ONE SIZE DOES NOT FIT ALL: SMALL COMPANIES AND ASX CORPORATE GOVERNANCE COMPLIANCE

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Abstract

The ASX Corporate Governance Council's Principles of Good Corporate Governance and Best Practice Recommendations (Released March 2003) has been criticised as unduly prescriptive and potentially costly, particularly for small firms. Using a sample of 518 West Australia and Queensland based ASX listed companies, we show that small companies are less likely to comply with several of the ASX recommendations than large companies. We also show that some agency controls largely ignored in the recommendations, such as substantial shareholders, may substitute for some of the corporate governance mechanisms recommended by the ASX. We also consider the effect that the extent of director interlocking may have on compliance, and find that it is minimal. Overall, the results of this research provide a timely reminder that when it comes to corporate governance, one size does not fit all.

Keywords: Corporate Governance, Australia, Company Size, Regulation, Director Interlocking

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I. Introduction

The ASX Corporate Governance Council's *Principles of Good Corporate Governance and Best Practice Recommendations*, published in March 2003, was a response to the recent series of high profile corporate collapses both overseas, such as Enron and WorldCom, and domestically, such as One Tel and HIH. The ASX has adopted a 'comply or explain' stance on its 28 guidelines, consequently it is not necessary for all firms to follow each and every guideline but those who do not must provide a statement in their annual report explaining the lack of compliance. Many of these recommendations deal with board structure and prescribe, amongst other things, the proportion of independent directors on the board and individual committees, and the separation of the roles of chairman and CEO and has implications about the size of the board (da Silva Rosa *et al,* (2004) show that the ASX recommendations imply a minimum board size of five directors).

Adopting the ASX recommendations is not costless, and small companies are likely to be especially sensitive to these costs. Therefore, it would not be surprising to find low levels of compliance among these firms. On the other hand poor governance (perceived or real) compromises access to capital through an increase in company risk. This leaves small firms in a quandary; they can either incur the direct costs associated with complying with ASX best practice or the indirect costs of non-compliance.

Although the 'comply or explain' stance of the ASX is evidence that it acknowledges that a cost-benefit analysis of adopting the guidelines is required, there is a perception that the recommendations are becoming unwritten law and "many [small companies] fear they could be ostracised by investors if they do not adhere to the ASXs strong request for compliance" (Nicholas, 2003). Previous Australian research has shown that firms that go public for the first time, those that potentially have the most to gain from reducing agency costs, do not fully comply with the ASX corporate governance mechanism[39]. This evidence suggests that despite the publication of the recommendations, and the associated expectation of compliance, many firms consider compliance to be sub-optimal. More recently, the ASX has stated that the high level of 'if not why not' exception reporting is actually a good thing, and that it is "a consequence of companies' increased familiarity with and understanding of the Principles and a lesser focus on a "tick the box" approach" (ASX, 2006). The apparent success of such non-compliant firms in raising capital suggests that they have other mechanisms or processes in place that are effective substitutes for the ASX Best Practice Recommendations in minimising agency costs. We investigate these alternative mechanisms.

Further, the Business Council of Australia has "concerns that some of the provisions may be particularly onerous on small business" (Buffini 2003). Independent research on the variety and

[39] da Silva Rosa, *et al* (2004).

effectiveness of governance mechanisms that are not recognised in the ASX guidelines can provide both investors and companies with assurance that failure to comply with the ASX guidelines can be legitimate and even optimal, depending on a company's circumstance. In short, we seek to provide evidence and analysis in support of Hamilton's (2004) observation that, with respect to the guidelines, "one size fits all is a very bad fit".

The study focuses on the extent of compliance by Western Australian and Queensland companies with the recommendations. Several factors contribute to our decision to confine our tests to companies based in the two states. These factors that influence our choice of WA include its geographical isolation from the nation's major financial centres, its very high concentration of natural resource-based companies, a high incidence of IPOs (relative to other states), and the presence of a disproportionately high percentage of small listed companies. The large number of small listed companies ensures we have a sufficient sample to base our tests on the likelihood of compliance among small firms. The Queensland economy also contains firms with relatively similar size and industry characteristics to WA but is not as geographically isolated from the nation's major financial centre, Sydney. These facts combine to make Queensland a useful inclusion in this study, as a comparison to West Australian companies.

Perth's geographical isolation has contributed to its development as a localised network of capital market participants which facilitates study of the importance of director interlocks in corporate governance. Director interlocking occurs whenever a director sits on two or more boards concurrently. Social Network Analysis (SNA) allows the strength and extent of one type of inter-firm connection to be measured and analysed. We test whether the extent of director interlocks impact on the decision to comply with the ASX recommendations.

Most corporate governance research attempts to document the relation between a particular aspect or measure of corporate governance and some measure of firm performance. This paper tackles the corporate governance issue from a different perspective by using a sample of Australian Stock Exchange listed companies to answer the question; to what extent can company characteristics explain the likelihood of compliance with a range of 'comply of explain' corporate governance recommendations?

II. Review of the literature

Agency theory stipulates that managers will opportunistically act in their self-interests at the expense of owners. The problem arises because of information asymmetries between the agents (managers) and principals (owners). Jensen and Meckling (1976), integrate elements from agency theory, the theory of property rights and the theory of finance to develop a theory of the ownership structure of the firm. They stipulate that firm value will increase with an increase in the effectiveness of the monitoring of management. They explain that this relation exists because as monitoring increases, management will have less opportunity to partake in dysfunctional activities, and as a consequence, costs relating to them will decrease.

Fama (1980) explains how the separation of ownership and control can be an efficient form of economic organisation. He sets aside the presumption that the firm has any meaningful owners, and also ignores any role an entrepreneur may play. In his model the firm is subject to competition from other firms, and managers face both the discipline and opportunities provided by the markets for their services. Fama concludes that "wage revision", a process imposed by the managerial labour markets that amounts to full ex-post settling up by the manager for their performance, is one of the "ingredients in the survival of the modern large organisation" with their diffuse ownership and separation of ownership and control.

In the agency theory context, boards perform a monitoring role over agents, and act in the interests of the principal. Fama and Jensen (1983) discuss the role of organisational mechanisms in controlling agency conflicts and highlight the importance of board independence. They also stress the importance of both inside and outside directors for effective boards, the implication being that a board's effectiveness is at least partially determined by the mix of independent and insider directors.

A characteristic of the existing research into boards is the lack of consistency in results. Some results support the implications of agency theory in a board structure context while several others find a lack of any significant relation between the composition of boards and corporate performance. Kiel and Nicholson (2003) examine the relationship between board demographics and corporate performance in a large-scale study of 348 of Australia's largest public companies. They describe several attributes of these firms and their boards including company size, diversification, board composition, number of interlocks, and corporate performance. They present evidence that, after controlling for firm size, board size is positively correlated with firm value. They also show a positive relation between the proportion of inside directors and firm share performance. Kiel and Nicholson also contend that a common problem in corporate governance research is a misguided search for a relation between a single segment of the corporate governance mechanism and some measure of performance rather than a more comprehensive view of how boards add value. Corporate governance, they argue, is too complex a process to be simplified into an analysis of this type. Individual firm circumstances and the economic and legal environment must be also considered.

In stark contrast to Kiel and Nicholson (2003), Yermack (1996) documents an inverse relationship between firm value and board size. Using a sample of over 450 large industrial U.S. firms over the period 1984 to 1991, Yermack shows that the Tobin's *Q* of firms with smaller boards is significantly higher than that of firms with larger boards. Yermack's methodology is quite different to Kiel and Nicholson (2003), he controls for many potential confounding factors such as size, industry, insider stockownership, differing governance structures and growth opportunities. The incremental increase in costs with growing board size is greatest when boards go from being small to medium sized. He estimates that the cost involved with increasing the board size from 6 to 12 is approximately the same as the costs of increasing a board from 12 directors to 24. Another difference between large and small board firms that is documented is that firms with smaller boards have more incentivised CEOs through both the compensation structure and threat of dismissal. Yermack argues that his results support the conjecture that even though the monitoring capacity may increase with board size, the benefits are outweighed by costs such as slower decision-making, less candid discussions, and greater risk aversion.

Cotter and Silvestor (2003) fail to find a significant association between full board or committee independence and firm value. They focus on the composition of the audit and remuneration committees, as well as the boards as a whole, for 109 of the largest 200 Australian publicly listed companies in 1997. They show a positive association between the proportion of independent directors on the full board and the two committees, and a greater proportion of independent directors on both committees than the full board. They also find that full board independence is associated with low managerial ownership and an absence of substantial shareholders. Furthermore, audit committee independence, when combined with low leverage, is associated with reduced monitoring by debtholders. They do not find evidence to support the hypothesis that board and committee independence is positively related to firm value. An important point to note is that board composition was largely unregulated during this period. It is entirely plausible that with the increase in regulation, for example through the introduction of the ASX Corporate Governance Council's best practice recommendations, we may observe an increase in the perceived benefit of these corporate governance mechanisms.

The major finding of Cotter and Silvestor (2003), that director independence is unrelated to firm value, is consistent with Udeni (1998). Udeni examines the independence of outside directors in 180 large UK corporations from 28 industry sectors and identifies the boards' different power dimensions. Udeni shows that although outsiders account for 48% of board members, only 20% can be considered truly independent (using a definition very similar to the ASX's), and finds reliable, valid, and stable measures of structural, ownership, and prestige power in the boards. The implication is that outsider independence, while necessary, is insufficient to capture how the composition of the board determines its ability to protect shareholders' interest. Independent outside directors without power cannot monitor executives. Udeni argues that the prestige power of a director can be proxied by the number of boards a director occupies. Although Udeni (1998) has a different focus to the current study, it highlights the potential interplay between board independence and interlocking, a relationship examined in the current study.

There are many mechanisms that can be employed to reduce agency problems, independent boards is but one of them. Prior literature suggests that increased (a) managerial ownership of equity, (b) dividend payout, and (c) leverage can influence the extent to which managers' interests are aligned with shareholders. Jensen and Meckling (1976) posit that the higher the proportion of equity owned by managers, the greater the alignment between manager and shareholder interests. Jensen (1986) argues that the contractual obligations associated with debt, such as the payment of interest, reduces the amount of discretionary funds available to management. With less discretionary funds, the incentive to engage in value destroying activities is reduced.

Other mechanisms, such as large shareholders, may also act as controls on management. Shliefer and Vishny (1986) observe that if shareholdings in a company are diverse, the free-rider problem prevents any of the many small owners from monitoring management. In their model, the presence of a large minority shareholder provides a partial solution to the free rider problem by actively monitoring management. Shliefer and Vishny (1997) find that substantial shareholders can act to mitigate agency costs by exercising their voting rights. The large stake that these investors have in the firm provides an incentive to monitor management, as in this situation the benefits of monitoring may be expected to exceed the costs.

The governance literature generally acknowledges that multiple directorships are not of concern per se as their mere existence cannot be taken as proof of an active relation (Scott, 1991). Interlocks are indicators of potential power relationships between companies at the highest level but it cannot be inferred that directors exploit networks of board membership merely because such potential exists (Pettigrew 1992).

Ocasio (1994) describes boards as "normative arenas" and suggests their actions reflect honour, obligation and appropriateness; this casts doubt on the appropriateness of the ASX's definition of independence, which ignores interlocks. This paper examines the impact of interlocking on director independence and several other firm characteristics.

III. Hypotheses

The ASX Corporate Governance Council's *Principles of Good Corporate Governance and Best Practice Recommendations* outlines ten fundamental corporate governance principles, and 28 recommendations that the Council believes would enable companies to achieve the principles. The 28 recommendations have attracted significant controversy; they have been criticised as being overly prescriptive and particularly 'onerous to small firms'. Amongst their critics is Michael Chaney who has said "it is just impractical for small companies with a limited number of directors to be engaged in some of the structural things that are in those guidelines" [40]. The fact that compliance with the ASX recommendations can be expensive, particularly for small firms, leads to the first hypothesis:

H_1: Small firms are more likely to deviate from ASX board structure recommendations than large firms.

The ASX best practice recommendations consist of a range of mechanisms that the ASX proposes will improve corporate governance. These are not, however, an exhaustive list of possible governance mechanisms. There is a vast selection of other company characteristics that have been conjectured in the literature to lower agency costs, some of these may be more appropriate than the ASX recommendations in certain situations. Corporate governance is currently a high profile topic and, as a result, firms considered to have poor corporate governance may be incurring a risk premium and subsequently be finding it hard to access the capital markets. The WA market is successful and prosperous, so the third research question is; what other corporate governance mechanisms do WA firms employ to compensate for ASX best practice non-compliance? A high concentration of shareholdings reduces the free-rider problem and subsequently the agency problem by increasing the principles (owners) incentive to monitor the agents (managers). Concentrated share ownership may therefore act as a substitute for other corporate governance mechanisms, leading to the second hypothesis:

H_2: Firms with concentrated ownership are less likely to comply with the ASX corporate governance recommendations.

High leverage reduces the free cash flow that dysfunctional managers can use to benefit themselves at the expense of the owners. High leverage may also encourage more intense scrutiny by debtholders, which may serve to supplement or substitute for other corporate governance mechanisms, so:

H_3: Firms with high leverage are less likely to comply with the ASX corporate governance recommendations.

Resource dependence theory explains the presence of director interlocks as tools used to achieve access to information, expertise, and other resources that a firm would otherwise not have access to. According to the theory, interlocks will occur when a firm needs access to a resource they do not already have, which is largely independent of other firm characteristics (except possibly size) and corporate governance mechanisms. If resource dependence theory accurately explains the presence of director interlocking in WA we would expect that;

H_4: The extent of director interlocking does not affect compliance with the ASX best practice recommendations.

IV. Data and Variables

As discussed earlier, we have restricted our sample to WA and Queensland firms. Unlike previous corporate governance studies that typically ignore small mining companies, all industries are included. In fact the large proportion of these often neglected firms in the WA market was a consideration in selecting this state as the sample. Prior interlocking and governance studies generally focus on the largest capitalisation companies in a market.

Initially, *Connect4* was utilised to gather information for each publicly listed firm based in Western Australia or Queensland from their annual reports. This led to an initial sample size of 632**,** which comprised of 472 WA based firms and 160 Queensland based firms. The sample firms have an average market capitalisation of 142 million Australian Dollars and, reflecting the focus of the West Australian and Queensland markets comprise of 53 percent Mining and Energy companies. The majority of the remainder being categorised either as Technology (13 percent), Capital Goods, Real Estate or Banks (approximately 5 percent each) (describe the industrial statistics of the firms in brief).. During this process several firm characteristics were recorded, these included market capitalisation, revenue, and auditor. Data on substantial shareholdings were gathered from *DatAnalysis*.

The level of compliance with the ASX Corporate Governance Guidelines was determined using one of three sources. Where the firm's Corporate Governance Statement was available, *Connect4* was consulted and the data manually recorded, automatic downloading of this information is not possible. Firms report their corporate governance practices in a variety of ways, and for a large proportion of the sample this information was not available on *Connect4*. When a company's compliance was not available on *Connect4*, the next source was the corporate governance sections of their websites. Still, some websites were offline or did not contain all of the relevant information, in these cases corporate governance information was obtained from annual reports, downloaded either from the ASX or company websites.

As with the company characteristics discussed above, *Connect4* was used to obtain the name and

[40] Quoted in Pheasant and Buffini (2003)

status of each director of every WA and Queensland based publicly listed company at 30 June, 2004. Table 1 shows the distribution of sample companies across the two states.

INSERT TABLE 1 ABOUT HERE

In selecting the sample, we felt that it was important to avoid any potential survivorship bias. All firms that were listed in either Western Australia or Queensland at the end of the 2003-04 financial year were included in the initial sample. Information was not available for all of the initial sample firms for all of the variables. These gaps in the data lead to a substantial reduction in the final sample size.

The variables in this study include many of those previously hypothesised in the literature to have impacts on corporate governance, as well as several social network analysis statistics. The definition of the variables used, and the motivation for their inclusion, is presented below:

Market Capitalisation: The market capitalisation of firm *i* at the end of June 2004, it is obtained from *AspectFinancial* and as such is rounded to the nearest one million Australian dollars. It is included in this study as a measure of firm size because we hypothesise that the smaller the firm, the less likely it will comply with the ASX best practice recommendations.

Revenue: This is measured as the annual revenue of firm *i* in the 2003-04 financial year as reported in the annual report. This is another proxy for size, and although highly correlated with market capitalisation, the relation may be weaker for the smallest firms. Compliance with the ASX recommendations can be costly, so revenue may also be related to ASX compliance.

Industry: The four digit GICS code of firm *i*. For consistency, this is determined by matching the industry description taken from *AspectFinancial* with the closest four digit GICS description. Different industries are exposed to different risk factors, and subsequently a firm's industry may influence the extent to which it is interlocked and its ASX compliance.

Big4: This variable takes the value of 1 if the firm's 2003-04 financial statements were audited by Ernst and Young, KPMG, Deloitte or PriceWaterhouse Coopers, and 0 otherwise. These four auditors undertake over sixty-five percent of the audit work for the top 1000 Australian public companies and subsequently have high incentives to maintain their reputations. As such they may be considered a valuable corporate governance mechanism.

Substantial ownership: This is measured as the percentage of the firm's outstanding shares owned by all shareholders who individually hold more than 5%. This is taken from the firms' 2004 annual reports. This variable has been included because large shareholders have long been considered a useful way to control agency problems between managers and shareholders.

Largest Owner: This is the percentage of the firm's shares owned by the largest shareholder, whether an individual or institution. It is also gathered from the firms' 2004 annual reports. Another proxy for the power of shareholders, it has been included because the presence of a large shareholder may influence to corporate governance mechanisms employed by a firm.

DE: The debt to equity ratio as reported in *FinAnalysis* as of June 30, 2004.

The following measures are used to capture the extent of director interlocks:

Degree Centrality: The degree centrality of an individual firm in a network is a direct measure of the connectedness of a firm in a network. It is included because it is one of the staple measures of social connections.

Normalised Degree Centrality: This is simply degree centrality scaled by g-1, where g is the size of the group, to allow comparison across networks.

Betweenness: This is the betweenness centrality of an individual firm in a network. This measures connectivity including indirect connections and is another staple measure of social connections.

Normalised Betweenness: This is simply betweenness scaled by [(g-1)(g-2)]/2, As suggested by Wasserman and Faust (1994), where g is the number of actors in the network. This allows comparisons to be made across networks.

Table 2 contains summary statistics of the sample firms. The average market capitalisation and revenue of West Australia-based firms is approximately half that of Queensland based firms. WA has more variation in company sizes than Queensland and the largest WA firms are substantially larger than the largest Queensland companies. This is a result of the resource focus of the WA market, many of the companies are very small, but some of the successful ones, such as Woodside, are giants. Queensland and West Australia experience relatively similar shareholding patterns.

INSERT TABLE 2 ABOUT HERE

V. Results

Compliance with the ASX Corporate Governance Recommendations

This study focuses on compliance with the following ASX Best Practice Recommendations:

2.1 That a majority of the board be independent directors

2.2 That the chairperson be an independent director

2.3 That the roles of chief executive and chairperson be exercised by different people.

2.4 That there is a nominations committee

4.2 That there is an audit committee

4.3 That the audit committee is structured such that it consists of; only non-executive directors, a majority of

independent directors, an independent chairperson who is not the chairperson of the board, and that is has at least three members

9.2 That there should be a remuneration committee

These recommendations were selected for the analysis because they involve board structure. Changing the board structure is significantly more expensive than adopting the other ASX recommendations, so we expect that firms are more likely to fail to adopt these recommendations than the others.

Table 3 shows the percentage of sample firms that comply with each of the recommendations being tested. Average compliance differs greatly between the recommendations ranging from less than nineteen percent for recommendation 4.3 on the structure of the audit committee to over seventy percent for recommendation 2.3 on the separation of the roles of chairman and CEO. Only about 30 percent of our sample companies have a board that comprises a majority of independent members. This is marginally below the proportions reported in da Silva Rosa et al (2004) for their sample of IPO firms for 1994 and 1997, several years prior to the announcement of ASX best practice best practice recommendations in 2003. It is interesting to note that the extent of compliance post-2003 has not changed. Very few companies (only about one in five) chose to have a nominations committee, a function which may well be carried by the whole board. Although a significant majority of companies have separate roles for chief executive and chairman (at about 73%), only two in four of our sample companies have an independent director as Chairman of the Board.

Interestingly, a recent review by the ASX of financial statements for companies that had a 30 June 2005 balance date (ASX, 2006) shows that two years on, the level of compliance is only slightly higher than that found for our WA and Queensland companies, as shown in the last row of Table 3. In 2005, only about a third of ASX companies have a majority of independent board members, and only about half have an independent Chairman. Very few, only one in five, choose to have a nomination committee.

INSERT TABLE 3 ABOUT HERE

Given the variability in the degree of compliance for the various recommendations, we tested the questions posed in our earlier hypotheses: what explains the likelihood of compliance? The greater the costs associated with compliance, relative to non-compliance, the smaller is the likelihood of compliance. Table 4 presents the results of multivariate logistic regressions to assess the relation between company characteristics and ASX corporate governance compliance. The first hypothesis, that small firms are less likely to comply with the ASX recommendations, is strongly supported; the coefficient on LogMktCap is consistently significant and positive for all recommendations we studied. This supports the statements reported earlier that the costs of compliance for the smaller companies are non-trivial.

The second hypothesis predicts that firms with a greater proportion of substantial shareholders would have lower compliance with the ASX. Our results do not support this hypothesis. The coefficient on *Largest Owner,* a measure of the proportion of a firms shares held by the largest shareholder is negative and significant only for the recommendation calling for an independent chairperson and is marginally significant (*p*-value 0.058) for the recommendation that a majority of the board be independent. In all other cases the coefficients are statistically insignificant. It appears then that high ownership concentration negates the importance of director independence, but not the other ASX recommendations. This is an interesting result: that high ownership concentration is a substitute for director independence.

The hypothesis that the higher level of monitoring from debtholders that is associated with higher leverage may substitute for some of the ASX corporate governance recommendations can not be supported here. The measure for gross leverage, *DE*, was insignificant in all cases. Given that leverage has been considered a useful corporate governance mechanism since at least Jensen (1986), this result is surprising. The industry dummy variables proved to be quite informative. The likelihood of compliance is smaller for mining companies, even after controlling for the effect of size.

INSERT TABLE 4 ABOUT HERE

Despite the success in explaining the probability that a firm will establish committees, the explanatory power of several of the regressions is still very low. The R^2 of the regressions on the recommendations to have a majority of directors independent, dual leadership and an independent chairperson are all less than 0.08. This suggests that perhaps there are other, as yet unidentified, factors influencing ASX corporate governance compliance.

Director Interlocking

There are several reasons to expect that large companies may have more interlocks than smaller companies. Large companies have greater resource demands than others, and their directors would be expected to ease access to them. If experience, expertise and relationships are developed through multiple directorships, it logically follows that the directors of large companies will be more interlocked. In order to test whether the degree of interlocking is related to firm size, Pearson correlation coefficients were calculated between interlocking statistics and size. As with the testing of earlier hypotheses both market capitalisation and revenue were used as size measures, the social network analysis variables analysed are degree centrality and betweenness

centrality. If the hypothesis is supported there will be a significant correlation between the measures of size and the social network statistics. The results of these tests provide very little support for the hypothesis and are presented in Table 5.

The weak results of the correlation tests can be interpreted in at least two ways in a resource dependence theory context. The first is simply that directors who sit on multiple boards are no more likely to be able to provide access to resources than non-interlocked directors. The alternative explanation is that size is an over simplified proxy for an organisation's resource demands.

The results suggest that the implications of director interlocking on corporate governance are less severe than is often claimed. The extent to which a firm is interlocked is unrelated to its compliance with the ASX corporate governance recommendations analysed here. It appears that the view that multiple directorships are a means through which good practices can pass between firms, information on markets and potential opportunities can be gathered, and valuable experience can be built is not supported in the West Australian and Queensland cases.

INSERT TABLE 5 ABOUT HERE

Table 6 provides the results when an interlocking measure is introduced in the model to assess if director interlock has any influence on the likelihood of compliance. If resource dependence theory is supported, interlocking should not influence a firms' decision to comply. The results provide evidence consistent with resource dependence theory. In all regressions except one, the coefficient on degree centrality is not statistically significant. It does not appear that the extent to which a company is interlocked influences the decision to have a nomination committee, dual leadership, audit committee (or its composition) or a majority of the independent board membership.

INSERT TABLE 6 ABOUT HERE

VI. Discussion of Results

6.1. ASX Corporate Governance Compliance

Together, the findings outlined above lead to several important implications for researchers, investors, and regulators. One of the clearest conclusions that can be drawn from this study is that future corporate governance research should not exclusively focus on large firms outside of the mining industry. There are substantial differences in the corporate governance mechanisms employed by firms of various sizes and industries that should not be ignored. Doing so is likely to lead to conclusions that are not relevant to the wider market, deeming the results largely irrelevant. Regulators should also be wary of introducing prescriptive corporate governance requirements. The fact that many firms, and especially small firms, are opting for non-compliance suggests that they consider several of the recommendations to have negative net benefits. Forcing compliance through either greater regulation or through adopting a 'tick the box' mentality to corporate governance is likely to only achieve inefficiencies, and taken to the extreme this may prevent otherwise suitable small firms from going public, stifling market growth and the Australian entrepreneurial spirit.

This study finds that the relationship between board size and ASX compliance is positive. Previous studies, for example Yermack (1996), find that smaller boards are actually more effective overseers of the CEO than larger boards. These two findings highlight that investors and regulators alike should not asses a firm based solely or even predominantly on the extent of their compliance with the ASX corporate governance mechanisms. Taken alone, the twenty-eight recommendations espoused by the ASX are both highly prescriptive and incomplete. This study demonstrates that the shareholders likely to be in the best position to influence management, i.e. the largest ones, do not press firms to comply with the board structure recommendations and appear to act as a substitute for director independence. The ASX Corporate Governance Councils' *Principles of Good Corporate Governance and Best Practice Recommendations* do not acknowledge that substantial shareholders may fulfil a corporate governance role.

A study by Corporate Governance International Pty Ltd, of voting in 2003 in 100 'widely held' Australian listed companies showed that the holders of only 44% of the eligible share capital voted on director-election resolutions. In general, without a highly controversial issue to motivate them to vote, most shareholders do not. This implies that a block shareholder does not need a large percentage of the share capital to gain an input into control. Combined with the evidence presented in this paper that substantial shareholders can substitute for director independence, this suggests that any comprehensive analysis a company's corporate governance should consider the influence of large shareholders.

These findings also have implications for markets outside of Australia. In the United States, for example, the Securities and Exchange Commission, NYSE and NASDAQ have recently established similar rules to those of the ASX, including calling for listed companies to have a board consisting of a majority of independent directors. While size was shown to be the most powerful determinant of a firms' compliance with the ASX recommendations, and both NASDAQ and especially NYSE listed firms are much larger on average than Western Australian and Queensland based public companies, the requirements may still be inappropriate to the extent that companies on these markets have substantial shareholders.

VII. Conclusion

Corporate governance is a complex issue. The ASX Corporate Governance Councils' *Principles of Good Corporate Governance and Best Practice Recommendations* are recommendations, only recommendations, and they should be acknowledged as such. The recommendations are neither perfect nor complete. On an aggregate level, they were shown to have at least one imperfection that they do not acknowledge the monitoring role of large shareholders.

Other research such as Pheasant and Buffini (2004) has documented concerns that compliance with these issues may be difficult for small firms in particular. This research presents evidence that lack of compliance with the recommendations should not be taken at face value as evidence of poor corporate governance or management. This notion is supported by the ASX, which has expressed satisfaction with the increased level of exception reporting between 2004 and 2004, claiming that it is evidence that companies are moving away from a 'tick the box' mentality. Small firms have consistently poorer compliance than large firms. Despite this, small firms have performed exceptionally well lately. The research also presents evidence contrary to the common belief that director interlocks are in some way a collusive mechanism designed to achieve subversive goals. The extent to which a firm is interlocked is shown to be unrelated to compliance with the ASX recommendations and company size. This research has highlighted the importance of adopting an approach to corporate governance that moves beyond simple ASX compliance. It has shown that the relationship between firm characteristics and corporate governance mechanisms is complex and it is ignorant to look for firms that display the 'best' combination of corporate governance issues without having an appreciation of the various challenges facing the particular firm. The recommendations are not, nor where they intended to be, an optimal selection of corporate governance mechanisms for all firms.

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Appendices

Table 1. Sample Selection

	Western Australia	Queensland
Initial Sample	472	160
Annual Reports Not Available	70	13
Executive Pay Uncertain	12	6
Compliance Not Reported	8	5
Final Sample	382	136

Table 2. Summary statistics for 518 ASX listed firms in 2004 based in either Western Australia or Queensland

Market capitalisation is calculated using the closing price of the shares at the 31st June, 2004. Revenue is as reported in the 2004 annual report, as is the substantial shareholding data.

		WA	Qld
Market Capitalisation	Mean($ Million)	116.6	206.4
	Median ($ Million)	11	25
	Standard Deviation	823.5	745.9
	Maximum	11,113	7,620
Revenue	Mean ($'000)	77,218	146,618
	Median ($'000)	960	2306
	Standard Deviation	555.3	477.2
	Maximum	84,074,902	4,594,000
Shareholders	Mean Largest (%)	18.55	25.42
	Standard Deviation	14.7	21.12
	Mean Over 5 percent (%)	35.02	42.58
	Standard Deviation	23.42	25.95

Table 3. Compliance with Structural ASX Governance Recommendations

The number of firms, out of the sample of 519 WA and Queensland based publicly listed firms that comply with each of the seven structural corporate governance mechanisms called for by the ASX Corporate Governance Council.

Recommendations:
2.1: that a majority of the board be independent directors.
2.2: that the chairperson be an independent director.
2.3: that the roles of chief executive and chairperson be exercised by different people.
2.4 is that there be a nominations committee.
4.2: that there be an audit committee.
4.3: Is that the audit committee is structured such that it consists of; only non-executive directors, a majority of independent directors, an independent chairperson who is not the chairperson of the board, and that is has at least three members and
9.2: that there should be a remuneration committee

Recommendation	2.1	2.2	2.3	2.4	4.2	4.3	*9.2*
Comply	154	227	380	100	299	97	197
Don't Comply	365	292	139	419	220	422	322
Proportion that comply	0.30	0.44	0.73	0.19	0.58	0.19	0.38
ASX (2006) study*	0.35	0.52	0.85	0.20	0.72	0.39	0.55

*This information is from the ASX's analysis of corporate governance practice disclosure in annual reports of companies that had a 30 June 2005 balance date.

Table 4. Company Characteristics and ASX Compliance

Estimates of multivariate binary logistic regressions run between firm characteristics and the probability that a firm will comply with the ASX corporate governance recommendation calling for a majority of independent directors (Panel A), an independent Chairperson (Panel B), dual leadership (Panel C), a nomination committee (Panel D), an audit committee (Panel E) and a remuneration committee (Panel F). The sample consists of 518 firms that are publicly listed on the ASX and based in either Western Australia or Queensland as at June 30, 2004.
LogMktCap is the natural logarithm of the market capitalisation of each firm based on closing prices on June 30, 2004.
LargestOwner is equal to the percentage of ordinary shares outstanding owned by the single largest shareholder as reported in the 2004 annual report.
DE is equal to the debt to equity ratio of the firm according to the balance sheet of the 2004 annual report.
Mining and Tech are industry dummy variables.
WA is a dummy variable taking the value 1 if the firm is based in Western Australia and 0 if it is based in Queensland.

*# The reported R^2 is the Nagelkerke R^2; * Significant at the 5percent level. ** Significant at the 1 percent level.*

		S.E.	*Wald*	p-*value*	*-2 LL^*	$R^{2\#}$
Panel A: Majority of Directors Independent *N*= 518						
LogMktCap	0.099	0.046	4.564	0.033*	570.36	0.047
Largest Owner	-0.01	0.007	2.144	0.143		
DE	-0.262	0.177	2.209	0.137		
Mining	-0.208	0.245	0.719	0.397		
Tech	-0.297	0.331	0.803	0.37		
WA	-0.089	0.248	0.129	0.719		
Constant	-1.513	0.558	7.362	0.007		
Panel B: Independent Chairperson *N* =518						
LogMktCap	0.109	0.042	6.814	0.009**	636.271	0.067
Largest Owner	-0.021	0.006	11.314	0.001**		
DE	-0.038	0.042	0.814	0.367		
Mining	-0.126	0.222	0.321	0.571		
Tech	-0.023	0.314	0.005	0.942		
WA	-0.429	0.228	3.52	0.061		
Constant	-0.409	0.499	0.672	0.412		
Panel C: Dual Leadership *N* = 518						
LogMktCap	0.086	0.041	4.341	0.037*	532.416	0.048

LargestOwner	-0.008	0.006	1.646	0.200		
DE	0.002	0.005	0.145	0.704		
Mining	0.316	0.243	1.681	0.195		
Tech	0.471	0.369	1.628	0.202		
WA	-0.77	0.28	7.586	0.006**		
Constant	0.78	0.514	2.308	0.129		
Panel D: Nomination Committee *N* = 518						
LogMktCap	0.48	0.076	40.034	0.000**	406.578	0.211
LargestOwner	0.003	0.007	0.195	0.659		
DE	0.003	0.004	0.335	0.563		
Mining	-0.56	0.286	3.827	0.050*		
Tech	0.042	0.391	0.011	0.915		
WA	-0.116	0.287	0.163	0.687		
Constant	-5.997	0.883	46.114	0		
Panel E: Audit Committee *N* = 518						
LogMktCap	0.359	0.059	37.514	0.000**	529.59	0.297
LargestOwner	0.001	0.007	0.038	0.845		
DE	0.001	0.003	0.151	0.698		
Mining	-0.703	0.255	7.624	0.006**		
Tech	-0.119	0.365	0.107	0.744		
WA	-1.755	0.317	30.563	0.000**		
Constant	-1.223	0.644	3.608	0.057		
Panel F: Audit Committee Composition *N* = 299						
LogMktCap	0.363	0.079	21.148	0.000**	320.424	0.166
LargestOwner	-0.007	0.008	0.791	0.374		
DE	0.003	0.007	0.186	0.666		
Mining	-0.164	0.308	0.284	0.594		
Tech	-0.041	0.434	0.009	0.925		
WA	-0.578	0.294	3.868	0.049*		
Constant	-4.002	0.893	20.091	0		
Panel G: Remuneration Committee *N* = 518						
LogMktCap	0.437	0.067	42.522	0.000**	548.839	0.235
LargestOwner	-0.011	0.007	2.589	0.108		
DE	-0.407	0.217	3.515	0.061		
Mining	-0.497	0.249	3.981	0.046*		
Tech	-0.083	0.348	0.056	0.813		
WA	-0.593	0.249	5.645	0.018*		
Constant	-3.967	0.732	25.529	0		

Table 5. Company Size and Director Interlocking

Pearson correlation coefficients of tests run between company size and various interlocking statistics. The figures are calculated using revenue as the measure of size. Results do not significantly change if market capitalisation is used as the measure of size.
[a,c] DegCent is the degree centrality of firm i, Btwn is the betweenness of firm i
[b,d] NDegCent and NrmNtwn are the degree centrality and betweenness value normalised for comparison across networks of different sizes.
** Significant at the 5 percent level*
*** Significant at the 1 percent level*

		Size	DegCent[a]	NDegCent[b]	Btwn[c]	NrmBtwn[d]
Size	Correlation	1	-0.018	0.046	-0.003	0.045
	p- value		0.678	0.293	0.938	0.311
	N	518	518	518	518	518
DegCent	Correlation	0.017	1	0.718	0.688	0.675
	p- value	0.693		0	0	0
	N	518	518	518	518	518
NDegCent	Correlation	0.079		1	0.37	0.49
	p- value	0.074			0	0
	N	518			518	518
Btwn	Correlation	0.066			1	0.952
	p- value	0.133				0
	N	518				518
NrmBtwn	Correlation	0.114				1
		0.009**				
		518				

Table 6. Director Interlocking and ASX Compliance

LogMktCap is the natural logarithm of the market capitalisation of each firm based on closing prices on June 30, 2004. LargestOwner is equal to the percentage of ordinary shares outstanding owned by the single largest shareholder as reported in the 2004 annual report. DE is equal to the debt to equity ratio of the firm according to the balance sheet of the 2004 annual report. Mining and Tech are industry dummy variables.
WA is a dummy variable taking the value 1 if the firm is based in Western Australia and 0 if it is based in Queensland.
*[#] The reported R^2 is the Nagelkerke R^2; * Significant at the 5percent level. ** Significant at the 1 percent level.*

	B	*S.E.*	*Wald*	p-*value*	*-2 LL^*	$R^{2\#}$
Panel A: Majority of Directors Independent *N*= 518						
LogMktCap[a]	0.1	0.046	4.743	0.029	569.124	0.05
LargestOwner[b]	-0.01	0.007	2.105	0.147		
DE[c]	-0.253	0.176	2.076	0.15		
Mining[d]	-0.189	0.245	0.596	0.44		
Tech[e]	0.308	0.332	0.864	0.353		
WA[f]	0.177	0.26	0.465	0.495		
DegCent	-0.043	0.039	1.212	0.271		
Constant	-1.481	0.557	7.079	0.008		
Panel B: Independent Chairperson *N* =518						
LogMktCap	0.109	0.042	6.702	0.01	636.039	0.068
LargestOwner	-0.021	0.006	11.359	0.001		
DE	-0.038	0.042	0.818	0.366		
Mining	-0.13	0.222	0.342	0.559		
Tech	0.021	0.314	0.004	0.947		
WA	-0.465	0.241	3.726	0.054		
DegCent	0.017	0.035	0.233	0.63		
Constant	-0.424	0.501	0.716	0.398		

Panel C: Dual Leadership N = 518						
LogMktCap	0.084	0.041	4.152	0.042	531.489	0.051
LargestOwner	-0.008	0.006	1.68	0.195		
DE	0.002	0.005	0.147	0.701		
Mining	0.305	0.244	1.567	0.211		
Tech	0.464	0.37	1.574	0.21		
WA	-0.853	0.292	8.501	0.004		
DegCent	0.038	0.04	0.91	0.34		
Constant	0.753	0.515	2.14	0.144		
Panel D: Nomination Committee N = 518						
LogMktCap	0.482	0.076	40.017	0	405.235	0.215
LargestOwner	0.003	0.007	0.227	0.634		
DE	0.003	0.004	0.33	0.566		
Mining	-0.536	0.288	3.474	0.062		
Tech	0.055	0.392	0.019	0.889		
WA	-0.012	0.3	0.002	0.967		
DegCent	-0.057	0.05	1.3	0.254		
Constant	-5.942	0.886	44.97	0		
Panel E: Audit Committee N = 518						
LogMktCap	0.362	0.06	36.919	0	524.529	0.309
LargestOwner	0.001	0.007	0.033	0.856		
DE	0.001	0.003	0.156	0.693		
Mining	-0.727	0.256	8.08	0.004		
Tech	-0.121	0.369	0.107	0.743		
WA	-1.963	0.333	34.676	0		
DegCent	0.086	0.039	4.943	0.026		
Constant	-1.334	0.653	4.172	0.041		
Panel F*: Audit Committee Composition N = 299						
LogMktCap	0.363	0.079	21.158	0	320.367	0.166
LargestOwner	-0.007	0.008	0.804	0.37		
DE	0.003	0.007	0.187	0.665		
Mining	-0.172	0.31	0.308	0.579		
Tech	-0.048	0.435	0.012	0.912		
WA	-0.605	0.315	3.694	0.055		
DegCent	0.013	0.052	0.057	0.811		
Constant	-4.025	0.899	20.04	0		
Panel G: Remuneration Committee N = 518						
LogMktCap	0.438	0.067	42.414	0	547.357	0.238
LargestOwner	-0.011	0.007	2.657	0.103		
DE	-0.419	0.217	3.703	0.054		
Mining	-0.517	0.25	4.283	0.039		
Tech	-0.093	0.349	0.071	0.79		
WA	-0.694	0.264	6.902	0.009		
DegCent	0.047	0.038	1.489	0.222		
Constant	-3.758	0.736	26.08	0		