AUSTRALIAN INSTITUTE of COMPANY DIRECTORS

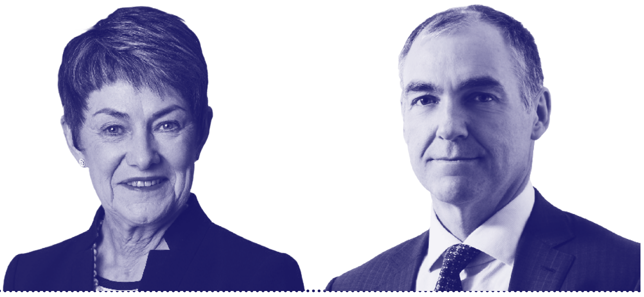
KPMG

Driving productivity from the top

A survey of Australian directors and governance leaders

2017

Chairmens' welcome



The Australian Institute of Company Directors (AICD) and KPMG are delighted to partner on this important study which asks directors and governance leaders to evaluate the conditions and decisions that drive productivity in Australia.

The views captured in the survey and this resulting report provide useful insights into the priorities of directors - including the role of directors and the board in establishing and leading a productivity agenda.

Specifically, the report identifies the impacts of often fluid public policy on productivity, innovation and social cohesion. It highlights the challenges of the current - largely short-term - policy-making process with respect to creating longevity, stability and meaningful reform for the Australian economy and society. It also underlines where the government should focus policy development for the long-term and how public policy can impact on productivity and innovation and re-shape the workforce.

With opinions and views from the AICD's Chief Economist Stephen Walters MAICD and not-for-profit (NFP) policy adviser Lucas Ryan GAICD, as well as KPMG's Partner in Charge of Risk Consulting, Sally Freeman GAICD, the report also provides a valuable analysis of the survey data.

Being a director of a company, regardless of its size and type, is complex and comes with many responsibilities and liabilities.

Directors and governance leaders guide the strategic direction of our organisations – whether that be in the listed, private, public or NFP space. They are significant contributors and facilitators in the debate around lifting Australia's economic growth and prosperity. Increasingly, they are also champions for reform, taking a growing role in influencing more stable policy development and implementation.

The role directors and boards play – or need to play – in championing reform and influencing public policy is a question the AICD recently tackled in its *Blueprint for Growth* which broadened the AICD's policy agenda to address issues of national importance.

The AICD and KPMG share a recognition of the role that governance leaders can and should play in the broader debate about issues related to the governance of the nation. This report aims to help inform the wider discussion of the issues that drive productivity and we hope you find it makes a positive contribution to this national conversation.

Elizabeth Proust AO FAICD
Chairman
Australian Institute of Company Directors

Peter Nash MAICD
Australian Chairman
KPMG

Contents

Executive summary	5
Productivity and its payoffs	6
What is the purpose of business?	9
The director's role	13
Detailed survey findings	16

When reading this document it should be kept in mind that this sample is not necessarily representative of the broader director population and reflects a survey result.

Executive summary

Productivity growth in Australia has remained almost stagnant over the last 10 years, averaging just one per cent each year.

The impact of this is significant – affecting employment, income, our standard of living and, as this report highlights – ultimately the social cohesiveness of our communities.

This effect is mutually reinforcing as social cohesion also has a direct impact on productivity. Socially cohesive communities are more connected, compliant and trusting, meaning that transaction costs are lower. Socially cohesive societies also tend to exhibit higher levels of educational attainment and superior health outcomes which contribute to higher levels of productivity.

Throughout our conversations on the issue of productivity, the AICD and KPMG have consistently highlighted the link between public policy and productivity growth. Despite the many reviews and other initiatives undertaken by or on behalf of successive governments with the aim of growing productivity, very little has changed.

This survey was conducted with 695 Australian directors and governance leaders who are members of the AICD. It reveals a solid and consistent theme: that short-term decision making and a lack of leadership are impacting business productivity in Australia. These factors limit the ability of businesses to plan for the future, to make decisions that lead to more jobs and investment and significantly, to innovate.

The survey also reveals some interesting perspectives about the purpose of business and the role directors see corporations playing in our society – bringing into question the traditional role of the director, particularly in light of changing stakeholder expectations and a blurring of what were once clear roles for the private and public sectors.

Specifically, the survey found that:

- Australian business is frustrated with the political situation. Directors feel that a lack of political courage is the key inhibitor of long-term productivity reform initiatives.
- Training and skills development could 'turn-the-dial' on productivity and requires a renewed focus and investment. Directors believe that this is the responsibility of management.
- Engaging in public debate on issues affecting productivity and implementing better practices in their own businesses are seen as the most important activities directors can undertake to influence public policy and champion reform.
- Directors acknowledge that the business sector has a clear role to play in driving productivity reform in Australia, although most tend to believe it requires a combined approach between the public and private sectors.
- Half of respondents believe the social contract between corporate Australia and Australian society needs to be renegotiated.
- There is a clear recognition from directors that businesses must play a role in supporting social cohesion.

These issues lie at the heart of Australia's productivity challenge. It is clear from the survey and this resulting report, that the director community, and the business community more broadly, are keen to play a leadership role in tackling this complex problem.

Productivity and its payoffs

Stephen Walters MAICD
Chief Economist
Australian Institute of Company Directors

Australia still has a productivity problem, despite recent signs of improvement. Indeed, since the mining investment boom kicked off in earnest more than a decade ago, productivity has been slowing. In fact, from 2003 until the end of last year, productivity growth averaged barely one per cent per year, well short of the glory days of the late 1990s, when output per hour grew four per cent.

Productivity improvements can be difficult to achieve, but are crucial to our national well-being. Working longer hours won't achieve the necessary improvement – it is a rise in output per hour that counts. Higher productivity requires all of us to work "smarter", and involves better interaction between all factors of production, not just our labour.

To be fair, productivity is cyclical, influenced by structural changes like the boom in mining investment and the earlier IT bonanza in the US. But the longer-term trend in Australia has been poor. In fact, for much of the last decade, productivity not only was sluggish, but falling. This pushes up business costs and compromises our international competiveness.

Moreover, weak productivity has profound implications for potential growth – the economy's speed limit – which in turn affects employment, incomes and our standard of living. Potential growth is determined by productivity and population growth, which also is slowing, partly because of the inevitable drag from ageing.

Slower potential growth means the economy can't run as quickly as before – it overheats faster as spare resources are exhausted sooner. Inflation results, ultimately requiring higher interest rates which cruel growth prospects. It is a vicious cycle that is difficult to reverse.

Eminent economist Professor Ross Garnaut AO calls our extended period of suboptimal productivity "the Great Australian Complacency", a period of "easy prosperity" when we didn't have to worry about sagging productivity because our terms of trade – the ratio of export prices to import prices – continued to rise. National income grew strongly as a result, despite weak productivity.

Our terms of trade, however, peaked back in 2012 and has since halved. So, the onus is back on productivity to deliver prosperity. There had been signs of improvement, but the recent National Accounts showed another slump in productivity as real GDP also fell, only the fourth such occurrence in the last 25 years.

The earlier improvement partly reflected the cooling of the mining investment boom as projects are completed and output begins. This transformation generates favourable arithmetic for productivity and has further to run.

But, it is important to examine what went wrong over the previous decade. Complacency was a major factor – the motivation to innovate and better use our technology is fleeting when your income is soaring. Few of us work for mining companies, but we all benefited from the largest rise in the terms of trade since the 1890s.

Also, there was the decade-long run-up in investment in resources, where projects are notoriously lumpy. It takes years to construct multi-billion dollar facilities and associated infrastructure, with no output until the project is completed. This creates havoc for the productivity calculations.

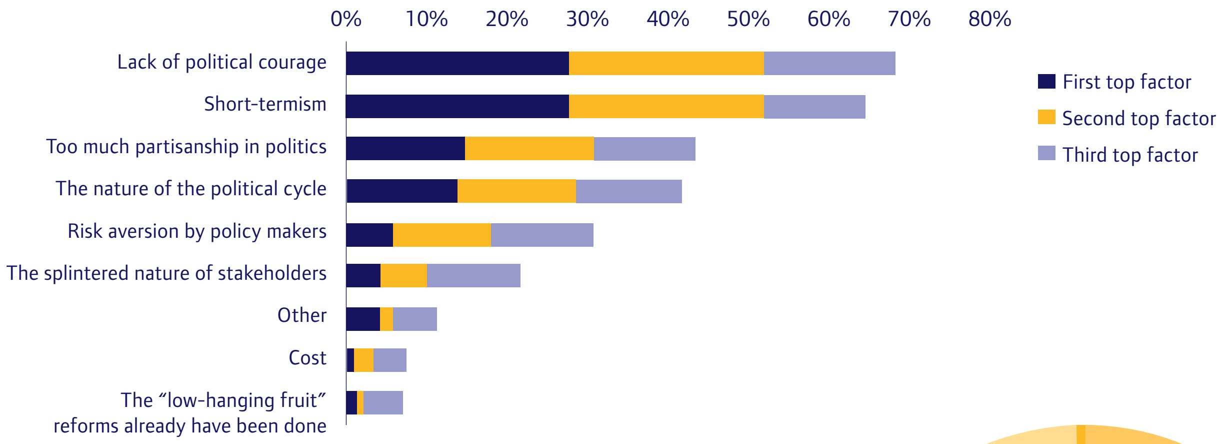
But, policymakers need to take a large share of the responsibility for our failings. There have been few lasting structural reforms in the last 15 years that have added to the economy's efficiency. Since tax reform in mid-2000, there has been little bold reform that comes to mind. There were important workplace changes along the way, but many of these later were unwound. Little else has endured.

Things were very different in the 1980s. There were profound microeconomic reforms back then that generated long-term pay-offs including higher productivity. To be fair, these reforms were often driven by crisis or recession, which Australia has avoided for more than two decades. There was welcome bipartisan political support for many of the changes back then – this is sadly lacking today.

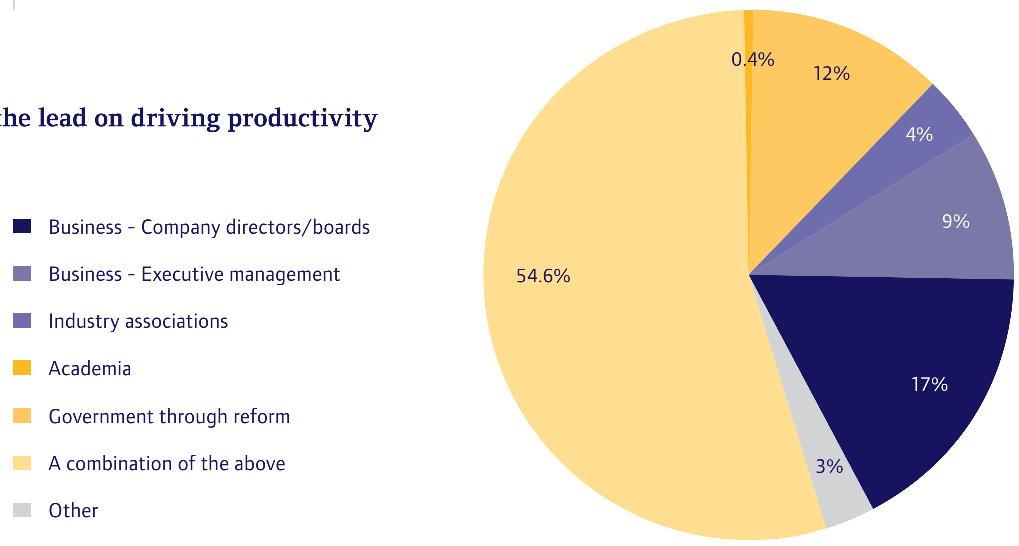
The absence of a crisis may explain the lack of enduring reform recently, but doesn't excuse it. Governments lose political skin making difficult changes, only for the longer term rewards to go to their opponents; no wonder many politicians are reluctant to sponsor reform. Moreover, much of the low-hanging fruit already has been picked.

For too long the private sector has held back, hoping politicians will overcome their reform inertia. This partly explains the lack of investment outside mining, and the private sector's puzzling reluctance to drive the reform debate. While this survey shows that directors endorse a combined effort to drive productivity, as an economist, it is my view that industry should take the lead.

Graph 1: What, in your view, are the top three factors holding back long-term productivity reform initiatives by governments?



Graph 2: Who should take the lead on driving productivity reform in Australia?



"It is worth questioning whether directors can truly set their sights on long-term value creation if profit is the primary purpose of the company."

Lucas Ryan GAICD

What is the purpose of business?

Lucas Ryan GAICD
NFP Policy Adviser
Australian Institute of Company Directors

In 1970, Milton Freidman wrote in a *New York Times* article that the only social responsibility of companies is to create profit.[1] This idea, commonly called 'shareholder primacy', has dominated the structure and regulation of markets (including some interpretations of directors' duties) since the industrial revolution.

But sentiment is shifting. As this survey found, only three per cent of directors felt that corporate Australia had no role in supporting social inclusion, indicating that it is well accepted that business must play a part in addressing inequality. But the question of what role business should play has been left largely unanswered.

Graph 3: What is the role of corporate Australia in supporting social inclusion?

[1] Milton Friedman, 'The Social Responsibility of Business is to Increase its Profits', *New York Times*, New York, September 13 1970

Among OECD countries, inequality is at its greatest in 30 years,[2] not only in terms of wealth, but also education, employment, health, and the extent to which human rights are upheld.

In our research, 89 per cent of directors felt that the inequitable distribution of benefits contributed to fraying social cohesion (the ability of members of a society to cooperate in order to survive and prosper)[3] in Australia.

Many now recognise the role of corporations in creating (or eroding) equality. This reflects a growing appreciation from business that extreme inequality harms economic growth, largely owing to its corrosive effect on the accumulation of human capital.[4]

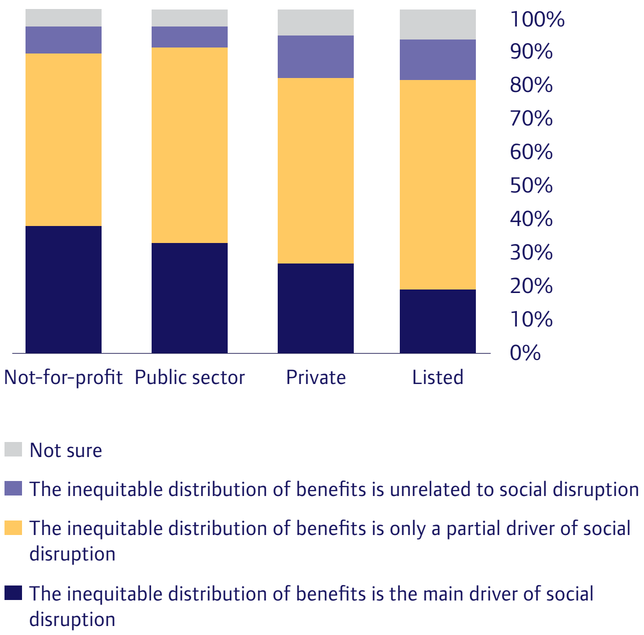
Companies appreciate this and are increasingly giving consideration to interests other than profit in assessing their performance. Ninety per cent of the ASX200 provide some level of reporting on environmental, social and governance (ESG) factors,[5] demonstrating that such considerations are now firmly embedded in Australia's corporate psyche.

When the broader community bears the bulk of negative ESG impacts while investors reap the financial rewards, the imbalance is sometimes viewed through the prism of the 'social licence to operate' (SLO). SLO refers to the broad acceptance of a business' operations by a community. Our study showed that 76 per cent of directors perceived a connection between an organisation's productivity and its SLO, indicating that consideration of broader community interests are critical to business success.

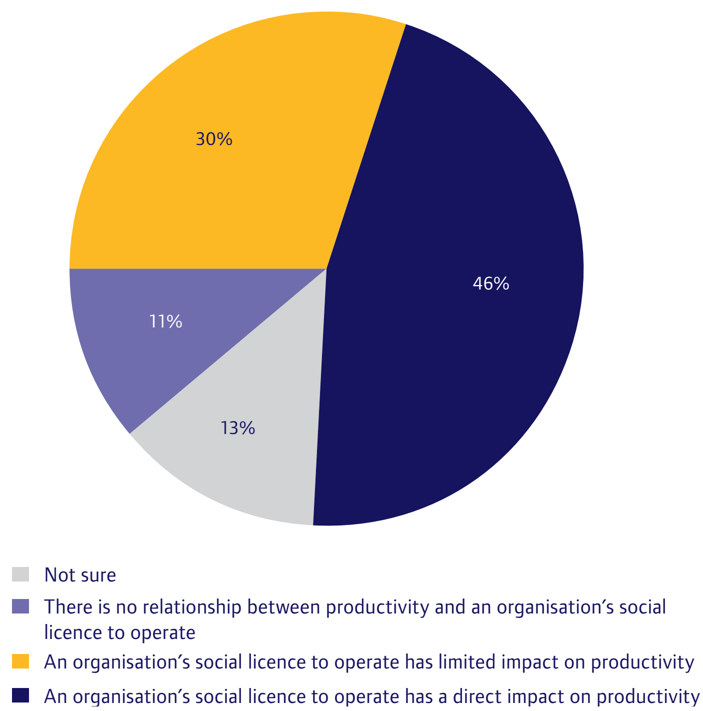
However, these frameworks still interpret social and environmental considerations through the lens of their relationship to profit. For example, a farming company might prioritise environmental factors only to the extent that they could undermine operations or cause reputational damage.

At the very least, it should be possible for directors to give reasonable weight to such factors in decision-making without considering them exclusively as they relate to profit. To do this, it must be possible to embed considerations such as SLO as part of a company's purpose.

Graph 4: To what extent is the inequitable distribution of benefits contributing to the fraying of social cohesion in Australia?



Graph 5: In your view, is there a connection between productivity and an organisation's social licence to operate?



[2] OECD, 2015, All On Board: Making inclusive growth happen, OECD Publishing, Paris, p. 11

[3] Scanlon Foundation, 'Social Cohesion', <http://scanlonfoundation.org.au/social-cohesion/> (accessed 30 January 2017)

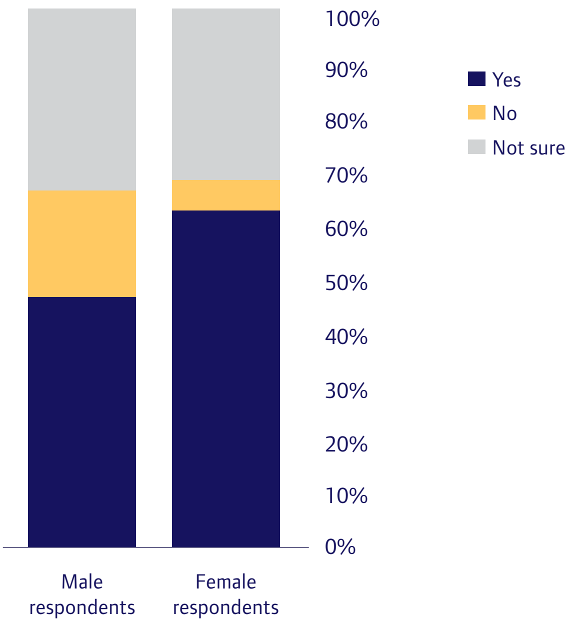
[4] OECD, 2014, 'Focus on income inequality and growth', <https://www.oecd.org/social/Focus-Inequality-and-Growth-2014.pdf> (accessed 30 January 2017)

[5] Australian Council of Superannuation Investors, 2016, 'Corporate Reporting in Australia: Progress in disclosure of sustainability risks among S&P/ASX200 companies', <https://acsi.org.au/images/2016SustainabilityReportFINALweb.pdf'> (accessed 30 January 2017)

The 'benefit corporation' is an emerging incorporation model which seeks to address this imbalance by providing long-term mission alignment with value creation. They allow companies to raise capital and trade publicly while also providing a specific legal obligation for directors to consider mission-related factors in decision-making. Thirty-one American states already provide this incorporation type[6] and interest in such structures is growing globally.

This interest reflects recognition among corporations, communities and legislators that there may be a need to re-think the implicit 'social contract' between business and the community. In our survey, we asked directors whether there was a need to renegotiate this 'social contract'. Of all our questions, this received the most polarising results; from those rejecting that a social contract exists at all to those calling for its radical and immediate revision.

Graph 6: Does the social contract between corporate Australia and Australian society need to be renegotiated?



Half of directors felt that the social contract needed to be renegotiated and only 18 per cent disagreed. Interestingly, 30 per cent of respondents were 'not sure', indicating a need for a more inclusive debate about this issue and for the creation of a common language to establish a dialogue on the relationship between business and the community, and how it should be governed.

If boards are to set their sights on long-term value creation, it is necessary to consider whether profit as the primary purpose of a company provides the right foundation to do this, or whether it will ultimately hollow out longer-term sources of prosperity. Short-termism is cited as the scourge of good governance, but is it possible to truly focus on the long-term without considering, on some level, the community's interest in and thereby acceptance of a corporation's activity?

When considering what the right balance is for the purpose of a corporation, it is worth reflecting on what role we want business to play in our society, and to what extent the focus on maximising profit undermines equality and therefore long-term, sustainable economic growth. The purpose of business should be found in the answer to this question.

6 B Lab, 2017, 'Benefit Corporation: State by state comparison of legislation', <http://benefitcorp.net/policymakers/state-by-state-status>, (accessed 30 January 2017)

"In the context of broader productivity and social issues, the traditional role of directors may need to be reconsidered."

Sally Freeman GAICD

The director's role

Sally Freeman GAICD
Partner in Charge
KPMG Australia's Risk Consulting Group

In the context of broader productivity and social issues, the traditional roles of directors may need to be reconsidered.

Interestingly, there now appears to be a blurring of what were once clear roles for the public and private sectors. Traditionally, the public sector focused on working for the interests of the broader community, where the private sector tended to focus solely on the interests of shareholders. This was a natural evolution of enterprise and government which to a large extent still remains. It is apparent however, that over the last several decades, the complexity of political, social and economic issues has created a change in stakeholder expectations, consumer behaviours and the focus of some shareholders and investors. An emerging expectation for private entities to focus on the interests of the broader community results in social accountability driving corporate value. Similarly, government entities are being urged to become more commercially minded. This is driven largely by budget/fiscal pressures or through changing business models, leading to public/private partnerships becoming more common – particularly for larger-scale infrastructure projects.

A strong theme out of the survey was leadership, more specifically, political leadership of governments who are perceived to operate in a short-term policy capacity based on three-year political cycles. Qualitative responses were grouped into themes which indicated that roughly 68 per cent of respondents cited a lack of political courage at government level as a major barrier to improving productivity (see Graph 1, page 7).

More specifically, respondents were looking for open dialogue with politicians and public servants through clearer and more well-defined engagement opportunities in the form of regular open forums, more direct channels of engagement and greater transparency with respect to processes and outcomes.

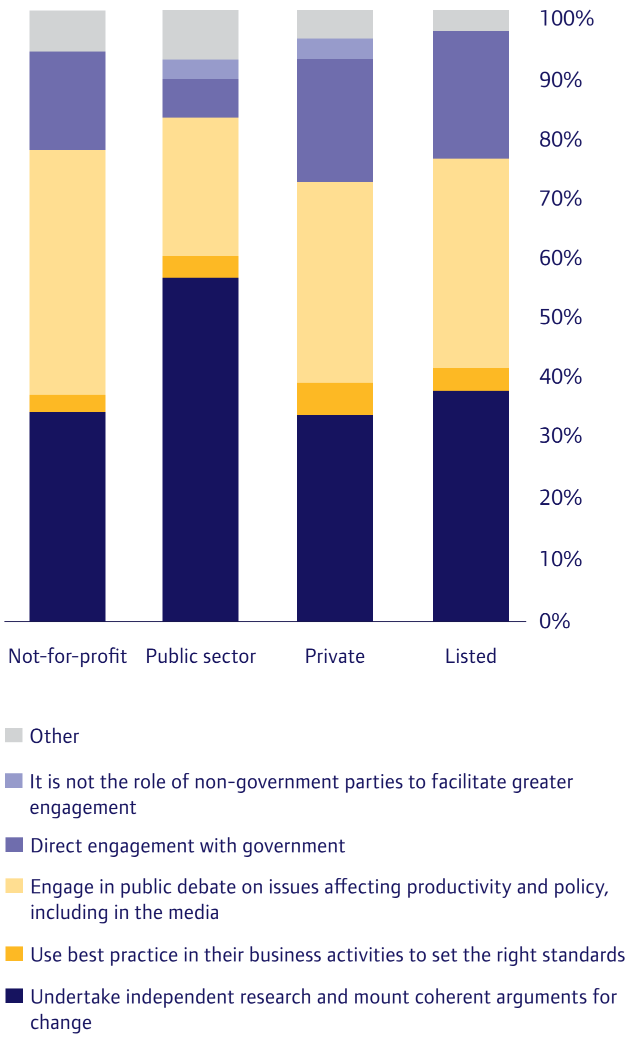
Some directors (18 per cent) felt that greater representation from industry bodies such as AICD and the Business Council of Australia (BCA) would be a useful mechanism for more structured and transparent engagement.

The impacts of a lack of engagement were seen to be driven by a lack of political will and “short-termism” within policy development. A three year political cycle was considered by 43 per cent to drive short-term thinking and inhibit governments from actively engaging on a longer-term structural reform agenda to tackle issues such as infrastructure, productivity and social cohesion.

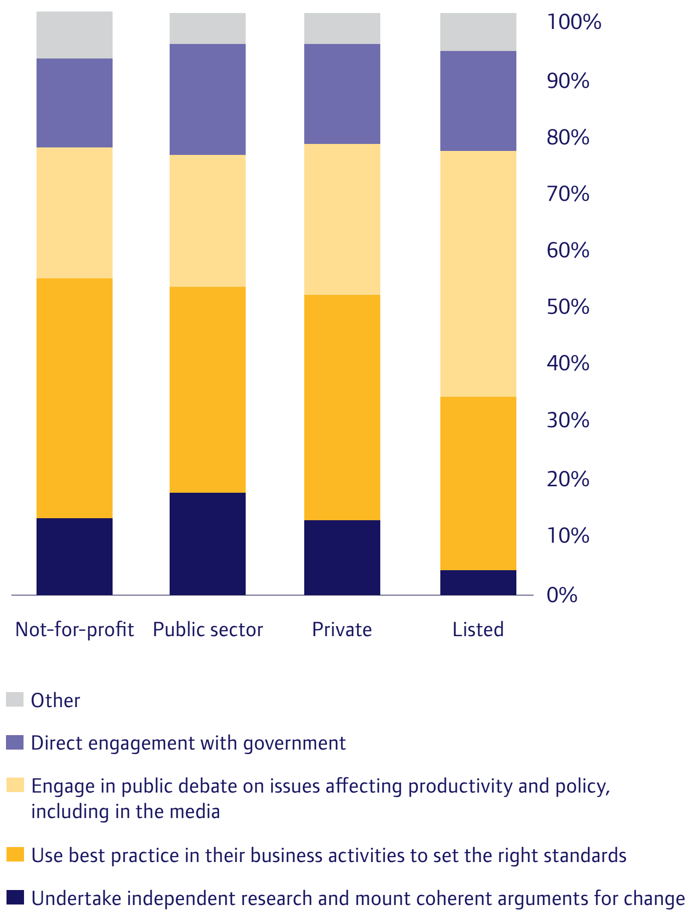
When posed questions regarding social cohesion and the links to productivity, the survey provided some interesting and vastly contrasting results. These questions were often the most polarising.

Interestingly, while some directors indicated that they were unclear on the definition of "social contract", 50 per cent believed that the social contract between corporate Australia and the community needed renegotiating (62 per cent of females and 47 per cent of males).

Graph 7: What role should non-government parties (e.g. industry bodies, the AICD) play in facilitating greater engagement?



Graph 8: What is the most important thing directors should do to champion reform, influence public policy and encourage long-term thinking?



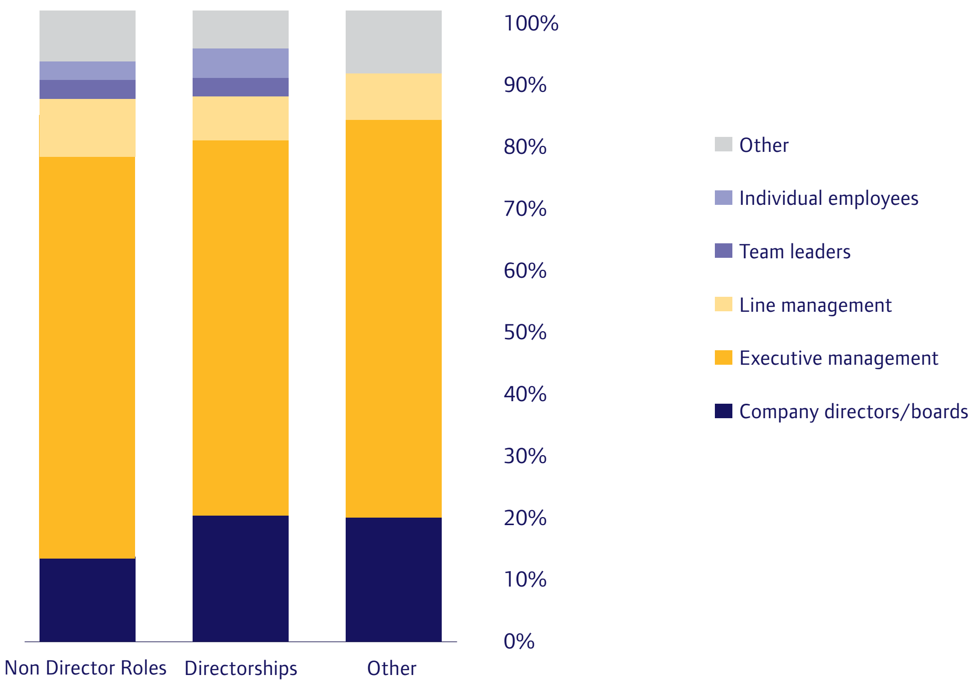
The survey responses raise a range of interesting questions about the role of directors in the corporate, NFP or public sectors. For example:

- In the absence of governments and or industry bodies being more proactive in how they engage, how, if at all, would the role of boards and directors need to change to facilitate greater engagement on policy issues, both short and long-term?
- While a significant number of respondents feel hamstrung by short-termism and a lack of government investment of long-term resources or policy/regulation to reduce cost and create more certainty for businesses to invest, what can – or should – directors/boards do collectively or individually? Is the board's role to simply manage the short-term impacts on their organisation or can (should) they take a more proactive approach, encouraging industry to take the lead – and possibly forcing governments to respond?
- In the context of potential changes to the role of the board, are there any specific skills, behaviours or aspects of a director's role that need to change from the traditional way of thinking?
- In organisations, there is strong consensus (73 per cent of respondents) that management are responsible for reskilling an organisation's workforce. The question remains, however, as to who is responsible for upskilling the board?

  Better practice governance would suggest that the board is responsible, as all directors must be individually and collectively accountable for their overall performance. KPMG suggests that boards often find it difficult to accurately self-assess or successfully identify gaps, and then fail to adequately address such gaps through professional development programs or recruitment and turnover.

How well are some of the emerging dependencies between productivity and social cohesion understood? It appears that as well as individuals having different definitions of social cohesion, there is also a diverse range of views with respect to the role of corporates in facilitating greater social connectivity and inclusiveness. Just as governments are having to re-think their role in a more productive and profit-driven environment, boards also need to make an assessment about what role they should play in meeting the needs of the broader community – that will be an individual decision for each director and each board collectively.

Graph 9: Who should have principal responsibility in your organisation for upskilling the organisation's labour force to improve productivity and promote social cohesion?



Detailed survey findings

1. Profile of respondents

Role category: 695 respondents	Listed	Not-for-Profit	Private	Public	Not stated	Total
Directorships	7%	14%	39%	6%	1%	**67%**
Non director roles	5%	7%	12%	6%	4%	**33%**
Total	**12%**	**21%**	**51%**	**12%**	**5%**	**100%**

2. What in your view are the top three factors holding back long term productivity reform initiatives by governments?

Survey answer	First top factor Percentage of survey answers	Second top factor Percentage of survey answers	Third top factor Percentage of survey answers
Lack of political courage	28%	24%	16%
Short-termism	28%	24%	13%
Too much partisanship in politics	15%	15%	19%
The nature of the political cycle	14%	15%	14%
Risk aversion by policy makers	6%	12%	14%
The splintered nature of stakeholders	4%	6%	11%
Other	4%	1%	6%
Cost	1%	2%	3%
The “low-hanging fruit” reforms already have been done	1%	0%	4%

3. How important is a renewed focus on training and skills development in driving productivity?

Survey answer	Percentage of survey answers
Not important at all	0.14%
Not very important	3.74%
Somewhat important	22.01%
Very important	34.24%
Extremely important	39.86%

4. What is the most important thing directors should do to champion reform, influence public policy and encourage long-term thinking?

Survey answer	Percentage of survey answers
Engage in public debate on issues affecting productivity and policy, including in the media	33%
Use best practice in their business activities to set the right standards	31%
Direct engagement with government	15%
Undertake independent research and mount coherent arguments for change	13%
Other	6%
It is not our responsibility to champion reform, influence public policy and encourage long term thinking	2%

5. Assuming directors want to take a more active role in influencing long-term policy development, what in your view are the top three barriers?

Survey answer	First top factor: Percentage of survey answers	Second top factor: Percentage of survey answers	Third top factor: Percentage of survey answers
Concern regarding potential stakeholder/shareholder reaction	22%	17%	11%
Limited opportunity to engage with government	28%	13%	8%
Unwillingness of directors to engage	12%	15%	12%
Resource constraints	8%	13%	14%
Lack of awareness and knowledge of the issues	9%	11%	8%
Lack of action from peers	3%	8%	13%
Completeness of/access to publicly available data	5%	9%	7%
Industry positioning	4%	5%	12%
Potential loss of lobbying ability/influence	3%	7%	8%
Other	7%	3%	6%

6. What role should non-government parties (e.g. industry bodies, AICD) play in facilitating greater engagement?

Survey answer	Percentage of survey answers
Undertake independent research and mount coherent arguments for change	36%
Engage in public debate on issues affecting productivity and policy, including in the media	36%
Direct engagement with government	18%
Other	6%
Use best practice in their business activities to set the right standards	4%
It's not the role of non-government parties to facilitate greater engagement	1%

7. Who should have principal responsibility in your organisation for reskilling the organisation's labour force to improve productivity and promote social cohesion?

Survey answer	Percentage of survey answers
Executive management	68%
Company directors/boards	18%
Other	7%
Line management	6%
Individual employees	1%
Team leaders	1%

8. Who should take the lead on driving productivity reform in Australia?

Survey answer	Percentage of survey answers
A combination of above	55%
Business - Company directors/boards	17%
Government through reform	12%
Business - Executive management	9%
Industry associations	4%
Other	3%
Academia	0%

9. To what extent is the inequitable distribution of benefits contributing to the fraying of social cohesion in Australia?

Survey answer	Percentage of survey answers
The inequitable distribution of benefits is only a partial driver of social disruption	61%
The inequitable distribution of benefits is the main driver of social disruption	28%
The inequitable distribution of benefits is unrelated to social disruption	8%
Not sure	3%

10. In your view, is there a connection between productivity and an organisation's social licence to operate?

Survey answer	Percentage of survey answers
An organisation's social licence to operate has a direct impact on productivity	46%
An organisation's social licence to operate has limited impact on productivity	30%
There is no relationship between productivity and an organisation's social licence to operate	13%
Not sure	11%

11. Does the social contract between corporate Australia and Australian society need to be renegotiated?

Survey answer	Percentage of survey answers
Yes	50%
Not sure	31%
No	18%

12. What is the role of corporate Australia in supporting social inclusion?

Survey answer	Percentage of survey answers
Corporate Australia needs to find a balance between supporting social cohesion and giving a voice to emerging concerns	56%
It is essential corporate Australia supports social inclusion	36%
Not sure	5%
Corporate Australia has no role to play in supporting social cohesion	3%

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