

## CPA Australia Podcast – Episode 23

### Contemporary perspectives on corporate governance

#### Transcript

Intro: Hello and welcome to the CPA Australia Podcast, your source for business, leadership and public practise accounting information.

John Purcell: Niamh Brennan is Michael MacCormac Professor of Management at the University College of Dublin. Professor Brennan qualified as a chartered accountant at KPMG, holds a PhD from the University of Warwick and is Chartered Director of the Institute of Directors, London. She is an inaugural honorary fellow of the Institute of Directors in Ireland. Niamh has published on financial reporting, corporate governance, forensic accounting and clinical governance, with 100 plus publications. One of her papers received the 2010 British Accounting Review Best Paper Award. And another, Accounting, Auditing, and Accountability Mary Parker Follett Best Paper Manuscript Award in 2011. In Survey of alumni, Niamh was voted one of UCD's top three lecturers for the 2000's onwards.

She has served as Head of Accounting and as Associate Dean of Research at UCD School of Business. Niamh has held visiting positions at the University of Sydney, the University of South Australia, the University of Canterbury at Christchurch, New Zealand, the University of Otago, New Zealand, Queensland University of Technology, the Rotman School of Management, University of Toronto, Swinburne University of Technology in Melbourne and at RMIT University, also here in Melbourne.

Having Established the UCD Centre for Corporate Governance in 2002, Niamh plays a lead role in public discourse in Ireland and internationally on corporate governance. And it is to discuss this rich field of endeavour that I welcome Niamh here today.

Niamh Brennan: Thank you, John.

John Purcell: Appropriately, if we could launch ourselves in to, as I said, this rich subject matter of Corporate Governance one of the things I'd like to first explore is ... Have a look at your observation that corporate governance varies depending upon company type. I was wondering if we could have a look at two dimensions, first between public listed companies, and private held family companies, and secondly also if we could have a look at the difference in governance between parent and subsidiary.

Niamh Brennan: Thank you John, for that question. A publicly listed company often, but not always, has a more dispersed shareholding, and that has a significant influence on governance. They also have higher accountability duties, public accountability duties. By comparison, a family company is much more closely

held, and there are the added complications of the families interest intertwined with business objectives. But some listed companies could be characterised as family businesses, you think for example the Rupert Murdoch empire comes to mind, it's a family business and it's a publicly listed company. In listed businesses, and also in family businesses, what makes a significant difference is the presence of a single, large, dominant shareholder, and that influences the distribution of power.

So, you could be on a board of directors, you could be a non-executive director, and you may not have the freedom and scope to run the company the way you like to, or the way you think the company should be run, because of the influence of a single large shareholder. When you come to a subsidiary, that influence becomes extreme, and acute, because a subsidiary has a single shareholder, and that is the parent company. And arguably the subsidiary has to do what the parent company tells them, and using the parent-child metaphor, the default assumption is that the parent will look after the child, but that default assumption cannot always be made-

John Purcell: How does this work with external parties dealing with the subsidiary? For example, creditors?

Niamh Brennan: There's that, the anecdote I was going to give you to illustrate how a parent can sometimes harm a subsidiary, not look after it, and that is Lehman Brothers. And so Lehman Brothers had a subsidiary in London, and as Lehman Brothers was approaching collapse it instigated the practice, and you have to do what your parent tells you, it instigated the practice of sweeping cash out of the London subsidiary back to the States. And one, awful day, the board of directors walks in and finds itself in charge of an insolvent company. So, the dominant position of a parent company, and a parent subsidiary relationship can be very tricky, it can be, and there is a much greater understanding of that following the banking crisis.

And so, you've got the white knuckle ride, if you're on a subsidiary, of owing your duty to the entity of which you are a director, which is the subsidiary, and at the same time having certain duties to do as the parent company tells you. And there are certain decisions that a parent, that a subsidiary would never take, so the parent company will be in charge, for example, of how to capitalise the group, and will be moving capital around subsidiary companies within a group. And if you're on a board of a subsidiary you have very little input into those head office type decisions. There's a good chance that the CEO of the subsidiary is paid by the CEO, or the remuneration is determined by his or her line manager, who is the CEO of the parent company.

So, that key lever that a board would have in a listed company, the key lever of remunerating the CEO, is not a key lever available to them because they're a subsidiary company. And so, from the CEO's point of view, again the CEO has potentially role conflict because, on the one hand, the CEO is reporting to his or her line manager, the CEO of the parent company, and on the other hand is

reporting to the board. So, which is more important for the CEO? So, it is a very complex situation in practice, and I would say to anybody listening to this podcast that if you're invited to be a director of a subsidiary company, be afraid.

John Purcell:

Would it now, if, could I have look then into the subject matter of director's duties? Now, in Australia we have had limited law reform reviews, and one of the things, which had been looked at a few years ago was rejection of an adoption of what's understood to be an enlightened shareholder value approach. In Australia, we're comfortable instead with a more traditional notion of the best interests of the company as a whole. How has the arguably more liberal UK approach showed both director and company behaviour, and has the approach worked its way into other aspects of corporate regulation?

Niamh Brennan:

Well as I've discovered, John, from my many trips to Australia I have a great admiration for the Australian approach to corporate governance, I think it is superior. And I think your regulators deciding not to go with the enlightened shareholder value approach is, I agree with that. I am not a fan of the enlightened shareholder value approach, and in fact in the little goldfish bowl that I come from, Ireland, we had a root and branch consolidation of all company law in Ireland into a single piece of legislation, the Company's Act 2014, and our people did not adopt the enlightened shareholder value approach either. They adopted the absolute traditional, going back hundreds of years in company, and in common law, the traditional perspective, which is that if you are a director you owe your duty to the company, and not to the shareholders.

John Purcell:

So you're a strong adherent to the division of corporate powers?

Niamh Brennan:

I'm a strong adherent to the idea that directors will do a better job if they conceptualise their duty as being to look after the firm. That, for example, gets them around the problem, if they think about the shareholders, well then what shareholders are they thinking about, yesterday's, today's, tomorrow's? So, instead of thinking about shareholders, thinking about the good of the firm, which ultimately will be good for shareholders. I think of, you know in the collapse of Enron, arguably the biggest corporate collapse in the whole world, it's a while ago now in 2001, but the directors were focused on the shareholders, and the share price, they should have been focused on keeping the company alive. And everybody would have been so much happier, if they had that higher level sense of their duty to the company.

Now, I'm sorry to tell you that this enlightened shareholder value approach comes from the academic world. It comes from a theory called agency theory, and agency theory does not feature the firm. Agency theory is about the owners, their shareholders, and managers, and the firm, this higher level notion of the firm as a collective doesn't feature. And agency theory drives this widespread belief that the job of, directors for example, is to maximise shareholder value, and there's a brilliant article in the May issue of the Harvard Business Review written by Bowers and Paine and they set out a brilliant counter-argument to the idea that the job of the directors is to maximise

shareholder value. And they say that it, that the shareholder value perspective is confused, as a matter of corporate law, it's a poor guide to managerial behaviour, and it has a huge accountability problem.

So, all my students from now on will have that one paper as required reading to sensitise them to a shareholder perspective being flawed. And the higher, look after the firm, perspective is the one that I would totally subscribe to, and which John, from your question, your Australian regulators have taken that route as well. And they are absolutely, to my mind they are doing absolutely an excellent job for corporations in Australia by taking that perspective.

John Purcell: Yeah, and I think also it's supported by a long tradition of judicial examination.

Niamh Brennan: Precisely.

John Purcell: Of corporate behaviour and the role of the directors that the duty is very much to the company, as a legal person.

Niamh Brennan: Yeah.

John Purcell: Now a lot of your research focuses on ethical and other forms of dilemmas confronting company directors and boards. What are the major sources of these conflicts in choice, and what role is played by the law of director's duties in both ameliorating or exacerbating these dilemmas?

Niamh Brennan: Well I think John what you're referring to is a little book that I wrote in 2016, sorry it was published in 2016 it took me three to four years to write it. The book is called **Shades of Grey: Directors' Dilemmas**. And what I was trying to do, and by the way that book, it's published by the Institute of Chartered Accountants of Scotland and it is available to download on the internet free. But, what I was trying to do is I was trying to help people understand that when you walk into a corporate boardroom it's not at all black and white, you are constantly faced with dilemmas. And so, I tried to design the dilemmas such that there's no right or wrong answer, and really so that when I use them in my classes, that I get an argument and a debate going with my students.

Which is exactly what happens in boardrooms, that nothing is obviously we should do X, we should do Y, it sometimes doesn't work out as clearly as that. And, to try and get people to understand how things can go wrong in a boardroom. And again, what my students, because they find it hard to know what it's like to be on a board, and nowadays in universities all students have to do group work, they have to produce assignments in a group of let's say, six students. And I said to my class, "Do your groups work well?" And invariably they say no, and I said, "Well this is, you can now begin to understand why boards of directors mightn't work so well either." Because they're just like student groups, they are a group of people trying to grapple with difficult issues.

In terms of where I got the dilemmas, I got them from three sources. Firstly my own experience as a non-executive director, so those dilemmas are obviously heavily disguised because I have a duty of confidentiality in relation to those assignments, so personal experience. My second source was sometimes from my students, and then the third source would be that I was sitting in the kitchen on a Sunday morning, reading the Sunday papers, reading something in the business press and I'd say, "That'd make a very good dilemma." So actually some of them you can identify, if you know enough particularly about the Irish business world.

But John, let me give you my favourite dilemma, and it's very short, and it's my favourite one. You are the chairman of the board of directors, and you discover that for the last two years, the management director and the finance director have been having an affair. What would you do?

John Purcell: Very topical here in Australia at the moment.

Niamh Brennan: Well I was just going to add, that when I ... Every class starts with news of the week, and in about March, one of my MBA students gave me the following news of the week article, Australia's Executives' Pay Packets Hit After Office Fling. Remuneration increasingly linked to ethics in governance, as well as financial results, X CEO had 550,000 Australian dollars cut from his bonus after he had an affair with his executive assistant. And interestingly about that article John is, it wasn't that he had the affair that caused him to have the cut in bonus, because you can't control for Cupid's arrow and all the rest, it was that he did not comply with the company's policy for what you do in such situations, so he breached company policy and he was fined by the board for doing so. So, that dilemma gets a great amount of laughter and debate going in my class.

John Purcell: And continues to unfold here today in Australia.

Niamh Brennan: Right, well, and everywhere else by the way. I wouldn't single out Australia for that kind of incident.

John Purcell: Now I'm going to delve down a little bit more into the nitty gritty of the law of director's duties. You've described two major planks of common-law sources of director's duties, fiduciary duties and the duty of care and skill. How would you assess the average director's appreciation for the nature of a fiduciary, and what as between fiduciary duties and the duty of care and skill is the more likely to be at the centre of dilemma in practising the art of a director?

Niamh Brennan: Well, let me just tease out the two common law duties first, and they are absolutely fundamental. So, fiduciary duty means that a company director who's in a very powerful position at the top of the company, the fiduciary duty means that the director has to look after the company's best interests ahead of their own personal interest. You cannot profit personally from your position as a director of a company, my interpretation of that duty is much broader than

many peoples'. I believe it's not just about money, it's more than that it's about using your position for personal advantage. So, for example if I was on a board of director's and I used that powerful position to get my son, or daughter, I only have sons by the way, so to get my son a job that would be breach of fiduciary duty, in my opinion. In terms of director's adherence to that standard, it varies. Some of them haven't a clue, some people just do not understand fiduciary duty.

John Purcell: It comes from trust law, and it's not well understood I think.

Niamh Brennan: Well, it's just that they don't know the difference between right and wrong, and I mean nobody ever taught me about fiduciary duty, but I just, in my gut I do understand what's right and what's wrong.

John Purcell: I wonder, if you go back to our discussion about enlightened shareholder interest, if you really start to focus on the duty being owed to the company as a person I think you start to get a sharper understanding of the tightness of a fiduciary duty.

Niamh Brennan: Well, the test that I would always have in the back of my mind in terms of executing a duty like that, would be the front page of what I would call the Irish Times. You might say the front page of the Australian Age, or whatever newspaper, but if somebody knew that you as a company director had done X, and if they saw it written on the front page of a newspaper, how would they react? So, that would be my standard, but I don't think about it that much because I just think it's a gut feeling.

Now, the second common law duty of directors is the duty of care and skill, and that means that in executing your duties you have to take care, and exercise skill, the skill appropriate to your qualifications. So funnily enough, the skill required of a non-qualified director is lower than would be qualified if somebody like me is a chartered accountant. And, there is an absolutely, one of the papers that I wrote that also got a prize in my own institutes' journal, Accountancy Ireland, I had come to New Zealand in 2011 and I had discovered about a New Zealand case and an Australian case based on almost identical circumstances.

And the identical circumstances where that the board of directors, in both cases, introduced international financial accounting standards in 2005, they early adopted international accounting standards. And both companies went out of business, and prosecutions were taken against them both, and in the New Zealand case the company was called [inaudible], the judge found in favour of the directors, they hadn't breached their duty of care and skill. But in the Australian case, central the directors were found, the judge found against them.

John Purcell: Quite a controversial, well not controversial in so much as it didn't create new law but it really focused director's attention on the nature of the county standards.

Niamh Brennan: Well one of the director's defences, and there's a lesson in this for all boards, one of the director's defences was that the board packs had become enormous, and that they had missed, three meetings ago they had missed 2 pages in a 1,180 board pack. And the judge did not accept that defence. Because the judge said that the central directors had control over what came into the board room, and they allowed the board packs to get that large, but once the board allowed that to happen they then had a duty of care and skill to read every page that they allowed the executives to bring into the board room. And so, they were negligent in missing the two pages that, had they read more carefully, would have indicated that the liability should be classified as short term, when in fact they were classified as long term.

And that was a very important decision, because the company really quickly afterwards went into liquidation. So, now I should also clarify that in exercising the duty of care and skill it is not negligent, for example, not to be in the office of the company every day. So, as a non-executive director you can attend a surprisingly few board meetings and still be judged to have exercised due care and skill. So, I mean there's a lot of detailed statutory provisions about the conduct of boards, directors, et cetera, but those two common law duties, the fiduciary duty and the duty of care and skill, well if you can get those right more or less everything falls into place.

John Purcell: You look at, something along those lines - I think you allude to this - the actual nature of being a director. And I think there's something to debate as to whether being director's a science or whether it's an art. Can a person learn how to be an optimum director?

Niamh Brennan: Well, another thing, aspect of being on a board of directors that people who've not been a don't, possibly, fully understand. And that is a huge amount of, I mean the board has to make some pretty serious decisions, like hiring and firing the CEO and stuff like that, or major acquisition decisions or whatever. And that is a function of judgement, so the best director is somebody who has very good judgement, and that it certainly not a science, it is the product of human endeavour. You mentioned in the introduction to this podcast that in 2002, I established a centre for corporate governance at my university. And the reason, John, I did that is because at an embarrassingly young age I had gotten a non-executive directorship, and then another one, and then another one, that's the way it works.

And what I knew, when I took on my first directorship, about corporate governance, could have been written on the back of a postage stamp. So, roll on the years and I said, "I bet you there's other people taking on those onerous legal roles, and they don't really know what they're meant to be doing." So, the centre for corporate governance provides training to company directors, and I

have a credited diploma in corporate governance, which is an absolutely in-depth programme where the students come in two evenings a week for two semesters, to UCT. Are they good directors at the end of it? Some are, some aren't, because I cannot teach judgement. I can teach them the rules, the regulations, I can talk to them about behavioural issues around boards and all the rest. But, at the end of the day it's about them as a person as to whether they are or are not good directors.

John Purcell: Could I just ask you a question around this idea of judgement as an aside, we have in Australia a lot of debate about the scope of what we call the business judgement rule, what's the status, and the expectations, the stressors around that type of relief in the UK and Ireland?

Niamh Brennan: Well where I think, where I think the business judgement rule is called out most clearly is actually in the US, it's, we don't call it out as much as we should do in Ireland and the UK so I'm pleased to hear, yet again, that the Australians are ahead of the pack in emphasising it, it's very important to emphasise it. But, basically, to summarise the business judgement rule in a nutshell, unlike the Pope - company directors are not expected to be infallible. You may make a wrong decision, you may make an error of judgement, but the courts will not find against you that you made the wrong decision. However, in case there's anybody listening to this podcast who might be kind of feeling a sense of relaxation after that comment, the courts will find against you if in taking the decision, you took the decision in a negligent way. But, if you've gone about taking the decision with care and skill, getting robust evidence, and stuff like that, and then things go wrong then that's a judgement issue. And we should come back to fundamentals John, which is what is the purpose of a company? And when I ask my students this question they blurt out the purpose of a company is to make profits, that's the wrong answer because you've many not for profit companies, the purpose of a company is to manage risk. And companies often are taking risks, and if you're taking risks things go wrong, and it's a very competitive world out there. So, the fact that things go wrong, you'd rather as a company director that things didn't go wrong because that's a bit of a black mark on your CV if that has happened. But things may go wrong because of errors of judgement, because you didn't anticipate the activity of your competitor fast enough, and they stole a margin on you, and they've now taken your business away from- These are business judgement issues.

John Purcell: Yeah, and if you put it in fundamental financial terms, there's risk-reward relationships. And you know, shareholders are there for reward but they also have the benefit of limited liability.

Niamh Brennan: We're going back to, actually the first question where you're trying to look after the best interests of the firm, so you're trying to make sure that the firm doesn't take so many risks that it will go out of business. And I'm working on a paper with a colleague of mine, Collette Kerwin, and this is her phrase and I think it's an absolutely brilliant phrase, she conceptualises directors as being guardians of the firm. And I think that's a lovely expression. And she did interview research,



and she got that idea from one of her interviewees who compared being a non-executive director in a private family business as being like the relationship between a parent and a child, and that's where she got the word guardian. And the word features more in the legal literature than in the business literature.

Unfortunately, as I said earlier, the business literature is dominated by this notion of maximising shareholder value, whereas the legal literature recognises that actually it's about guarding the interests of the firm, being guardians of the firm.

John Purcell: Now, I think it's valuable to go back to those fundamentals.

Niamh Brennan: Absolutely.

John Purcell: Now, I'd like if we could to turn to the dynamics of company boards of directors. What are the major sources of dilemmas between the interest, aspirations, behaviours, and responsibilities of the chair, the chief executive, and non-executive directors. And how, finally, are these relationships best guided toward reduction of conflict and sound business outcomes?

Niamh Brennan: Of all of the questions, John, that you've asked me this is without question the hardest one. Group dynamics around a board, it's very, very difficult and it really is a function of the people around the board. I think that professional directors probably are better at group dynamics because they understand their role much better than, for example, a group of volunteers on a board of a not-for-profit. So, I think knowing what your job is, and by the way the fundamental of knowing what your job is that if you are a director you are a governor, you are not a manager. And that distinction is really important. And again, in the under-resource of a not for profit the volunteers who are directors, are possibly, and their enthusiasm for the object of the not for profit business or entity has them interfering in day to day management. You cannot govern yourself, so you cannot govern and be a manager at the same time.

So that distinction I think does contribute positively to better group dynamics. But there's no guarantee, and again as I said earlier with my students I said, "Does your group work well?", "No.", "Well that's a bit like a board of directors." And I always say to people, I, when I retire, I have no intention of retiring but anyway when I retire, I have to do my PHD in psychology, or possibly [inaudible] to even begin to work out how to get the group dynamics of a group of people going. But, I'm currently on a board where one of my fellow board members has a diploma in coaching, and I find her brilliant, and I'm learning an awful lot from her.

The way she goes about the board work is quite different than I do. She has learned from her coaching diploma how to be more empathetic with people, and I just, it's those kind of soft skills that make an enormous difference to any

group of people, a board of directors or any other group of people working well or otherwise.

John Purcell: Age and gender, what are the shifts in Ireland and UK in terms of make up on boards, are you seeing ...

Niamh Brennan: One of the boards that I'm currently on, which is a state board in Ireland, has a fifty-fifty male female split. That's probably the first time I've been on a board where it's been split that evenly, and it's probably also the first board where I would say that some of the larger than life characters, not all of them, but some of the larger than life characters are female, rather than male. It's more often, the females are, well it would've started on my first board appointment I was the token woman and part, my appointment was possibly driven by the board deciding they need to have a woman. And then, I was on a board where there were three women, so again your influence by reference to gender, it becomes greater because there's more than one of you.

However, I'm not really much, to be honest into gender. I'd much rather that you would express the issue around diversity, as opposed to a single measure of diversity, which is gender. You have, a board works much better if you have people that think in diverse ways. If you have everybody thinking the same way, you could be all heading over to the cliff, and about to go over the cliff, because we're always thinking the same way. So I think it's much healthier to have diverse thinking, and even better to have people who have the confidence to say, I remember this happening on one board I was on, where we all eleven of us said yes to X, and one person said, "Well hold on a moment." And of course the minute he said it, the eleven of us realised, of course he's right.

So, not only to have the diverse thinking but to have people who have the confidence to actually express a contrary view to the rest of the group. I mean one thing that is astonishing, on a board, and I've seen it so many times is the people who show up to the board meetings and say virtually nothing. So there are people who take it, and I'm going to use strong language but I feel strongly about it, they just take a free ride. They just sit there, on the board, and they don't participate in the discussion. And I'm saying to myself, "Well why are you even turning up to the board meeting, you're not saying anything, what are you contributing?"

John Purcell: I actually think that the free riders are the ones who find themselves potentially exposed.

Niamh Brennan: Well, sorry, there are some who are even cleverer than that, when the board comes to make a very big decision, they suddenly somehow aren't available for that meeting. So, these are all human dynamic behavioural issues that make a board of directors, and any other group of people, at times awkward to deal with.

John Purcell: Niamh this has been an absolutely fascinating and very rewarding discussion, I'd like to thank you very much, and wish you safe and prosperous travels back to Dublin.

Niamh Brennan: Yeah, and John can I thank you, and can I also insert a little ad break at the end here, but I would also like to thank Swinburne University of Technology, who has invited me out on this visit, and I'm very grateful to Swinburne for, because this is my third visit to Swinburne, I'm grateful to Swinburne for the opportunity.

John Purcell: We've all benefited greatly, thank you very much.

Niamh Brennan: Thank you.