposed with this is the new approach's own analysis of the post-GFC collapse of the Hastie Group. This chapter seeks to show 3 things. First, to extract the themes and tensions of the Enron collapse to support the identification, structure and articulation of the eight Governance Factors. For comparison, the collapse of the Hastie Group is analysed. Second, to identify the intervening factors or problems which reduced the effectiveness of the Governance Variables examined in the Book. Finally, to show how these Governance Variables behaved in the multitude of governance failures of the Enron and Hastie corporate collapses. This chapter will be a precursor to showing the development of 'core' features in the Governance Codes and schemes in chapter 6. This chapter 5 was awarded the **Governance Institute of Australia Prize for Best Paper** at the Annual Corporate Law Teachers' Association Conference, 3-4 February, 2014, the leading Australian conference for corporate law academics.

Chapter 6

Key Field No. 3 – Comparative corporate governance codes

The Enron corporate collapse (and others) spawned a large number of corporate Governance Codes of 'best-practice'. Chapter 6 is thus a comparative analysis of these and subsequent international and national corporate Governance Codes. The aim of chapter 6 is two-fold. First, to produce **a 'model' or comparative scheme in table-form** which can be used as a benchmark or comparison for all Governance Codes. Second, to identify a smaller **'core' set of variables from international and national codes** for justifying the selection of the themes and tensions in the Three Relational Axes of Good Governance and the Governance Factors.

Chapters 7 -10
Key Field No. 4 – Empirical studies of the effectiveness of Governance Variables

Chapter 7   Part 1: National shareholder protection regime and board factors I

There follows the first of four parts on the Empirical Studies Key Field No. 4. In chapter 7, the Governance Variables are examined to determine their *effectiveness in reducing agency costs and increasing the long-term efficiency and sustainability of the firm*. This is the first chapter which presents a **relational effect path** for each Governance Variable - this path sets out the number and identity of Governance Factors affected by the relevant Governance Variable and the direction of the effect. The relational effect paths are critical for two reasons:

- First, they are an interpretation/translation of the empirical and statistical studies into the (more understandable) components of the new approach; and

- Second, for the explanatory power of the relational approach - *to determine the relative importance of a Governance Variable vis-à-vis other Governance Variables in reducing (increasing) agency costs and enhancing (reducing) the long-term efficiency and sustainability of the firm*. The greater the number of Governance Factors affected by a Governance Variable in either direction, the greater is that Variable's relative importance relative to other Variables.

Thus, **chapter 7** examines 'overall' governance (as a function of multiple Governance Variables), the strength of the national shareholder protection regime and 'Board Factors I' - director independence and the proportion of non-executive/independent directors.

Chapter 8   Part 2: Board factors II and other firm-specific variables

Then, for **chapter 8**, the Governance Variables examined are:

- 'Board Factors II' - board size and outside board positions of independent directors; and

- Other firm-specific variables - anti-takeover mechanisms such as staggered board elections, audit subcommittee presence, independence and expertise, 'block' and institutional shareholdings and division in the CEO/Chairperson roles.

Again, a relational effect path is presented for each Governance Variable and

firm efficiency and sustainability is measured by firm operating performance and firm value.

Chapter 9   Part 3: Board and audit committee factors and earnings manipulation

Part three of the Empirical Studies Key Field No. 4 is contained in **chapter 9**. In chapters 7 and 8, the relational approach's over-arching purpose to reduce agency costs and enhance firm long-term efficiency and sustainability was examined by proxies relating to firm operating performance/profit and firm value/share price.   In this chapter 9, the proxy for long-term efficiency and sustainability is earnings manipulation or management. Increases in earnings management represent increases in the agency costs of outside shareholders and therefore a fall in firm sustainability. The Governance Variables examined include many identified previously - but now assessed against the probability of earnings management/manipulation.

Chapter 10   Part 4: 'Good' corporate governance and director, CEO and management compensation

The purpose of **chapter 10** is to present the fourth and final part of the Empirical Studies Key Field No. 4. The corporate governance effects of director, CEO and management compensation are examined with respect to Governance Variables which include:

- compensation effects on the level/quality of monitoring and firm value and operating performance;
- the connection between firm size and director/CEO/executive compensation; and

- compensation effects on governance through reputational constraints.

The approach running through the chapter is to revisit the effects of compensation issues - including equity payments and options - on the independence, monitoring quality and risk management functions of the directors from the Enron and Hastie collapses. The chapter then identifies empirical and other statistical studies in the literature to support the Enron and Hastie analysis. From this review, the chapter constructs the relational effect paths for the compensation-related Governance Variables including director/CEO pay levels, equity/option holdings of directors and management and short-term options for directors and outside directors on the audit committee.

Chapter 11
Relational approach conclusions

The relational approach concludes in chapter 11 with observations and analysis relating to the interrelationships and relational proximity of the 39 Governance Variables. Links are drawn in relation to the themes and tensions underpinning the four Key Fields. Comparisons of the new approach's findings on the relational proximity rating of Governance Variables are made against the current state of research in those Fields. Chapter 11 concludes with observations on the structure, explanatory power and scope of the relational approach as well as areas for future research.

Appendices

The Book also includes the following as assistance to the reader for understanding the new relational approach:

Appendix 1: Glossary of governance variables

Appendix 2: Glossary of relational approach terms and components

Bibliography (by Key Field)

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