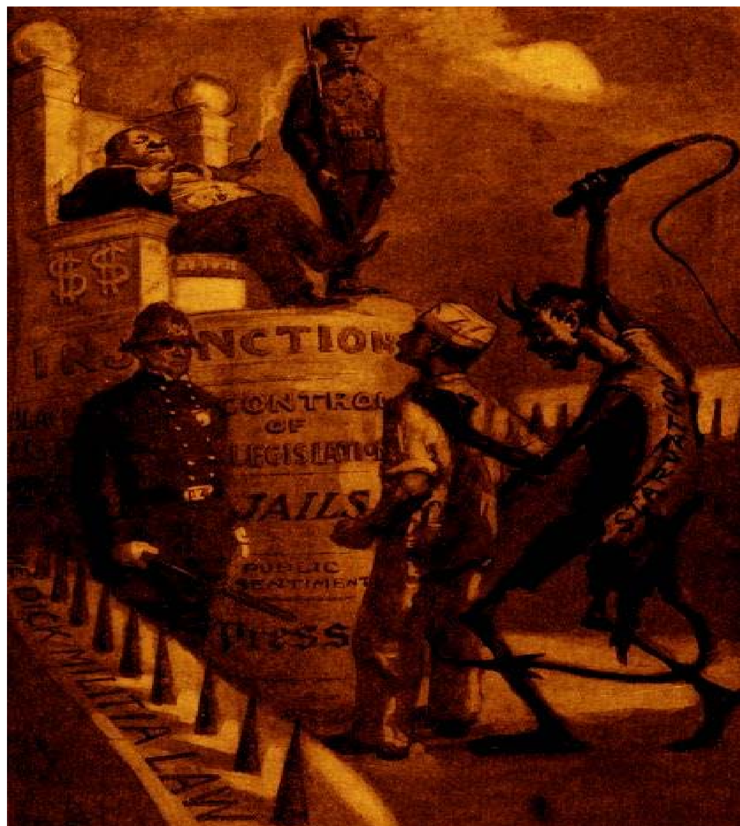
RESEARCH REPORT

Corporate Governance and its Contribution to Higher Standards of Accountability and Business Performance



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1. INTRODUCTION

This review is an examination in summary, of the various corporate governance principles and the effect their adoption can have (in a practical, specific, situational sense), in lifting:

- the competencies of directors, and managers, and the level and quality of internal control, compliance and risk management.
- the contribution of the adoption of higher standards of accountability, business performance and disclosure.
- the preservation of investor confidence access to financial markets.

The Australian Stock Exchange's description of corporate governance, which I consider to be practical and understandable, is described as a system by which companies are directed and managed. It influences how the company objectives are set and achieved, how risk is monitored and assessed, and how performance is optimised. Good corporate governance structures encourage companies and their people to create value (through entrepreneurship, innovation, development and exploration) and provide accountability and control systems relative to the risks involved.

Corporate governance is a multi-faceted subject. An important part of corporate governance deals with accountability, fiduciary duty, disclosure to shareholders and others, and mechanisms of auditing and control. In this sense, corporate players should comply with codes to the overall good of all constituents. Another important focus is economic efficiency, both within the corporation (such as the best practice guidelines) as well as externally (national institutional frameworks). In this "economic view", the corporate governance system should act not only in the interest of shareholders, but also all the other stakeholders.

In recent years there has been a lot of interest in the corporate governance practices of modern corporations, particularly since the high profile collapses of large firms such as Enron Corporation, WorldCom and in Australia HIH. Corporate governance encompasses the framework of rules, relationships, systems and processes by which fiduciary authority (held in trust) is exercised and controlled in corporations. Rules include applicable laws of the land as well as internal rules of the corporation.

The most important relationships exist between the owners, managers, directors of the board, regulatory authorities and to a lesser extent employees and the community at large. Systems and processes deal with matters such as delegation of authority, performance measures, assurance mechanisms, reporting requirements and accountabilities. Key elements of good corporate governance principles include honesty, trust, integrity, openness, performance orientation, responsibility and accountability, mutual respect and commitment to the organisation.

2. Issues involving corporate governance principles - include:

- Oversight (failure to disclose or inaccurate disclosure) in the preparation of the entities financial statements.
- Poor internal controls and independence of the company auditors
- Review of the compensation arrangements for the chief executive officer and other senior executives.
- The way in which individuals are nominated for positions on the board.
- The resources made available to directors in carrying out their duties.
- The oversight and management of risk.
- Dividend policy.

Recent international developments in corporate governance guidelines and controls such as in the United States with the introduction of the Sarbanes-Oxley act, which came into force in July 2002, followed by Australian Stock Exchange release of the Principles of Good Corporate Governance and best Practice in 2003.

The approach of the Australian Government and the ASX is based on disclosure rather than prescriptive rules however mandated requirements do exist in respect of the CLERP 9 Act's new CEO/CFO sign off to directors and Audit Committee requirements under the listing rules for listed entities in the S&P All Ordinaries Index.

The CLERP 9 Act, which came into effect in June 2004, represents the Governments legislative approach to the reform agenda for corporate governance which has included significant initiatives such as:

- The Ramsey Report on the independence of Australian company directors.
- Developments in the US with changes to the New York Stock Exchange Listing Rules and the enactment of the Sarbanes-Oxley Act in 2002.
- Developments in the UK with the release of the Higgs Report on non- executive directors, the Smith Report on the audit function and proposed changes to the Combined Code.
- The ASX's Listing Rules amendments on Enhanced Disclosure and corporate governance,
- The establishment of the ASX Corporate Governance Council and the release by the Council of its Principles of Good Corporate Governance and Best Practice Recommendations in March 2003.
- The adoption of some of the recommendations contained in the HIH Report.
  Allens Arthur Robinson, Corporate Governance Site, CLERP 9 – Overview, 2005.

3. Essential Principles of Corporate Governance – ASX 2003

A company should:

1. **Lay solid foundations for management and oversight.**
   Recognise and publish the respective roles and responsibilities of board and management.
2. **Structure the board to add value.**
   Have a board of an effective composition, size and commitment to adequately discharge its responsibilities and duties.
3. **Actively promote ethical and responsible decision making**.
4. **Safeguard integrity in financial reporting**.
   Have a structure to independently verify and safeguard the integrity of the company's financial reporting.
5. **Make timely and balanced disclosure on all matters concerning the company.**
6. **Respect the rights of shareholders and facilitate the effective exercise of those rights.**

7. **Recognise and manage risk.**
   Establish a sound system of risk oversight and management and internal control.
8. **Encourage enhanced performance.**
   Fairly review and actively encourage enhanced board and management effectiveness.
9. **Remunerate fairly and responsibly.**
   Ensure that the level and composition of remuneration is sufficient and reasonable and that its relationship to corporate and individual performance is defined.
10. **Recognise the legitimate interests of stakeholders.**
    Recognise legal and other obligations to all legitimate stakeholders.

The ASX has taken a principles based approach whereby Issuers may choose not to comply with the principles, but, when they do not, must disclose ("why not") how and why they have done this, so that the only compliance required is disclosure other than the CLERP 9 amendments described above.
On the opposite end of the spectrum, the hastily introduced Sarbanes-Oxley Act of the United States is a rule's based prescriptive act which has ongoing onerous legal and compliance issues. While it is fair to say that no approach has avoided criticism, the ASX guidelines have been criticized for being too "self-regulated" and passive whereas the Sarbanes-Oxley Act as being too inflexible, legalistic and rules based.
In response to both the collapse of Enron and the general influx corporate malfeasance in the US, the Sarbanes-Oxley Act became Law in July 2002.

4. The Key Provisions of the Sarbanes-Oxley Act are:

- CEO/CFO sign-off to directors that the financial report accurately reflects the company's financial position.
- Bans personal loans to executive officers.
- Financial reporting and disclosure of all transactions.
- Specifies that the audit committee must be composed of entirely independent directors, and prohibits an outside auditor from providing services to the company it is auditing concurrently.
- Lead auditor and reviewing partner must rotate at least once every five years.
- Establishment of an Accounting Oversight Board.

In response to requests from board members for practical guidance in the aspects of governance and running a board, Pryce Waterhouse Coopers prepared a set of guidelines known as the "The Board Agenda", the third volume in their 'Meeting Market Expectations' series, which looked at the board's overall role, and the practical aspects of running a board and disclosure.

The following extract is an overview of the 'The Board Agenda', Price Waterhouse Coopers, March 2001.

5. Board Structure;

There are two main categories, and these vary widely throughout the world.

1. Two tiered board, is where you have the supervisory and management functions separated. The upper tier (supervisory) is mostly concerned with overseeing management of the company and consists solely of non-executive directors.
   The lower tier (management) is made up of solely executive directors. This model is found in continental European countries such as Germany and the Netherlands.
2. One Tier or Unitary Board can consist of both executive and non executive directors who are brought together in a single structure. This assumes that all directors share collective responsibility for decisions made. A board that has a strong presence of non-executive directors can ensure broad accountability. This model is found in the UK, US, Australia, and other "Anglo-Saxon" influenced countries.

Regardless of which structure is adopted, the board should operate within a corporate governance framework which ensures the following.

- The board remains accountable to the company and its shareholders.
- The board monitors the company's management effectively.
- The board members are committed to achieving the companies agreed strategic aims.

Good Practices for an effective Board will be the development of;

- A working partnership between the board and executive management.
- A strong independent element on the board.
- A board size that is small enough to allow effective decision making.

6. Conduct of Board Meetings

Responsibility of the Chairperson

- Ensure that the agenda is prepared before the meeting.
- Maintain control of proceedings without dominating discussions.
- Stimulate debate by drawing out the contributions of all members.
- Guide discussions, while making sure genuine disagreements are aired and resolved.
- Ensure that decisions reached are properly understood and recorded.
- Manage the board and ensure that policies are followed.
- Establish standards for the preparation of board papers and reports.

Responsibility of Board Members

- Prepare adequately for meetings by reading agenda and supporting meeting papers.
- Be objective (particularly if a non-executive).
- Be open minded, and willing to engage in debate and be receptive to others perspectives.
- Provide expertise and knowledge to make decisions.
- Commit to collective decisions, once agreed.
- Keep up to date with on issues relating to the company between meetings.

Responsibility of the Corporate Secretary

- Work with the chairperson on preparing the agenda.
- Circulate agenda and other meeting papers to board members.
- Arrange venue and additional secretarial support for meeting
- Advise on legal and regulatory matters during meetings.
- Write and circulate the minutes of the board meetings.
- Maintain statutory books in accordance with legal requirements.
- Send board members information relating to the company as needed.
- Keep abreast of and inform directors of current governance thinking and practice.

Board papers prepared for each meeting will vary depending on the company and the circumstances of the meeting. However there are certain basic papers which are seen as necessary to enable directors to fill their role, these include;

- The meeting agenda, which is normally prepared or approved by the chairperson.
- Minutes of the previous meeting which are usually provided by the company secretary.
- The CEO's operational report, giving an overview of major events affecting the business since the previous meeting.
- The financial report, presenting up to date statements of operating profit or loss, cash flow, and availability of finance.

There are also likely to be a number of other reports prepared by senior management, supporting relevant items on the agenda.

7. Competencies of Executives and Board Members

The task of attracting, retaining and developing the right people involves a wide range of factors. The board needs to ensure that executives with the appropriate skill sets are recruited. At the same time, recognising that people with energy and ability tend to be attracted to companies whose employees share a sense of vitality and commitment to succeed, the board needs to set the tone for the company as a whole.

General Competencies

- Ability to make informed decisions.
- Entrepreneurial
- Can see wider picture and perspective
- Integrity in personal and business dealings

Strategic Competencies

- Can see strengths and weaknesses in company and how decisions will impact on them
- Ability to recognise opportunities and threats in specific industry.
- Ability to recognise wider business and social changes, particularly in the context of global markets.
- Ensures that strategies, budgets and business plans are compatible with vision and strategy.
- Are aware of change and the need for change.
- Understand the difference between governance and management issues.

Analytical Competencies

- Can read and interpret financial reports.
- Ability to think critically and challenge proposals.
- Understand issues from different perspectives.
- Asks for and uses information to make informed judgements.

Character Competencies

- Acts on morals and values
- Is willing to act on and remain accountable for board decisions.
- Courage to pursue personal convictions.
- Can be objective at all times about what is best for the company.

Communication Competencies

- Can articulate thoughts, opinions, rationales, and points in a clear, concise and logical manner.
- Is flexible and willing to change stances when necessary or appropriate.
- Has the ability to listen, process and understand key points.
- Can interact with other board members in a group setting, both contributing to, and valuing the contributions of all members.
- Ability to coach members of staff.
- Ability to deal with the media, comfortable on public platforms.
- Recognises the motivations of investors, analysts, customers, competitors, employees, regulators and other groups, and communicates with them accordingly.

Knowledge Competencies

- Understands responsibilities as a director or senior executive.
- Aware of the latest business and management practices.
- Understands the roles, processes and relationships of the board members.
- Knows the key performance indicators of the company and its senior management.
- Understands legal, accounting, and regulatory requirements affecting the company.

8. Running the Business:

There should be clear a division of responsibilities, with the board providing strategic oversight and tactical guidance, and management being engaged with operational planning, decisions and implementation. In understanding the types of factors that boards should take account of when reviewing management's strategy proposals, it is useful to anticipate the types of questions that shareholders might ask the board about strategy. An example of questions that shareholders often ask about company strategy, and questions that board members need to be able to answer convincingly:

General Business Strategy.

- What major business challenges and risks will the company need to address in the short term? In the long term? and how does management plan to respond to this.
- Analysts and financial commentators are saying the business has lost customer focus and strategic direction. What do you propose to do about this?
- What opportunities or challenges does: globalisation; trade liberalisation; reduction in tariff barriers; deregulation; e-business; changing demographic profile; ageing/younger population, hold for the company.
- Are there plans to diversify into new markets, new products, or other businesses
- Is there any major legislation in the countries of operation that may affect the business? How do you plan to deal with this
- What non financial performance measures does the company use to evaluate operations (e g market share, customer satisfaction)? Are they aligned with strategic plans? Are the measures communicated to the market

Innovation

- How much has the company spend on research and development and what new product or products are in the pipeline?
- Do these new products require patents, licences, or other forms of regulatory approval (especially relevant for pharmaceutical, biotechnology and new technology companies)
- What level of R&D expenditure is budgeted for this year, how will this be funded and is the R&D expenditure sufficient to maintain long-term competitiveness.

Mergers and Acquisitions:

- Is the industry consolidating? How will recent mergers and acquisitions in the industry affect the company, and how does the company plan to compete against larger companies that can benefit from economies of scale.
- Are their acquisitions or new ventures plans? How will they be financed? What criteria are used to identify potential acquisitions? Will they dilute present shareholder interests?
- Is the company perceived to be an acquisition target? Has the company received offers, and if so how has the company responded.

Restructuring:

- The company has undergone more than one major restructuring, is this a sign that management have no coherent strategy?
- What businesses do management consider to be the company's "core" activities and how soon will non core businesses with the group be disposed of?

Geographical Factors:

- How was the company affected by the recent economic and financial crisis?
- Which regions of the world and national markets does the company consider offer the greatest growth prospects
- What potential effects could different world events have on the company (e g trade blocks in Asia, volatile market currencies, transatlantic trade agreements, trade subsidies, global warfare
- Has the company become involved in emerging markets? Does it plan to and if so how will it monitor risks related to these markets (e g credit risk, foreign currency risk and political risk)?

9. Internal Control, Compliance and Risk Management:

Risk is no longer limited to the possibility of something bad happening, but covers a range of future outcomes that may be very negative to very positive. Risk also represents an opportunity and is therefore an important element in the success of a well governed company. To be able to manage risk effectively a company must have a basic system of internal controls.

The internal control system should:

- Enable the business to respond to significant business, operational, financial and compliance risks.
- Safeguard assets from inappropriate use and loss from fraud or error.
- Help ensure the quality of internal and external reporting, through the proper maintenance of records and information flows.
- Facilitate compliance with applicable laws and regulations and internal policies.

Financial Reporting

The provision of high quality financial reporting is one of the board's principle responsibilities. Good financial reporting helps investors make informed decisions on a company's prospects, and is likely to be instrumental in building market confidence in the company and its management. Even though business processes are increasingly becoming global, adequate understandable financial reporting by boards is unfortunately made difficult as accounting rules are still governed by a countries national regulation. A number of global companies still produce accounts in accordance with their national 'generally accepted accounting standards' (GARP's), although a growing number are now using 'International Accounting

Standards' (IAS') with continuing approvals being made by the IOSCO (the world's securities regulators) for cross boarder listing purposes.

Until such time as accounting standards become the same for all counties of the world, company boards and financial managers must respect the individual requirements of the counties that they operate in, whether it be raising capital or doing business. This unfortunately will slow the process of the development of a unified reporting system.

Audit Committees.

In some counties now (as in the US), listed companies are now required to establish an "audit committee" to oversee financial reporting, in others such as Australia this is entirely voluntary. There is a growing recognition of the valuable role such a committee can play in the external financial reporting and internal controls, in particular where the audit committee provides a forum for candid discussions with management and auditors regarding the quality of their financial reporting.

An effective board or Audit committee's financial responsibilities

- Be aware of changes in accounting standards frameworks affecting the company.
- Appoint an audit committee to take board level responsibility for financial reporting, or be responsible for this in the absence of an audit committee.
- Take responsibility for all published financial information.
- Gain an understanding of the areas of greatest financial risk and how management are managing these.
- Have the audit committee work with the internal and external auditors to consider nay fraud, illegal acts, or deficiencies in internal control.
- Review significant accounting and reporting issues.
- Review any legal matters which could impact on financial statements.

10. Disclosure and Transparency,

OECD Principles of corporate Governance, May 1999.

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the company, including the financial situation, performance, ownership, and governance of the company.

Disclosure should include material information on:

- The financial and operating results of the company.
- Company objectives.
- Major share ownership and voting rights.
- Identities of the board and key executives, and their remuneration.
- Material foreseeable risk factors
- Material issues regarding employees and other risk factors
- Governance structures and policies

Understanding the information requirements of shareholders and other stakeholders, publishing a balanced account of the operating and financial results of the company, while taking into account the need for wider accountability is vital for boards in disclosing their activities. Reporting models which capture the social, ethical, and environmental position of a company's operational activities is of ever increasing importance in underpinning shareholder value creation and sustainability.

11. SUMMARY

Numerous high profile cases of corporate governance failure around the world have focused the minds of governments, companies and the general public on the potential threat posed to the integrity of financial markets. It also not clear that any system will or should prevent business failures, or that it is possible to provide a guarantee against fraud.
The ASX Corporate Governance Council released its Principles of Good Corporate Governance and Best Practice recommendations in March 2003, and in May of 2004 amendments to the Australian Governments CLERP 9 ACT, requiring only listed entities that comprise the top 300 of the top 500 company's listed in the S&P All Ordinaries Index, will be required to comply with the CGC's recommendations in respect of the audit committee composition requirement.

The introduction of the Sarbanes-Oxley Act in the US has placed a heavy burden on corporations doing business there. There has been enormous effort put into interpreting and implementing the act by registrants, lawyers, auditors and others involved in corporate reporting, all of which the US SEC (Securities and Exchange Commission) is responsible for enforcing. The increased time and costs associated with compliance must be met by all publicly listed companies doing business in the US and listed on the NYSE. The risk of moving the focus from their day-to-day businesses and the reason they are there in the first place is ever apparent. This situation will continue for the foreseeable future and illustrates some of the difficulties of taking a rules as opposed to a principles based approach to compliance. (Corporate Governance Focus, PWC, July 2003.)

It is clear that corporate governance practices must be evolutionary and responsive to the information needs of local and international investors to ensure that they remain relevant, take account of local and international developments, and continue to reflect international best practice - but at the same time not be unduly restrictive to the business environment.

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