



The relationship between corporate governance and community engagement: Evidence from the Australian mining companies

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ABSTRACT

We investigate whether effective corporate governance mechanisms help improve firm-level community engagement activities, using a sample of Australian mining companies for the period 2005–2013. We firstly document that effective board structure and functionality positively contribute to mining companies' community engagement. Secondly, we analyze the components of community engagement and examine each of them individually with governance mechanisms. The results show that the effects on engagement with indigenous people and indirect economic are mostly significant and profound. Thirdly, we hypothesize that firm performance proxied by dividend yield can moderate the relationship between governance mechanisms and community engagement. Our empirical results support this hypothesis, suggesting that dividend yield mitigates the negative effects of the largest shareholders ownership and strengthens the positive effects of board size, board meeting and the presence of CSR committee on community engagement level.

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Introduction

Australian mining companies have a long history with the Australian Stock Exchange (ASX). Thanks to the recent mining boom, mining companies represent about one-third of all ASX-listed companies. In terms of market capitalization, the mining sector accounts for 20% of the total stock market reaching A\$320 billion¹. Representing about 10% of GDP in Australia², the mining sector in total generated an operating profit before tax of A\$17.6 billion in 2008–09³ when the resource boom peaked. The issue of how to levy and allocate the super profit⁴ effectively during the boom has been debated among various interested groups, including the mining industry, the federal government, state governments and Australian

households. According to the Australian Bureau of Statistics⁵, in 2011–12 Australian mining companies paid A\$21 billion for company tax and royalty. Besides, they employed 187,400 people directly and an additional 599,680 in supporting and related industries. In remote Australian mining districts, it is the largest non-government sector employer of indigenous Australians. All in all, it is undeniable that mining contributes significantly to the Australian economy and provides numerous supports to the local community.

Nevertheless, the public in Australia believe that big miners have not paid enough tax to compensate their damages to the local community as shown in a recent survey⁶. Oppositions and resistance from the local community are widely documented (Davis and Franks, 2011; Moffat and Zhang, 2014). Community opposition comes from many concerns, including environmental contaminations that pollute water and soil quality, relocation of local communities, increases in living cost due to the massive inflow of mining labor, and so forth. To address these concerns, mining companies need to engage in community activities to build legitimacy in operating community (Lowndes et al., 2001). Hence, community

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¹ http://www.asx.com.au/investor/industry/mining/asx_involvement.htm.

² "Economic Irrationalism". Sydney Morning Herald, 2012/03/12.

³ Release of 8418.0 – Mining Statistics Newsletter, 2009–2010, Australian Bureau of Statistics.

⁴ The so-called super profit tax, also referred to as the Minerals Resource Rent Tax (MRRT), was introduced on July 1, 2012 by the Australian Labor Government. The levy of MRRT was on the "super profits" from the iron ore and coal mining in Australia. It only applied to companies with an annual profit reaching \$75 million and small companies with small profit were exempted. As the new coalition government won the election, they announced the repeal of the MRRT on October 24, 2013.

⁵ Minerals Council of Australia – 2011–2012 Pre-Budget submission, http://www.mineralscouncil.com.au/file_upload/files/submissions/MCA_Pre%20Budget_FINAL.pdf.

⁶ A poll conducted by UMR research on January 2014. <http://www.smh.com.au/federal-politics/political-news/big-miners-in-firing-line-over-tax-payments-20140115-30va9.html>.

engagement is vital for mining companies' long-term project development as any inadequate or inappropriate engagement can pose a risk to mining operations and the community in which they operate (Esteves, 2008; Kemp, 2010; Kemp and Owen, 2013). For example, BHP Billiton acknowledges potential community-related risks⁷ in their annual report, such as community protests or civil unrest that can delay proposed developments or adversely impact production.

In the mining industry, the term 'community' generally refers to the inhabitants of immediate and surrounding regions that are influenced in some way by a company's operations (Harvey and Brereton, 2005). To be responsible entities, mining companies need to consider positive and negative impacts they bring to the community in which they operate. In order to deal with negative impacts from mining operations and acquire operational approval from the local residents, mining companies engage in community activities to fulfill their responsibilities to the community. They consider successful implementations of community engagement as one of companies' bottom line target (see e.g., The BHP 2013 Annual Report; Harvey and Brereton, 2005). Companies can have options in choosing engagement models and activities and a set of appropriate engagement strategies, which depend on external and internal factors. External factors can be community citizen's attitude and preference which compel firms to implement strategies to meet the particular needs (Brammer and Millington, 2003). Internal factors include firm corporate governance models and firm financial positions, which are the focuses of our studies.

To the best of our knowledge, the research on mining companies' corporate governance is relatively limited, though the issues of failed corporate governance monitoring are often discussed following major mining accidents in the past. For example, the BP Deepwater Horizon oil spill had triggered a number of debates on the effectiveness of corporate governance on the prevention of mining tragedy (Lin-Hi and Blumberg, 2011). There are competing arguments proposed based on different theories and hypotheses on the relationship between corporate governance and community engagement. On one hand, based on the agency theory (Jensen and Meckling, 1976), corporate governance is designed to safeguard the principal's interest from the agent's misconduct. Therefore, a sound corporate governance system should prompt the management of mining companies to engage in successful community activities to protect investors from any damage caused by mishandling. If mining companies can utilize effective governance mechanisms jointly with community engagement to resolve conflicts among stakeholders, community engagement is subsequently supposed to be positively related to effective corporate governance mechanisms.

On the other hand, effective corporate governance is also used to align the interest between principal and agent. A responsible CEO should invest in community engagement for the benefit of the company as a whole rather than for personal benefits. However, CEOs' decisions on community projects investment are not always beneficial to the company and stakeholders. Jensen (1986) suggests that management may utilize the free cash flow to embark on negative NPV projects in their own interest when there are information asymmetries and lack of effective mechanisms to align the interests between investors and management. Empirical evidence documents that overconfidence and dominance are the two essential factors that cause the CEOs to overvalue investment projects and spend internal finance inappropriately (see, e.g., Malmendier and Tate, 2005b; Brown

and Sarma, 2007). Therefore, if overconfident managers invest in CSR for their own reputation building, rather than maximizing firm's value, their behaviors are considered as value destroying and harmful to the investors (Malmendier and Tate, 2005a). Jo and Harjoto (2012) find that effective corporate governance mechanisms can prevent affiliated management from overinvesting in CSR because overinvestment can cause potential damage to shareholders. Therefore, they hypothesize a negative association between corporate governance and CSR choice since more effective internal and external governance monitoring should lower management's motivation and chances for CSR overinvestment. Following this prediction, community engagement, as a component of CSR, is considered not to be positively associated with corporate governance mechanisms which are used to restrain overinvestment in CSR.

Due to the competing arguments, the relationship between corporate governance and community engagement remains open for discussion. Limited empirical studies to date have been conducted to investigate whether corporate governance contributes to or mitigates community engagement level. Motivated by this literature gap, our main research objective is to investigate this relationship and dig it deeper by classifying community engagement into various components before individually testing each component. We find that firms with higher index in board structure and functionality are associated with higher level of community engagement activities after controlling for firm-level variables. The potential interpretation drawn from the positive relationship indicates that board structure is an important element in guiding mining companies' engagement in community activities to protect investors from future damages. In addition, board functionality, another vital board characteristic, affects the performance of engagement strategy. Moreover, the mining companies which reach required committee independence level and have high CSR index are found to be positively associated with community engagement components. We however observe that the largest shareholders' ownership is negatively associated with community engagement. As the controlling ownership increases, the effectiveness of governance mechanisms gradually declines⁸ and this sequentially reduces the engagement level. In addition to the main research objective, we also attempt to investigate whether the relationship of corporate governance and community engagement is conditional on firm performance, proxied by dividend payout ratio. We find that as firms perform better they are likely to have more investments in community engagement activities.

Our paper contributes to the literature two-fold. Firstly, we provide empirical evidence that effective corporate governance encourages community engagement based on agency theory and stakeholder theory. Effective governance structure should protect principal's interest against any future community-related accidents via prompting management to invest responsibly in community engagement. Engagement itself should be considered as the outcome of effective governance which is applied by mining companies to build legitimacy and attain a social license to operate. The importance of community engagement motivates us to investigate its determinants and how they work together. Secondly, our research provides a generalization to other mining intensive economies. The Australian mining investment has reached \$125 billion in the past 10 years and provided more than 680,000 employment opportunities totally⁹. As mining accounts

⁷ As shown in p. 12, The BHP Billiton 2012 Annual Report, "...local communities may become dissatisfied with the impact of our operations or oppose our new development projects, including through litigation, potentially affecting costs and production, and in extreme cases viability. Community related risks may include community protests or civil unrest, delays to proposed developments and inadvertent breaches of human rights or other international laws or conventions."

⁸ Corporate governance mechanisms and controlling ownership are negatively correlated as documented in previous findings (see, e.g., La Porta et al., 1999; Wu et al., 2009), suggesting that firms with certain level of concentrated ownership can gradually alleviate agency cost. Firms with concentrated controlling ownership can entrench the controlling investors from the exploitation of management and act as an alternative to the traditional corporate governance mechanism.

⁹ Minerals Council of Australia – 2011–2012 Pre-Budget submission, http://www.mineralscouncil.com.au/file_upload/files/submissions/MCA_Pre%20Budget_FINAL.pdf.

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