QUT Digital Repository:
http://eprints.qut.edu.au/

Dellaportas, Steven and Gibson, Kathy and Alagiah, Ratnam and Hutchinson, Marion R. and Van Homrigh, David and Leung, Philomena (2005) *Corporate Governance.* In: Ethics, Corporate Governance and Accountability. John Wiley and Sons, Milton, Qld., pp. 117-150.

© **Copyright 2005 John Wiley & Sons**

Chapter 5 .... **2**
Author: Dr Marion Hutchinson **2**
Learning Objectives **2**
A Introduction **3**
A Corporate governance **4**
B The parties to corporate governance *9*
B The principles of corporate governance *12*
<C> 1. Lay solid foundations for management and oversight *14*
<C> 2. Structure the board to add value *14*
<C> 3. Promote ethical and responsible decision-making *14*
<C> 4. Safeguard integrity in financial reporting *15*
<C> 5. Make timely and balanced disclosure *15*
<C> 6. Respect the rights of shareholders *15*
<C> 7. Recognise and manage risk *15*
<C> 8. Encourage enhanced performance *15*
<C> 9. Remunerate fairly and responsibly *16*
<C> 10. Recognise the legitimate interests of stakeholders *16*
B Culture and values *16*
A The tools, mechanisms and means to affect corporate governance *17*
B The evolution of cooperate governance controls **18**
B. External corporate governance controls *21*
B. Internal corporate governance controls *23*
C Monitoring by the board of directors *24*
C Remuneration *28*
D Performance-based remuneration 30
E Management share ownership 31
E Shares options 32
A The role of the accountant in the governance of the entity **34**
A Corporate governance and firm performance **38**
B Board composition and firm performance *38*
B Remuneration and firm performance *39*
C Compensation and firm performance 39
C Share-ownership and firm performance 40
C Share options and firm performance 40
A. Does corporate governance work? **41**
Key terms **42**
Further resources **45**
Case study **46**
The strength of the efficient market hypothesis **48**
The board's capacity to protect the integrity of financial disclosure – effective board monitoring. **49**
Tradeoffs in the use of stock options in executive compensation because of the potential of risk-preferring management **50**
Poor fit between stock-based employee compensation and retirement planning **51**
Appendix A: Best practice disclosure recommendations from the ASX **54**
Disclosure *54*
References: **57**
Glossary **58**

Chapter 5

Corporate Governance

Author: Dr Marion Hutchinson

Learning Objectives

After studying this chapter you should be able to:

- Describe corporate governance
- Identify the parties to effective corporate governance
- Identify and describe the principles of effective corporate governance
- Explain the importance of culture and values for good corporate governance
- Explain why corporate governance principles are put into practice
- Describe the role of the board of directors
- Discuss the usefulness of remuneration packages in aligning the goals of shareholders and managers.
- Explain the role of equity remuneration
- Identify and discuss the role of the accountant in the governance of the organization
- Discuss the relationship between corporate governance and corporate performance

> *"Public confidence is essential to effective capital markets - and this need for confidence is not limited to the companies listed on the exchange. It must also be reflected in the processes by which the capital market and the wider corporate environment is*

monitored and regulated……Increased disclosure whether it be through the recommendations, legislation or business's own initiative is intended to help investors and other information users understand and compare business performance - so they can be more informed in their decisions on who to punish and reward."

Greg Larson, CEO of CPA Australia (2003)

A Introduction

Governance is largely about the decision-making process in a complex organization Shareholders (owners) delegate authority to professionals who have the managerial skills to increase shareholders' wealth. As a consequence the contributors of a firm's capital base are usually different from the contributors of its management base. This separation of ownership from control has led to organizations establishing a system of corporate governance controls designed to discourage managers from pursuing objectives that fail to maximize shareholder wealth. These controls constitute the firm's corporate governance framework. Corporate governance controls are designed to monitor managers behavior or align the goals of management with the goals of shareholders.

In this chapter, a corporate governance framework is developed that outlines the roles and responsibilities of participants involved in governing the organization and portraying information to the capital market.

A Corporate governance

Corporate governance refers to the method by which an organization is governed, administered, directed or controlled and to the goals for which it is governed. Various participants, who have an interest in the organization, determine the direction and the performance of the organization. The principle participants are the shareholders, management, and the board of directors. As shareholders do not manage most large corporations, managers of the firm are given considerable degrees of decision-making authority. That is, the principal (shareholder) delegates decision rights to the agent (manager) to act in the principal's best interests. This separation of ownership from control implies a loss of effective control by shareholders over managerial decisions that affect the value of their wealth. Problems arise if the managers who initiate and execute decisions also approve and monitor the decisions without constraints on their actions as managers can pursue their own interests rather than those of the owners. Consequently, managers can divert potential profits to satisfy their own interests. This action reduces stockholders' gains while raising the managers' total compensation.

As a result of the separation of ownership from control, a system of corporate governance controls are implemented on behalf of the shareholder to discourage managers from pursuing objectives that fail to maximize shareholder wealth. These controls constitute the firm's corporate governance framework. The various corporate controls either assist in aligning the incentives of managers with those of shareholders or limit the self-satisfying opportunities managers can generate. These opportunities are referred to as agency costs, that is, the costs incurred by the firm which are associated with such problems as divergent management and shareholder objectives

and **information asymmetry**, where the manager has private information about the firm. For example, the cost of monitoring the agents (managers) behaviour could be the audit fees associated with ensuring the financial reports depict a true and fair view of the firm's performance and financial position. Corporate governance controls refer to internal and external controls designed to accord manager-shareholder (agency) conflicts of interest, that result from the separation of ownership and control (Williamson, 1984). These corporate governance controls are used to: monitor outcomes are in accordance with plans, that is the firm is attaining planned objectives such as increased profitability; and to motivate the organisation to be fully informed in order to maintain or alter the organisational activity, that is, the organization is familiar with, and understands, managements' future strategies.

In recent years there has been considerable interest in the **corporate governance practices** of modern corporations, particularly due to the high-profile corporate collapses of firms such as Enron and WorldCom in the USA and the HIH Insurance Group and One Tel in Australia. The result of these corporate collapses impacts on the economy at large, not only the direct **stakeholders** of the organizations such as employees, shareholders and creditors. For instance, insurance premiums rise when a major insurance provider vanishes from the market and confidence in the efficient management of the remaining organizations also declines (see In practice box below).

In Practice: The failure of HIH Insurance

The collapse of HIH made professional indemnity, public liability, home warranty and travel insurance policies worthless, placed retirees and disabled people on social security, led to building industry insurance instability, and escalated public liability

insurance. Around one thousand employees became unemployed immediately, while hundreds of others lost their jobs in the following months. The ramifications of the collapse were far reaching and resulted in public loss of confidence in the insurance industry. Mr Justin Neville Owen, Royal Commissioner, suggests that the failure of HIH was due to the firm not providing adequately for future claims – under-reserving or under-provisioning. This situation arose because the firm was mismanaged and failed to uphold many of the basic corporate governance principles. Ill-informed and extravagant business acquisitions, questionable business transactions, lack of attention to detail and lack of accountability of the CEO to the board of directors all made the corporate collapse inevitable. Poor business decisions included re-entering the US insurance market in 1996, expanding the UK operations in 1997 into areas in which HIH was unfamiliar, and the acquisition of the already failing FAI Insurance Ltd in 1998. The final doomed business decision was to sell off HIH's profitable businesses to enter a joint venture with Allianz Australia Ltd in 2000. The resulting negative cash flows led to the decision to place the company in provisional liquidation in March 2001.

Source: information from HIH Royal Commission (2003) *The Failure of HIH Insurance: A Corporate Collapse and its Lessons*, (Mr Justice Neville Owen (commissioner), 3 vols, Commonwealth of Australia, Canberra.

However, good corporate governance should be promoted without stifling entrepreneurial drive or impairing competitiveness. Management should have the freedom to drive the company forward, within a framework of effective accountability (Hermraj 2002).

The essential components of organizations' corporate governance are the parties involved in governing the entity, the principles of the governance framework, the culture and values of the organization to support the governance principles and the tools, or mechanisms, used to apply the governance principles. The following table is adapted from the CPA Australia Corporate Governance Task Group discussion paper.

Table 5.1 Some essential components of corporate governance

Component	Examples
The parties (people with a role to play in the effective governance of the firm)	• Governing body • CEO • Board of directors • Management • Shareholders • Other stakeholders (e.g. customers, suppliers, employees, lenders and the community)
The principles (a framework of effective governance)	• Being a good corporate citizen (developing a code of ethics and code of conduct) • Robust, regular performance reporting, monitoring, review and evaluation (using a monitoring system, Board assessment, CEO reviews, measuring corporate

	performance) • Robust compliance and risk management processes • Independent review and verification (through internal audit, external audit, peer reviews, audit committees, board independence, remuneration committees)
Culture and values that are supportive of effective governance	• Honesty • Trust and integrity • Openness • Performance orientation • Responsibility and accountability • Mutual respect • Commitment to the organisation
The tools, or mechanisms and means, to apply effective governance principles, suitable for the organisation	• Codes • Charters • Committees • Delegations • Policies and procedures • Key performance indicators (KPIs) etc.

Source: adapted from information from Emerging Issues Work Group (2003) ‘The essence of corporate governance’, CPA Australia Corporate Governance Task Group,

www.cpaaustralia.com.au/01_information_centre/1_0_0_0_home.asp, accessed 29 September 2003.

B The parties to corporate governance

The Sarbanes-Oxley Act (January 23 2002) arose following a succession of high profile corporate collapses in the US. The Act was designed to review dated legislative audit requirements. The goal of the act was to protect investors by improving the accuracy and reliability of corporate disclosures. The act covers such things as establishing a public company accounting oversight board, auditor independence, corporate responsibility, and enhanced financial disclosure. The Australian counterpart to the Sarbanes-Oxley Act, the Federal Government's CLERP 9 amendments to the Corporations Act was released in September 2002. CLERP 9 proposes three bodies to represent a range of interests; the Financial Reporting Council (FRC) to oversee standard setting for audit and accounting, the Australian Stock Exchange's (ASX) Corporate Governance Council to oversee the development of best practice guidelines for corporate governance within listed companies and the Shareholders and Investors Advisory Council (SIAC) to provide a forum for the consideration of retail investors' concerns.

The professional accounting bodies, the Institute of Chartered Accountants in Australia and CPA Australia (among others), commented on the draft of CLERP 9. It was the responsibility of these bodies to determine whether the legislation was sufficient to promote efficient corporate governance, and financial reporting and assurance. CPA Australia suggested that the legislation should build a framework that identifies auditors' conduct and practices but it should also include boards of

directors, staff who prepare financial reports, the internal and external audit functions, and include the roles of institutional investors, credit rating agencies, financial analysts and investment banks.

Contrary to the US experience, the CLERP 9 legislation's response to reviewing audit responsibilities, states, "most audits are conducted professionally and competently, with full regard given the interests of shareholders, the need for independence and professional ethics." The Institute of Chartered Accountants in Australia believe that the vast majority of audits are carried out this way and suggest that the corporate governance, financial reporting and auditing issues that led to the Sarbanes-Oxley Act are not evident in the Australian market.

The parties involved in the effective governance of the organization include the governing body (e.g. Australian Securities and Investment Commission, Australian Stock Exchange, Corporate Governance Council, Australian Taxation Office, Australian Competition and Consumers Commission), the CEO, the board of directors, management, shareholders and other stakeholders of the organization. Other stakeholders include customers, suppliers, employees, lenders, and the community at large.

It is the responsibility of the board of directors to formulate the organization's strategy, to develop policy, to appoint, supervise and remunerate senior executives and to ensure accountability of the organization to the owners. The board of directors is a governance mechanism designed to monitor the performance of the organization on behalf of the owners. This aspect is covered in more detail in section 5.3.

Shareholders are the owners of the entity, to whom the directors are accountable. Under the Corporations Act 2001 (Commonwealth) and the Australian Stock Exchange (ASX) Listing Rules, shareholders have the authority to sanction corporate transactions, appoint directors to supervise management and provide strategic direction, and to sanction other significant acts of listed companies reserved to shareholders. Shareholders rely on continuous disclosure to facilitate informed trading, and exercise the rights given to them, which they exercise at general meetings. However, shareholders participation at general meetings may be impeded because they do not have a clear understanding of the business to be conducted at the meeting or the time and cost involved in attending the meeting. As a consequence of these impediments, shareholders place greater reliance on the efficient governance of the corporation. For example, shareholders unable to attend the general meeting are dependant on managers making decisions that will increase their wealth.

Stakeholders (in addition to shareholders) have an interest in the effective performance of the organization. This interest can be direct or indirect. Customers, suppliers, employees, and lenders have a direct interest in the organization to which they buy from, supply to, or are employed by. Employees may have a greater stake in the organization than shareholders as their current and future income depends on the current and future performance of the organization. As a consequence, the organization has an obligation to safeguard their employees through the ethical and efficient governance of the organization. Organizations must ensure that customers' interests are maintained to guarantee the future viability of the organization. Without customers the organization will no longer exist. Suppliers of goods and services or

funds (lenders) have invested their assets in the organization and expect a return. Organizations can only guarantee that return if they continue to operate efficiently in the future. Effective corporate governance is a means of providing that guarantee.

B The principles of corporate governance

In March 2003 the ASX **Corporate Governance Council (CGC)** set out to develop an industry-wide corporate governance framework. It consists of 21 representatives of interested groups (shown in table 5.2).

Table 5.2 Corporate Governance Council representatives

• Association of Superannuation Funds of Australia Ltd	• Group of 100
• Australasian Investor Relations Association	• Institute of Actuaries of Australia
• Australian Council of Superannuation Investors	• Institute of Chartered Accountants in Australia
• Australian Institute of Company Directors	• Institute of Internal Auditors Australia
• Australian Institute of Superannuation Trustees	• International Banks and Securities Association of Australia
• Australian Shareholders' Association	• Investment and Financial Services Association
• Australian Stock Exchange Limited	• Law Council of Australia
• Business Council of Australia	• National Institute of Accountants

• Chartered Secretaries Australia	• Property Council of Australia
• CPA Australia	• Securities and Derivatives Industry Association
	• Securities Institute of Australia

Source: ASX Corporate Governance Council (2003) *Principles of good corporate governance and best practice recommendations*, *March 2003,* Australian Stock Exchange, Sydney, p. 4.

The CGC suggests that fundamental to good corporate governance is company management and a board with a mix of skills, experience, independence and the integrity necessary for ethical decision-making. The company must be accountable to attract capital investment, and should therefore meet the information needs of the investment community in a manner that upholds and recognises shareholders' rights.

The CGC recommends 10 essential **corporate governance principles**, covering such issues as developing guidelines for: the appropriate mix of **executive** and **non-executive directors**; the independence of non-executive directors; the oversight of the preparation of the entity's financial statements, internal controls, and the independence of the entity's auditors; the 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 that are made available to directors in carrying out their duties; and the oversight and management of risk. The principles in the framework presented in Table 5.1 of the CPA Australia corporate governance discussion paper are similar to the CGC's principles. However,

as the CGC's principles are guidelines for all listed companies to adhere to, these principles are discussed in the following section of the chapter.

<C> 1. Lay solid foundations for management and oversight

Organisations should clarify and make publicly known the roles and responsibilities of board and management to provide shareholders with a level of accountability. Boards should provide strategic guidance and oversee management. The division of roles and responsibilities between the board and management should provide a balance of authority so that absolute power does not rest with any single individual.

<C> 2. Structure the board to add value

The board needs a range of skills and understanding, be of sufficient size and have an appropriate level of commitment to fulfill its responsibilities and duties. The board must be able to deal with various business issues and have the ability to review and challenge management performance. The board should be made up of a majority of independent directors, have an independent chairperson, and key roles such as chairperson and chief executive officer should not be shared.

<C> 3. Promote ethical and responsible decision-making

Organisations should develop a code of conduct for their directors and executives that promote ethical and responsible decision-making. Organisations should also publish its position on trading in company shares and associated products by members of the board and employees.

<C> 4. Safeguard integrity in financial reporting

Organisations should implement procedures to independently verify and safeguard the integrity of the company's financial reporting. This can be achieved through the formation of an audit committee and use of the skilled, independent external auditors.

<C> 5. Make timely and balanced disclosure

Organisations should develop written policies and procedures that promote the timely and balanced disclosure of all material matters that concern it. These policies and procedures should ensure that all investors have access to timely information and that the organisation's announcements are clear, factual and balanced.

<C> 6. Respect the rights of shareholders

Organisations should respect the rights of shareholders and help shareholders exercise those rights. Organisations can help shareholders exercise their right by effectively communicating information that is understandable and accessible to shareholders and encouraging shareholders to participate in general meetings.

<C> 7. Recognise and manage risk

Organisations should establish a system of risk oversight and management and internal control. Organisations should be continually identifying, assessing, monitoring and managing risk, and informing investors of changes to risk.

<C> 8. Encourage enhanced performance

Organisations should review and actively encourage enhanced board and management effectiveness. Organisations can facilitate this by providing directors and executives with the information required to assess the company's performance.

<C> 9. Remunerate fairly and responsibly

Organisations should ensure that remuneration is sufficient and reasonable and that the relationship between remuneration and performance is clear. Organisations should ensure that they are adequately remunerating directors and employees to attract those with the necessary skills to enhance company performance.

<C> 10. Recognise the legitimate interests of stakeholders

Organisations should recognise that they have legal and other obligations to all legitimate stakeholders, such as customers, suppliers, employees, lenders and the community. Organisations should recognise the value added to the company by natural, human, social and other forms of capital.

B Culture and values

For stakeholders to have confidence in the organisation, key elements of the organisations' culture and values must support good corporate governance principles. The key elements include honesty, trust and integrity, openness, performance orientation, responsibility and accountability, mutual respect, and commitment to the organisation.

Fundamental to good corporate governance is the way the directors and management develop a model of governance that aligns the values of the corporate participants and then test this model periodically for its effectiveness. In particular, senior executives should conduct themselves honestly and ethically, particularly concerning actual or apparent conflict of interest, and disclosure in financial reports. Establishing a culture

where employees feel confident to report violations will ensure that the key elements of trust and integrity, openness, responsibility and accountability, mutual respect, will be upheld. The HIH case provides and example of organisational culture that failed to meet these fundamental elements. The CEO/founder continued to run the business as his own even to the point where company funds were used to pay for personal tax advice of senior executives and executive directors.

Corporate participants share common goals that shape our policy goals and guide our approach to finding solutions to governance issues. For instance, if the auditor and management share the goal of financial reporting transparency for the investing public, problems relating to failing to disclose relevant information such as related party transactions, will not arise. This means that investors can have confidence in the information flowing into the market that fulfils the goal of financial reporting transparency. To ensure effective corporate governance, all participants in the market system must share the goal that financial reporting should provide useful and reliable information that promotes informed investment decisions and confidence in the capital market system.

A The tools, mechanisms and means to affect corporate governance

Financial management and financial reporting are essential to manage and communicate the financial position of the firm at a particular time. There is the potential for the integrity of the result to be compromised through intent or omission to disclose particular information. There have been a number of corporate collapses, such as HIH, OneTel, World Corp and Enron, where the corporate governance

practices of the company or the absence of an appropriate governance policy has led to information failing to reach the investor. With more than 50% of adult Australians holding shares both directly or indirectly (due to compulsory superannuation), shareholders are no longer a select group and corporate governance responsibilities are far reaching. James McRitchie (2001) poses the following questions: Who controls these assets? Who executes voting rights? How do the workers benefit? Good corporate governance practices are important in determining the cost of capital in a market economy.

B The evolution of cooperate governance controls

Managers of publicly listed organisations have more information than investors about the current and future financial performance of the organisation. This information asymmetry causes agency problems of **moral hazard and adverse selection.** Moral hazard arises when the manager does not comply with the contractual terms. Moral hazard arises after capital is raised because management has incentives to use the capital for their own interests rather than those of the shareholder. Managers will adopt financing policies and a capital structure for the firm, which can help to secure their jobs. For instance, instead of investing in a new, potentially path-breaking product, technology, or market, a manager may choose the less risky route of expanding an existing product line that uses known technologies and sells in known markets. Although such a conservative strategy rarely produces large returns, it reduces the chance of a firm-threatening, manager-threatening failure. Forgoing potentially very profitable projects reduces the expected wealth of stockholders but enhances the expected wealth of managers. Adverse selection occurs when an inappropriate decision is made by the principal, given the information available to the principal (eg selecting managers with inappropriate skills for the required task).

Adverse selection can also occur because managers are concerned with promoting the sale of the firm's shares to investors and may overstate the benefits of buying the shares. Unless the manager can credibly signal the value of the firm, investors will reduce the amount they are willing to pay.

Governance controls are designed to eliminate the hazard that managers will not exert maximum effort on the behalf of shareholders, or consume the benefits of the capital raised through excessive abuse of privileges . The inefficiencies that arise from moral hazard and adverse selection can be reduced by either monitoring managers' behaviour or designing compensation contracts that link managers' performance to the performance of the firm. For example, to monitor managers behaviour, an independent third party attests the accuracy of information provided by management to investors. Thus, the independent auditor assures public investors that financial reporting provides useful and reliable information that portrays the economic realities of the business.

An ideal control system should regulate both motivation and ability. Corporate governance refers to internal and external controls designed to accord manager/shareholder conflict of interest that result from the separation of ownership and control. **Internal corporate governance controls** monitor activities and the take corrective action to accomplish organisational goals. Examples of internal controls include monitoring managers by the board of directors, **remuneration committee**s, audit committees and incentives designed to align managers and shareholders interests. **External corporate governance controls** encompass the controls external stakeholders exercise over the organisation. Examples of external controls include

debt covenants, external auditors and government regulations, that place restrictions on management behaviour or monitor their actions.

With the significant increase in equity holdings of institutional investors in many corporations, there has been an opportunity for a reversal of the separation of ownership and control problems because ownership was not so diffuse. However, the problems have continued. As institutional shareholders are not privy to the private knowledge of managers, they cannot be aware of all the financial and investment opportunities that can be accepted or rejected by management. Hence, the need for corporate governance mechanisms persists. The 'In practice' box below explains that investors are willing to pay more for shares in companies they consider to be well governed.

In practice: Investors willing to pay for well-governed companies

Coombes and Watson (2000) in three surveys of corporate governance found that investors are willing to pay more for shares of well-governed companies. They defined a well-governed company as one with a majority of outside directors with no management ties to the board, undertakes formal evaluation of directors, and is responsive to investors requests for information on governance issues. Directors should have significant share holdings in the company and a large proportion of their pay should be in the form of **share options**. The three surveys of over 200 institutional investors in Asia, Europe and USA and Latin America demonstrated that 75% of investors consider board practice to be at least as important as financial performance. The premium they were prepared to pay for well-governed companies was a function of the quality of financial reporting in the country where accounting

standards are perceived to be higher. The premium investors were willing to pay for a well-governed company in the UK or the USA was 18% compared to 22% premium for a well-governed company in Italy and 27% for and Indonesian well-governed company.

B. External corporate governance controls

One example of an external corporate governance control is the Australian Stock Exchange listing rule 4.10.3, which requires listed companies to set out in their annual reports a statement of the main corporate governance practices in place. The statement should disclose:

> *... the extent to which the entity has followed the best practice recommendations set by the ASX Corporate Governance Council during the reporting period. If the entity has not followed all of the recommendations the entity must identify those recommendations that have not been followed and give reasons for not following them. If a recommendation had been followed for only part of the period, the entity must state the period during which it had been followed.*

Source: ASX Listing Rule 4.10.3

The guidelines set out in the listing rule are voluntary only to the extent that listed companies can adopt alternative practices provided they explain why they did not adopt the ASX guideline. However, investors and information users will ultimately determine whether the adopted alternative practices are acceptable, by investing or not investing in the firm.

As mentioned, the principles and recommendations for corporate governance are guidelines. The ASX does not stipulate required practices, preferring to state that particular governance mechanisms may not be appropriate for all companies and in some cases may impose unwarranted costs on some listed companies:

How to approach adoption of the best practice recommendations

The best practice recommendations are not prescriptions. They are guidelines, designed to produce an efficiency, quality or integrity outcome. This document does not require a "one size fits all" approach to corporate governance. Instead, it states aspirations of best practice for optimising corporate performance and accountability in the interests of shareholders and the broader economy. If a company considers that a recommendation is inappropriate to its particular circumstances, it has the flexibility not to adopt it – a flexibility tempered by the requirement to explain why.

Companies are encouraged to use the guidance provided by this document as a focus for re-examining their corporate governance practices and to determine whether and to what extent the company may benefit from a change in approach, having regard to the company's particular circumstances. There is little value in a checklist approach to corporate governance that does not focus on the particular needs, strengths and weaknesses of the company.

The Council recognises that the range in size and diversity of companies is significant and that smaller companies may face particular issues in attaining all recommendations from the outset. Performance and effectiveness can be compromised by material change that is not managed sensibly. Where a company is

considering widespread structural changes in order to meet best practice, the company is encouraged to prioritise its needs and to set and disclose best practice goals against an indicative timeframe for meeting them.

See Appendix A in this chapter for best practice disclosure recommendations of the ASX.

Source: ASX Guidance Note 9A, p. 5.

The report on the failure of the HIH Insurance Group by Royal Commission tabled in April 2003 provides support for the CGC's recommendations that one size does not fit all regarding good corporate governance practice (Allens Arthur Robinson 2003). The Royal Commissioner Mr Justice Neville Owen stated that *"By its very nature corporate governance is not something which 'one size fits all'. Even with companies within a class, such as publicly listed companies, their capital base, risk profile, corporate history, business activity and management and personnel arrangements will be varied."(Allens Arthur Robinson 2003, p. 2)*

B. Internal corporate governance controls

Internal governance controls are designed to monitor the behaviour of managers and provide incentives to align managers' and shareholders' interests. Monitoring by the board of directors and compensation contracts represent two of the many governance controls available to organisations.

C Monitoring by the board of directors

Shareholders grant decision control rights to the board of directors. The decisions of managers are monitored and ratified by the board of directors. Shareholders and boards monitor and evaluate managers' actions over time enforcing their ideals on managers of how and what should be achieved. This involves considerable monitoring of actions, direction and intervention and may be very costly and may not totally eliminate information asymmetries.

The board of directors, with its legal authority to hire, fire and compensate top management, safeguards invested capital, and is therefore an important element of corporate governance. Directors have certain legal obligations to the shareholders and they can be held liable for damages if they fail to meet these obligations. As a consequence, directors will have some desire to maintain or establish reputations as good monitors and competent business people. The ultimate responsibility for full and fair disclosure to shareholders, and the direct responsibility for the independent audit relationship and the quality of the audit is with the board of directors and the audit committee. Regulators have suggested that the members of the internal audit committee, responsible for overseeing and liaising with the external independent auditor, should be non-executive directors. This recommendation implies that non-executive directors are better monitors of the auditor.

Researchers have investigated the usefulness of a board of directors as a monitoring device as they communicate the shareholders' objectives and interests to managers. Increased independent board members (non-executive directors) are likely to promote decisions that are in the interests of external shareholders. The board’s capacity to

monitor is jeopardized if internal members (executives of the corporation or others affiliated with management) dominate the board.

The CGC in Principle 2 suggests that the board should consist of a majority of independent directors. The criteria for board independence in Principle 2 states that a director is independent if they meet all of the following:

- The director is not a member of management.
- The director is not a substantial shareholder of the entity or an officer of or otherwise associated directly or indirectly with a substantial shareholder of the entity.
- The director has not within the last three years been employed in an executive capacity by the entity or another group member or been a director after ceasing to hold any such employment.
- The director is not a principal of a professional adviser to the entity or another group member.
- The director is not a significant supplier or customer of the entity or another group member, or an officer of, or otherwise associated directly or indirectly with a significant supplier or customer.
- The director has no significant contractual relationship with the entity or another group member other than as a director of the entity.
- The director is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the entity.

Source: ASX, Guidance Note 9, p. 4

The board, in a broader perspective, is devised to limit management and shareholder conflict. In particular, managers receive pecuniary incentives to maximize firm value from share ownership, share option plans, and adjustments in salary based on performance. A board of directors is the primary internal corporate governance mechanism responsible for, among other duties, setting management compensation and monitoring senior management. An effective compensation contract provides executives with an incentive to act in the shareholders' best interests. This means that the link between pay and corporate performance should be greater in firms with non-executive director dominated boards and remuneration committees. In addition to compensation monitoring, regular board meetings allow potential problems to be identified, discussed and avoided and should therefore lead to a superior level of performance.

The combination of incentives for performance and monitoring by the board provide the governance control system for top management. However, different board structures are optimal for different firms, for the simple reason that each firm faces its own management problems, and hence finds their own solution. Forcing companies to have a particular board structure (e.g. non-executive vs. executive directors) could be to the detriment of shareholders by compelling them to adopt board structures that are sub-optimal for their firms.

It is therefore likely that in some circumstances it may be more efficient to have a board composed primarily of executive (inside) directors. The ability of the board to monitor the firm's executives is a function of its access to information. Executive directors possess superior knowledge of the decision making process and therefore

evaluate top management on the basis of the quality of decisions that lead to financial performance outcomes, ex ante. In contrast, non-executive directors evaluate managers on the basis of financial performance measures ex post. Therefore, it could be argued that executive directors look beyond the financial criteria.

Even with a majority of non-executive directors on the board, the board functions on information provided by the CEO. The CEO can also play a principal role in determining the remuneration and tenure of non-executive directors. In addition, dispersion of ownership and increased powers of senior management have accompanied the evolution of the corporate system. This can result in a decline in the accountability of directors and management, resulting in a similar decline in the monitoring role of boards. Hence, these factors can have the effect of weakening the board as a crucial instrument of corporate governance. The 'In practice' box below suggests that the HIH collapse was affected by these factors.

In Practice: The failure of board of directors of HIH Insurance

Poor strategic decision-making was accompanied by blind faith in an ill-equipped leadership, insufficient independence and unidentified and mismanaged risks. At the board level there was little analysis of the future strategy of the company. For example, the rationale behind the re-entry into the US market and the expansion in the UK market was never discussed or approved by the board. The founder and CEO of HIH, Raymond Williams, did not clearly express the details of his strategy for the company. It is one of the board's key responsibilities to understand, test and endorse the company's strategy; otherwise they will not appreciate the associated risks. The board should measure performance against the company's strategic goal.

There were no clear limits placed on the authority of the CEO with regard to investments, corporate donations, gifts and staff compensation and the board rarely if ever rejected or changed a proposal put forward by management. Decisions about the performance and remuneration of senior officers were made by the CEO who attended all human resource committee meetings (by invitation).

The chairman of the board was ineffective, failing to guide the board to focus the their attention on conflict of interest resolution or related party disclosures. The chairman did not deal with the non-executive directors' concerns about the governance procedures of HIH. The agenda for each board meeting was prepared by the company secretary, approved by the chairman and commented on by the CEO. No other board members were involved. Information was hidden, filtered or sanitised. There were material omissions from information given to the board, even to the point where information was misleading.

C Remuneration

Pay for performance remuneration is useful when monitoring is costly, or impossible because the manager has private information about the firm's operations or future investment opportunities. Tying managers' compensation to shareholder's objectives, such as successful firm performance, is likely to motivate managers to behave in a manner consistent with shareholder's interests.

Incentives, both compensation and equity, provide targets, such as financial results, for managers to achieve. This type of control approximates a market contracting

arrangement, where the manager is free to select the method of achieving the desired result. However, performance-based incentives transfer risk to the manager's compensation. In addition, such incentive schemes are reactive in the sense that it provides no mechanism for preventing mistakes or opportunistic behaviour and can elicit myopic behaviour. For example a manager may focus attention on diversified acquisitions with the aim of increasing the share price and hence his/her compensation. However, this approach is in conflict with the organization's strategy if the organization's competitive advantage is specialization.

Firms may offer a range of incentives to their managers in an attempt to motivate effort and align the interests of managers with those of the shareholders. Incentives offered by firms include cash-bonuses, perks, promotions, shares and share options.

The Corporations Act requires annual disclosure by listed companies of the details of the nature and amount of each element of the fee or salary of each director and each of the 5 highest paid non-director executives. The ASX CGC's (2003, p. 52) recommended *guidelines* for disclosing remuneration include options such as:

- Salary
- Fees
- Non-cash benefits
- Bonuses accruing in respect of that year, regardless of payment date
- Profit share accruing in respect of that year, regardless of payment date
- Superannuation contributions
- Other payments in relation to termination and retirement of office

- The value of shares issued and options granted, according to an established and recognized method of valuation
- Sign-on payments

The CGC suggests that the remuneration committee is comprised of a majority of non-executive directors. The responsibilities of this committee will vary among firms but the key functions are to review and recommend remuneration for the CEO and senior management. The committee should obtain independent advice on current remuneration trends. HIH Insurance fell well short of any such independence, as the CEO attend all the remuneration meetings.

D Performance-based remuneration

Performance-related compensation is designed to relate some proportion of salary to individual performance within the context of overall company performance. **Performance based remuneration** may be in the form of cash or non-cash payments such as shares and share options, superannuation or other benefits that are linked to the firm's performance. Managers who do not maximize their performance level, and who do not act in the best interests of the shareholders, will suffer financially. Linking managerial reward to the price of a firm's shares alleviates the incentive problem of motivating management. In addition, shareholders are able to utilize the information that is publicly available, the share price, to monitor management. Performance-based incentives may therefore be regarded as a means of reducing conflict between decision-makers and shareholders.

Thus, performance-related pay is influential in making the interests of managers consistent with those of the shareholders. The compensation system employed by a firm is an important part of the process of controlling both effort and reward and can ultimately affect the profitability of the organization.

E Management share ownership

Management share ownership can be an important source of incentives and power for managers as well as outside shareholders. It typically bestows voting rights, which can give internal and external shareholders a voice in the governance of a corporation. Distribution of shares among these stakeholders can, therefore, have a significant impact on corporate actions that are dependent on shareholder voting. As managers become shareholders, they have a direct interest in an increasing share price. Better operating performance is one way of achieving this objective.

Two views are expressed regarding the impact of managerial share ownership on shareholder welfare. The first view suggests that as managers have already invested their non-diversifiable human capital in the firm, increased share ownership transfers additional risk to managers (compensation) and can lead to risk avoiding behavior on the part of managers, which may not be in the interest of shareholders.

The second view advocates share ownership as a means to align the interest of top managers with that of shareholders. That is, if managers own stock in a company they are less likely to take actions that are not in the interests of shareholders. The more shares management owns, the stronger their motivation to work to raise the value of the firm's shares, which is what the external shareholders want. Consequently share

ownership by board members and executives represents an alignment of goals with shareholders. When insiders own a significant portion of a firm's stock, they have a strong incentive to enhance its value and act in ways that are in shareholders' best interests. Management and board effectiveness depends in part on directors' identification with the interests of a firm's stockholders.

However, problems do not invariably decrease as share ownership by top management increases: large management ownership insulates management from other forces such as the threat of takeovers and the discipline of the board. If managers own substantial shares they may have enough voting power to curb the influence of the market. While share ownership can synchronize the interests of managers and external shareholders in some circumstances, conflicts in agendas and interests of the two groups can result in differences in voting patterns. For example, when efficient corporate policy requires changes in asset and employment structure, management shareholders are interested not only in the value of their equity investment but also in their employment with the firm. In contrast, external shareholders are normally interested only in their equity investment in the firm. As a consequence, mangers would prefer to maintain the status quo, avoiding risky investment opportunities, preferring to safeguard their employment, which may be to the detriment of the shareholders.

E Shares options

A share option is an agreement involving the sale or purchase of a share denoting equity in a company. The employee call option is the promise by the company to sell the share to the employee at a specified strike price, which may be greater than or less

than the current market price. The employee may decide to enforce the agreement and exercise the options, or let it expire unexercised. Share options may be an efficient way of overcoming the interest divergence between managers and shareholders especially when the managerial reward is linked to the price of the firms' shares. As share options allow the future purchase of stock at a fixed price they represent deferred remuneration that can be exercised at the manager's discretion. Consequently, shares options act as an incentive given the probability that shares prices increase. Share options have the potential to align executives' goals with those of the shareholders and therefore represent an incentive for managers to adopt value-increasing projects.

The relationship between owned equity shares and owned share options demonstrate the compensation risk managers are subject to. Share ownership gives the owners voting rights and a **linear payoff** that increases with their firms' performance. In contrast, share options grants recipients the rights to acquire equity at a future date with a **convex payoff** as they need not exercise the option if the share price has not increased. Options are similar to shares except that they fully benefit from share price increases but do not incur losses if the share price falls below the exercise price. Therefore, options do not have the same risk bearing properties associated with share ownership. As a consequence, managers who hold more options than shares are able to endure more firm risk, are more likely to invest in riskier assets and have less interest in hedging and managing the risk of the firm (Hutchinson 2003).

Following the corporate collapses mentioned in this chapter, together with excessive option grants in the US, concern has arisen over the accounting treatment of share

options. The issue raised is whether share options should be treated as an expense against profit. Proponents of adopting the expense approach suggest that excluding options understates executives' remuneration and provides the opportunity to overstate profits. The major benefit being that expensing options increases transparency. Opponents of the expense approach suggest that the valuation of executive share options is problematic for two reasons. First, they are not traded, so there is no market valuation to observe. Second, the features of executive share options are such that they bear little resemblance to options on stocks or securities in general. It would be difficult to have an international comparable method of valuation, and values move in both directions in line with share values. There is no mandate on expensing share options to date. However, firms are required to report the number of options awarded to and/or held by directors. Some firms have also chosen to voluntarily report the strike price and exercise date of the options awarded.

A The role of the accountant in the governance of the entity

Accountants, auditors and the corporate governance structure in which they operate, are the primary providers of information to capital market participants. Therefore, directors of the company should be entitled to expect that management would prepare the financial information in compliance with statutory and ethical obligations and rely on auditors' competence on their opinion of the truth, fairness and compliance of the reports. But ultimately it is the directors who make the final decision about the accuracy of the reports on the financial state of the organisation. The reliability of the accounts depends on the integrity of the information on which they are based. Without reliable financial information, the board and auditors are unable to assess the company's financial position and performance and detect any deterioration over time.

One area of concern for accounting and auditing is where the accounting firm acts as both independent auditor and management consultant to the firm they are auditing. This in turn puts in doubt the integrity and quality of the financial reports, due to client pressure to appease management to do things like conceal bad news. This loss of independence has led to the requests for firms to have an independent audit committee and mandatory rotation of the auditing firm every three years. CLERP 9 suggests that auditor independence can be strengthened: by restricting auditor client employment relations; mandatory audit partner rotation; disclosure of both audit and non-audit fees; and a statement in the annual reports on how the audit has not compromised audit independence.

In addition to the CLERP guidelines, the ASX Corporate Governance Council recommends that organisations have an audit committee comprising of a majority of independent non-executive members to ensure the independence of the committee from management. The audit committee is an essential component of effective corporate governance. The role of the committee is to oversee the financial reports and the audit processes, such as reviewing the external auditor’s independence. The major advantage of the audit committee is that the external auditor deals with the board through the audit committee and is therefore not subject to management pressure to comply with their wishes. It is not compulsory to have an audit committee but companies are required to disclose the existence of one. However, the majority of Australian companies do have audit committees.

The HIH Insurance and Enron collapses are examples of misleading financial reporting. Mr Justice Owen discussed several issues relating to financial reporting and assurance of HIH, including the interpretation of accounting standards, adoption of international standards and the need for the Australian Accounting Standards Board to provide timely advice on interpretation matters. He emphasised the importance of the audit function for capital markets and the users of financial reports. He suggested that role of the auditor requires independence equal to that of a judge to avoid bias in preparing the audit reports. As the 'In practice' box below shows it would appear that the HIH audit breached these principles of due care and independence.

In Practice: The failure of the accounts of HIH Insurance

Accounting techniques were used to hide the full extent of the decline. The financial statements were distorted by questionable entries, heavy reliance on one-of end-of-year transactions, and aggressive accounting practices. For example, HIH incurred significant income tax losses in 1999 and 2000 but continued to record the full value of future income tax benefits as assets. The relevant accounting standard states that where a company incurs an income tax loss, unless the future income tax benefits are certain, it is imprudent to record the future tax benefit as an asset.

The HIH audit committee concentrated on the accounts and the numbers contained in them, failing to identify and assess the risk the company was exposed to. An audit committee should be independent of management, consisting of non-executive directors. However, all directors, both executive and non-executive directors, attended the HIH audit committee meeting. The audit committee rarely if ever preferred the auditors' opinion over managements' opinion. Although the auditors

had a formal system of quality control and procedures in place they relied on the valuations of HIH's consulting actuary, when conducting its audit, thus breaching the independence of the auditors.

In addition to the Australian experience, Enron in the US also provides an example of misleading financial information and lack of audit integrity and independence.

In Practice: The failure of the accounts of Enron

The Houston based energy trading company, Enron Corporation, filed for bankruptcy in 2001. With $62.8 billion in assets, it became the largest bankruptcy in US history. The Powers report of February 2001 was a special investigative committee of the board of directors. The committee suggested that reported transactions were designed to present favourable financial reports, rather than present a bona fide view of the company's operations. Enron concealed huge losses by creating illusions that a third party was contractually obligated to pay the amount of any losses, that is, their risks were hedged. However, the third party was an entity in which Enron had a substantial economic stake. The Andersen partner responsible for auditing Enron was considered to be a client pleaser. Discussions of accounting practices inevitably led to the clients view prevailing. Subsequently, Enron was successful in removing a member of the Andersen's audit after he expressed his disapproval of many aspects of Enron.

Source: Vinten, G. (2002) The corporate governance lessons of Enron, *Corporate Governance*, Vol.2, No.4, pp. 4-9.

These high-profile failures and the questionable performance of the key players in the financial reporting system place doubt on investors' ability to rely on the oversight of the board of directors and independence of the audit committee. Are the accounting and disclosure standards sufficiently transparent for investors and the public? The range of topics covered by accounting standards has increased substantially throughout the years. In 1980 there were nine accounting standards, by 1990 there were around 26 and by 2000 the number had increased to 43. CLERP 9 recommends that accounting standards return to the dominance of the true and fair concept in financial reporting. Business has had to improve the nature, volume and quality of information available to shareholders, in response to the loss of confidence facing the market.

Can we rely on the self-regulatory corporate governance practices to guide management and ensure auditors efficiently perform their function? If governance controls are efficient there should be a positive relationship between these controls and firm performance.

A Corporate governance and firm performance

Research investigating the relationship between corporate controls and firm performance has been mixed and often weak. The question is whether **board monitoring** and incentive contracts reduce owner-manager conflict.

B Board composition and firm performance

Prior research has failed to arrive at a consensus regarding the relationship between board monitoring and firm performance. For example, some researchers have only

found support for the relationship between frequency of meetings and profitability. Some researchers find a negative relationship between the proportion of external directors and firm performance while others found no relationship between external board membership and performance. Therefore, it is likely that board composition is unlikely to have a direct impact on firm performance. Rather, it is feasible that the relationship between board composition and firm performance is associated with the type of firm and supports the notion that one-size-does-NOT-fit-all.

B Remuneration and firm performance

Incentives, both compensation and equity, are governance controls which provide targets, such as financial results, for managers to achieve. The corporation's objective is to construct an incentive contract that aligns the executive's interests with those of the owner.

C Compensation and firm performance

The result of previous research on the relationship between firm performance and CEO compensation have primarily been insignificant. Researchers have argued that CEO's will pursue their own interests rather than shareholders when their reward does not coincide with that of shareholders. Subsequently, research has tested the sensitivity of CEO pay to changes in performance. This argument suggests that an effective governance mechanism that aligns the goals of management with shareholders will be one where a change in shareholder wealth will lead to a significant change in CEO compensation. However, prior research has failed to find consistent and significant relationships between executives' remuneration and firm performance. However, low average levels of pay-performance alignment do not

necessarily imply that this form of governance control is inefficient Not all firms experience the same levels of conflict, and external and internal monitoring devices may be more effective for some than for others.

C Share-ownership and firm performance

Share ownership can be an important source of incentives and power for executives as well as outside shareholders. Distribution of stock among these stakeholders can, therefore, have a significant impact on corporate actions that are dependent on shareholder voting. Some researchers have found that the largest CEO performance incentives came from ownership of the firm's shares, while other researchers found that the relationship between share ownership and firm performance was dependent on the level of ownership. They found, at levels of ownership between five and twenty percent, profitability increases with ownership. At levels greater than 20% share ownership, profitability decreases with ownership. This result suggests that increases in ownership above 20% cause management to become more entrenched, and less interested in the welfare of their shareholders.

C Share options and firm performance

Research suggests that firm performance is positively associated with share option plans, suggesting that large pay-performance sensitivities were primarily the result of incentives provided by the executives' ownership of shares and share options. Share option plans direct managers' energies and extend their decision horizons toward the long-term, rather than the short-term, performance of the company.

A. Does corporate governance work?

Each firm's governance needs vary with firm-specific and environmental conditions. From the discussion in this chapter it is evident that failures of corporate governance can be devastating. Are the reforms to corporate governance that have arisen primarily from these corporate failures sufficient? Can we rely on corporate governance processes, the oversight of boards and audit committees, to ensure that management and auditors carry out their responsibilities in an efficient and ethical manner?

Good corporate governance does not necessarily lead to better firm performance; a positive relationship is likely to be dependent on the type of firm. However from the evidence provided by the corporate collapses we have examined, bad corporate governance is more likely to lead to poor firm performance. Enron and WorldCom are cases where financial reporting was deliberately distorted with the objective of misleading investors and the public about the underlying economic performance of the firm.

A Summary

Fundamental to good corporate governance is a board of directors and management with a mix of skills, experience, independence and the integrity necessary for ethical decision-making. The company must be accountable to attract capital investment, and should therefore meet the information needs of the investment community in a manner that upholds and recognises shareholders' rights.

The essential components of organizations' corporate governance are the parties involved in governing the entity, the principles of the governance framework, the culture and values of the organization to support the governance principles and the tools, or mechanisms, used to apply the governance principles.

Shareholders rely on the information provided to the capital market to make decisions about their investments. Accountants, auditors and the corporate governance structure in which they operate, are the primary providers of information to capital market participants. The board of directors, as overseers of the company, should be entitled to expect that management would prepare the financial information in compliance with statutory and ethical obligations and rely on auditors' competence on their opinion of the truth, fairness and compliance of the reports. The importance of corporate governance is demonstrated in the fact that investors are prepared to pay more for a well-governed entity.

Key terms

Adverse selection

Board monitoring

Corporate governance

Corporate Governance Council (CGC)

Corporate governance principles

Corporate governance practice

Executive directors

External corporate governance controls

Internal corporate governance controls

Information asymmetry

Moral hazard

Non-executive directors

Performance based remuneration

Remuneration committee

Management share ownership

Share options

Stakeholders

Questions

1. Would the economic consequences of poor governance be greater for public or private companies?
2. From your experience, how would you define governance and its implications for companies?
3. Describe the impact of good/bad corporate governance on stakeholders. Refer to the areas of the principles of corporate governance which impact on stakeholders.
4. How does shareholder/investor response to poor governance practices affect corporate financing?
5. The Corporate Governance Council suggests that corporate governance practices cannot be prescriptive as a one size fits all approach may compromise firm performance. Suggest some instances where imposing a particular governance practice may impede firm performance.

6. Describe the role of the board giving examples of the activities the board performs.
7. What are the advantages and disadvantages of appointing non-executive directors on the board?
8. To what extent should the board be concerned with the ethical conduct of the board and the company as a whole?
9. Is it the role of the board to promote values and ethics within the company? If it is not the role of the board, whose role is it?
10. Executives should be paid on the basis of their performance measures. They should not be paid a salary. Do you agree with this statement? Explain your answer.
11. What is the role of equity remuneration in efficient corporate governance?
12. What do you think would be the effect of expensing share options remuneration paid to executives or directors?
13. Examine the corporate governance statement of an annual report. (Eg, the website for Country Road is www.countryroad.com.au) For the company you have chosen, answer the following.
    a) Do they comply with the CGC principles, in particular independent directors and shareholders' rights?
    b) What guidance is provided by the CGC to address these issues?
14. A director of the board has borrowed money from the company to invest in property speculation. He plans to pay back the money when he has received the profit from the project. Explain the implications of the director's action and what, if any, disclosure is required.

15. Assume that the remuneration committee of Harvey Norman consults the firm for which you work. The committee is interested in the different forms of compensation that can be offered to their executives to motivate them to maximise shareholder value.

    a) What types of compensation packages could be used and how would you recommend structuring the compensation to align executives and owners goals?

    b) What performance measure of the firm could the different forms of compensation be linked to?

16. You are the executive director of a publicly listed firm Extrion Ltd, and you believe that an investment opportunity you have heard about will increase the profits of the firm. The firm operates more like privately-owned businesses and does not have the same emphasis on rigorous corporate governance policies as recommended by the CGC.

    This investment opportunity requires funding which you have arranged through Merchant Securities, an investment firm. You own 5% of the issued shares of Merchant Securities. The board of directors is meeting next week to consider the future of Extrion Ltd.

    a) You know you have the best interests of the firm at heart. What are your obligations as a member of the board, regarding the investment?

    b) What are your obligations regarding your shares in Merchant Securities?

    c) Do you see a conflict of interest, explain?

Further resources

ASX Corporate Governance Council website www.asx.com.au/corporategovernance

Journal articles

Coles, J.W., McWilliams, V.B., Sen, N., 2001. An examination of the relationship of governance mechanisms to performance, *Journal of Management* 27, 23-50.

Corporate Reform Law Economic Program; Report No. 9 released in September 2002

Dalton, D.R., Dailey, C.M., Ellstrand, A.E., Johnson, J.L., 1998. Meta-analytic reviews of board composition, leadership structure, and financial performance, *Strategic Management Journal* 19(3), 269-290.

Hermalin, B.E., Weisbach, M.S., 1991. The effects of board composition and direct incentives on firm performance, *Financial Management* 20(4), 101-112.

Jensen, M.C., Murphy, K.J., 1990. Performance pay and top management incentives, *Journal of Political Economy* 98, 225-264.

Kren, L., Kerr, J.K., 1997. The effect of outside directors and board shareholdings on the relation between chief executive compensation and firm performance, *Accounting and Business Research* 27(4), 297-309.

Case study

Corporate Governance and the collapse of Enron

The failure of the Enron Corporation in 2001 was one of the largest corporate collapse in the history of the US. The collapse placed in doubt the effectiveness of contemporary accounting, auditing and corporate governance practices.

The Chairman of the board, who was also the CEO, reassured investors that the company's core businesses and future earnings growth were stable, while at the same

time selling his shares and exercising options. In reality, write-offs against losses produced a loss of more than $600 million. This amount included a $35 million loss involving a conflict of interest where the company's CFO managed the businesses in partnership with Enron. Profits were overstated over a four-year period, primarily due to accounting manipulations. Consumer confidence in the company fell along with the share price, and Enron finally filed for bankruptcy.

The Powers report of February 2001 was a special investigative committee of the board of directors. The committee suggested that reported transactions were designed to present favourable financial reports, rather than present a bona fide view of the company's operations. Enron concealed huge losses by creating illusions that a third party was contractually obligated to pay the amount of any losses, that is, their risks were hedged. However, the third party was an entity in which Enron had a substantial economic stake.

Enron raises the following problems associated with poor corporate governance:

- The strength of the efficient market hypothesis
- The board's capacity to protect the integrity of financial disclosure
- Tradeoffs in the use of stock options in executive compensation because of the potential to motivate management to commit fraud and prefer risk
- Poor fit between stock-based employee compensation and retirement planning

The strength of the efficient market hypothesis

Enron's share price escalated at the same time as earnings fell demonstrating that markets sometimes ignore evidence about the finances of the firm. Even if Enron actively misled the market about its true financial condition, the sophisticated market participants should have sufficient knowledge of the firm that the efficient market would devalue Enron's shares. Enron's financial structure was highly complex with off-balance sheet entities that were obscured in Enron's disclosure documents. The fact that it was difficult to determine Enron’s true financial position should be sufficient to send warning signals to the market, and the market should adjust the share price downwards.

However, Enron's accountants at Arthur Andersen certified that the financial statements "fairly presented" the overall financial picture of the company. But the credibility of Andersen's certification was compromised. First, because it had permitted its independence to be undermined when the accounting firm cross-sold consulting services, such as tax planning and accounting planning, making the accountant part of the management team. And second, because the internal governance of Andersen was insufficient to control the behaviour of its Houston partners, the partners responsible for the audit and consulting services supplied to Enron.

Yet all of this is known to sophisticated investors and should have been impounded in Enron's share price. So why was it that there was only a gradual fall in Enron’s share price?

The board's capacity to protect the integrity of financial disclosure – effective board monitoring.

The monitoring role of the board is proposed as a remedy for a self-interested or incompetent managerial team. The major features are independent directors, specialized committees (in particular, an audit committee) consisting exclusively of independent directors to perform crucial monitoring functions, and a clear charter of board authority

On the surface, Enron's board fulfilled many of the corporate governance requirements. Enron had an independent board with only two insiders of the fourteen directors and an audit committee to oversee the Company's reporting process and internal controls. The majority of the external directors had relevant business experience, including accounting backgrounds, prior senior management and board positions, and senior regulatory posts. Most of the directors owned stock and received stock options as part of the director compensation package. The Audit Committee's had direct access to financial, legal, and other staff and consultants of the Company and the power to retain other accountants, lawyers, or consultants. However, the independence of virtually every board member, including Audit Committee members, was undermined by related-party payments and compromised by the ties associated with long service and familiarity.

There was a gap between what the Enron board knew and could have/should have known. Management effectively portrayed the Enron image of a well-managed firm. As a consequence the board did not question a proposal to suspend the corporate

ethics code, this suspension permitted conflict of interest transactions by a senior executive.

Tradeoffs in the use of stock options in executive compensation because of the potential to motivate management to commit fraud and prefer risk

At the time of the Enron collapse, the grant of a share option was not treated as an expense that reduces earnings, while the exercise of an option created an expense equal to the difference between the market price of the share and the exercise price of the option. There is an incentive for option holders to increase the value of the option as they benefit from increases in firm value. Stock options have value if exercised "in the money," that is, the stock price is above the exercise price. If option grants are very large and exercisable in the relatively near term, then a positive swing in the stock price can make the senior executives immediately very rich. As option grants increased, the executives of Enron, were confronted with two incentives: fraud, and risk-taking. Managers with an abundance of options have incentives to get the stock price high by any means necessary, fraud included. In particular, they may have incentives to increase the riskiness of the firm, including projects that offer volatile expected returns. This has the potential to increase the value of managers' firm-related investments and managers can become risk-preferring. Both fraud and costly risk-taking appear to have occurred in Enron. Enron became a hedge fund, taking leveraged bets in exotic markets that if successful would produce a huge jackpot for its executives.

Poor fit between stock-based employee compensation and retirement planning

The Enron case exposes the conflict between employee stock ownership, used for incentive purposes, with employee retirement planning. The actions of lower level employees are unlikely to have any impact on the share price. For example, improving individual divisional performance is unlikely to influence the share price of a large corporation. It is more likely that only senior management's actions will impact on the stock price. However, company shares can achieve organisational goals, such as economic decisions. In addition, company shares can also serve as a form of profit-sharing that does not require a cash outlay by the company and which receives favourable accounting treatment.

However, when shares are considered part of retirement planning it conflicts with the role of an incentive device. In the US, employee shares are typically placed into a contributory pension plan, for example, a 401(k) plan or an Employee Share Ownership Plan, which places strict limits on the employee's ability to sell the shares and tie up the proceeds until the employee's retirement. Thus the benefits of employee share ownership do not accrue until retirement.

Enron employees were heavily invested in employer stock in their 401(k) plans. An estimated $1.3 billion of the plan's $2.1 billion in pension assets consisted of now-worthless Enron shares. This investment in Enron shares may be attributable to the accounting and tax incentives that reduced Enron's cost of pension contributions if it used its own shares, combined with the pension plan rules that limited employee sales of Enron-contributed shares until age fifty. Therefore, employees pension funds were typically tied up in an undiversified portfolio.

Source:

Jeffrey N Gordon. (2002) What Enron means for the management and control of the modern business corporation: Some initial reflections, The University of Chicago Law Review. Vol. 69, Iss. 3: 1233-1250.

Required:

a) Why was there no adjustment in Enron's share price when sophisticated investors knew of the complex financial structure. off-balance sheet entities, lack of disclosure, the lack of credibility of Andersen's certification, and loss of independence between the auditors and Enron? Comment on the reasons why you think these factors were not impounded into the share price.

b) Even though Enron had what appeared to be a board structure that satisfies the guidelines for good corporate governance, how did information asymmetry and the board's culture add to the demise of Enron?

c) As option grants increased, the executives of Enron, were confronted with two incentives: fraud, and risk-taking. Does this mean that there were no positive effects associated with share options?

d) If employee share schemes are to continue as an incentive to motivate employees to increase firm value, what, if any, restrictions should be placed on them?

e) Enron demonstrates that there are problems that cannot be solved, but can only be contained. Imperfectly fashioned incentives and the lack of self-restraint contributed to the collapse of Enron. Comment on this statement. Are there

any other poor corporate governance practices that have played a part in the collapse?

Appendix A: Best practice disclosure recommendations from the ASX

Attachment B

Disclosure

Best practice recommendations
1.1 Formalise and disclose the functions reserved to the board and those delegated to management.
2.1 A majority of the board should be independent directors. 2.2 The chairperson should be an independent director. 2.3 The roles of chairperson and chief executive officer should not be exercised by the same individual. 2.4 The board should establish a nomination committee. 2.5 Provide the information indicated in ***Guide to reporting on Principle*** 2.
3.1 Establish a code of conduct to guide the directors, the chief executive officer (or equivalent), the chief financial officer (or equivalent) and any other key executives as to: 3.1.1 the practices necessary to maintain confidence in the company's integrity 3.1.2 the responsibility and accountability of individuals for reporting and investigating reports of unethical practices. 3.2 Disclose the policy concerning trading in company securities by directors, officers and employees. 3.3 Provide the information indicated in ***Guide to reporting on Principle*** 3.

4.1 Require the chief executive officer (or equivalent) and the chief financial officer (or equivalent) to state in writing to the board that the company's financial reports present a true and fair view, in all material respects, of the company's financial condition and operational results and are in accordance with relevant accounting standards. 4.2 The board should establish an audit committee. 4.3 Structure the audit committee so that it consists of: •only non-executive directors •a majority of independent directors •an independent chairperson, who is not chairperson of the board •at least three members. 4.4 The audit committee should have a formal charter. 4.5 Provide the information indicated in ***Guide to reporting on Principle*** 4.
5.1 Establish written policies and procedures designed to ensure compliance with ASX Listing Rule disclosure requirements and to ensure accountability at a senior management level for that compliance. 5.2 Provide the information indicated in ***Guide to reporting on Principle*** 5.
6.1 Design and disclose a communications strategy to promote effective communication with shareholders and encourage effective participation at general meetings.

6.2 Request the external auditor to attend the annual general meeting and be available to answer shareholder questions about the conduct of the audit and content of the auditor's report.
7.1 The board or appropriate board committee should establish policies on risk oversight and management. 7.2 The chief executive officer (or equivalent) and the chief financial officer (or equivalent) should state to the board in writing that: 7.2.1 the statement given in accordance with best practice recommendation 4.1 (the integrity of financial statements) is founded on a sound system of risk management and internal compliance and control which implements the policies adopted by the board 7.2.2 the company's risk management and internal compliance and control system is operating efficiently and effectively in all material respects. 7.3 Provide the information indicated in ***Guide to reporting on Principle*** 7.
8.1 Disclose the process for performance evaluation of the board, its committees and individual directors, and key executives.
9.1 Provide disclosure in relation to the company's remuneration policies to enable investors to understand (i) the costs and benefits of those policies and (ii) the link between remuneration paid to directors and key executives and corporate performance. 9.2 The board should establish a remuneration committee.

9.3 Clearly distinguish the structure of non-executive directors' remuneration from that of executives. 9.4 Ensure that payment of equity-based executive remuneration is made in accordance with thresholds set in plans approved by shareholders. 9.5 Provide the information indicated in ***Guide to reporting on Principle*** 9.
10.1 Establish and disclose a code of conduct to guide compliance with legal and other obligations to legitimate stakeholders.

Source: ASX Guidance Note 9A, 'Corporate Governance - Principles & Recommendations', pp. 24 and 25.

References:

Allens Arthur Robinson (2003) 'HIH Report and CLERP 9', *Focus: Corporate Governance*, May, p.2. www.aar.com.au/pubs/pdf/ma/focgmay03.pdf, cited July 2003.

ASX Corporate Governance Council (2003) *Principles of good corporate governance and best practice recommendations*, March 2003, Australian Stock Exchange, Sydney.

Coombes, P. and Watson, M. (2000) Three surveys on corporate governance, *The McKinsey Quarterly*, No.4, 74-77

Emerging Issues Work Group (2003) 'The essence of corporate governance', CPA Australia Corporate Governance Task Group. www.cpaaustralia.com.au/01_information_centre/1_0_0_0_home.asp, accessed 29 September 2003

Hermraj, M (2002) Preventing corporate failure: the Cadbury committee's corporate governance report, *Journal of Financial Crime*, Vol.10, No.2: 141- 145.

HIH Royal Commission (2003) *The Failure of HIH Insurance: A Corporate Collapse and its Lessons*, (Mr Justice Neville Owen (commissioner), 3 vols, Commonwealth of Australia, Canberra.

Hutchinson, M.R (2003) An analysis of the association between firm risk, executive share options and accounting performance: some Australian evidence, *Review of Accounting and Finance,* Vol.2, No.3. pp. 48-71.

Larsen, Greg (2003) The essence of corporate governance in Emerging Issues Work Group.

McRitchie, James. (2001) Enhancing the return on capital through increased accountability, *Corporate Governance*, www.corpgov.net cited July 2003.

Vinten, G. (2002) The corporate governance lessons of Enron, *Corporate Governance*, Vol.2, No.4, pp. 4-9.

Williamson, O. (1984) Corporate Governance, *Yale Law Journal*, Vol. 93, pp. 1197-1230.

Glossary

Adverse selection: the principal makes an inappropriate selection among alternatives.

Board monitoring: an internal corporate governance control where the role of the board of directors is to monitor the performance of the organisation and the management of the organisation.

Corporate governance: the method by which an organization is governed, administered, directed or controlled and to the goals for which it is governed

Corporate Governance Council (CGC): a council consisting of 21 parties interested in improving the corporate governance practices and reporting of Australian business.

Corporate governance principles: guidelines for the efficient governance of Australian business.

Corporate governance practice: the process employed by the organization to ensure the organisation is efficiently managed.

Convex payoff: benefits increase and decrease along a curved line

Executive directors: member of the board of directors who are also employees of the organisation.

External corporate governance controls: mechanisms external stakeholders exercise over the organisation that monitor and control the activities of employees.

Information asymmetry: the manager has private information about the firm that the owner is not aware of.

Internal corporate governance controls: in-house mechanisms that monitor and control the activities of employees.

Linear payoff: benefits increase and decrease along a straight line.

Moral hazard: the manager does not comply with the contractual terms.

Non-executive directors: independent members of the board of directors.

Performance based remuneration: remuneration which is designed to relate some proportion of salary to individual performance within the context of overall company performance.

Remuneration committee: An organisational committee with the principal role of setting executive compensation packages.

Management share ownership: an internal control designed to ensure the shares owned by management motivate managers to act in the best interest of shareholders.

Share options: the right to buy a share in the future at the price of the option at grant date.

Stakeholders: parties with interests in the organisation such as employees, shareholders and creditors.