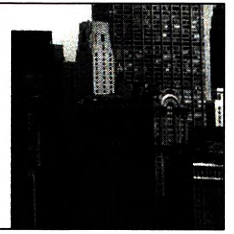
Recent Developments in Corporate Governance



By Corey Lewis, Blake Dawson Waldron

Corporate governance has received a lot of attention recently, both in Australia and elsewhere. Given the significant corporate failures over the last few years, the attention is both warranted and timely.

As a result, we have seen a growth in the amount of regulations and guidelines that exist for Australian listed entities. However, with the CLERP 9 legislation (Corporate Law Economic Reform Program) to be revealed in the Spring sitting of Parliament, there are more corporate governance reforms to be had.

Purpose of corporate governance

Corporate governance is, at its core, concerned with ensuring the proper conduct of those with power within an organisation, with a view to the best interests of a company as a whole. In practise, this means ensuring that managers do not put their interests before shareholders and other stakeholders.

The corporate governance question surfaces with almost cyclical regularity, often following the end of a bull market. When corporate results flounder and firms fail, investor confidence is one of the early victims. Coupled with opaque, or at times misleading, financial reporting, faith in the information that is provided to the market can be undermined. Corporate governance regulation in this context aims to ensure integrity of behaviour – a task for which legislation can be a particularly poor tool.

"Black-letter" versus principles-based approach

Corporate governance regulation can be divided into two broad categories: 'black-letter' legislative responses and principles-based responses. The latter seeks to provide flexibility of application by laying down a set of principles. Entities then endeavour to best apply them, according to their own circumstances.

Black-letter approaches are often criticised for ignoring the individual characteristics of an entity. In the U.S., the *Sarbanes-Oxley Act* has been criticised on the basis that the regulatory burden imposed far outweighs the purported benefits. For example, investor confidence may well be restored by having CEO/CFO sign-off of accounts, but when new entities shy away from U.S. capital markets because of the compliance cost, investors lose out.

Substance over form

Corporate governance, with its focus on relationships and how authority is exercised within an organisation, is ultimately about substance – the integrity and willingness to question assumptions of those involved in management. The form of the corporate governance model adopted is less important than how rigorously the model is tested to ensure that appropriate outcomes are achieved. A regulatory response to corporate governance issues must recognise that governance procedures will not eliminate risk and that legislation can be inadequate to regulate behaviour. Justice Owen in the report of the HIH Royal Commission stated:

> *"No system of corporate governance can prevent mistakes or shield companies and their stakeholders from the consequences of error. Corporate failures will occur. However, good governance practices help to focus those in charge of a company on the very purpose of their corporate activity and the direction of their business and enable them to identify emerging problems early.*
>
> *I think that any attempt to impose governance systems or structures that are overly prescriptive or specific is fraught with danger. By its very nature corporate governance is not something where 'one size fits all.'"* [1]

Australian developments

ASX Corporate Governance Council Principles of Good Corporate Governance and Best Practice Recommendations ("Best Practice Recommendations")

Released on 31 March 2003, the Best Practice Recommendations apply to listed entities for the first financial year after 1 January 2003.[2]

The Best Practice Recommendations set out ten principles with related recommendations, and are based on a U.K model. The principles cover issues such as: board structure and board committee composition and responsibilities, director and executive remuneration, and shareholder communications. Where an entity's practices are different from that described in the Best Practice Recommendations, they must provide an explanation in their corporate governance report contained in their annual report (Listing Rule 4.10).

Although receiving much adverse comment, for most large listed entities the additional requirements imposed by the Best Practice Recommendations should not pose an intolerable burden. It is for those entities with small market capitalisations that the recommendations will impose the greatest burden. To ameliorate this, the Best Practice Recommendations have been designed as just that: recommendations. Entities, in theory, have the flexibility to adopt the practices that best suit their organisation. The challenge will be to ensure that the market understands genuine cases of 'non-conformity' with the Best Practice Recommendations rather than treating them as 'non-compliance'. Again, to quote Justice Owen:

> *"There is also a danger that strict adherence to a published best practice model will lead to its becoming as blunt an instrument for the achievement of the aspirational aims of corporate governance as legislation can be. It would be unfortunate and counter-productive if users of the annual report and financial statements of companies themselves were to adopt the 'tick the box' approach and not acknowledge the existence of reasoned exceptions to a recommended best practice."* [3]

Corporations Amendment Bill 2002

An exposure draft of the Corporations Amendment Bill 2002 ("the Bill") was released last year for comment, with submissions due by late March 2003. In terms of the current corporate governance debate, one of the more significant proposals in the Bill is the amendment of s 300A. Currently, s 300A requires listed companies to provide information concerning "board policy" for directors and senior executives' remuneration, and the nature

and amount of remuneration for each of the directors and the five highest paid officers of the company.

The Bill will retain the requirement for a discussion in the director's report of the "board policy" for determining the nature and amount of remuneration. However, this discussion need only cover directors and "executive officers". Currently, s 300A(1)(a) extends to "senior executives". By restricting the section to "executive officers" – a term that is defined in s9 of the *Corporations Act 2001* (Cth) – the Bill will clarify to whom the reporting requirement applies.

A new provision to be inserted into the *Corporations Act* will be s 300A(1A). This section will require the information concerning directors and the five highest paid executive officers to disclose "the value of options granted to the person in that year" and the percentage this represents of the person's total remuneration for the year.

The final form of the Bill is yet to be released, and the extent to which these changes may be superseded by the CLERP 9 legislation remains to be seen.

Corporations Amendment (Repayment of Directors' Bonuses) Act 2003

This Act, which received Royal Assent on 11 April 2003, amends the insolvency provisions of the *Corporations Act*. The effect of the amendments is to permit liquidators to recover from directors (and their families) the "excessive" component of benefits that have been received within the four years before the liquidation of the company.

Importantly, the company need not have been insolvent at the time of providing the benefit. Rather, the benefit need only be excessive – which is any "payment, transfer of property or issue of securities made by the company to the director where it may be expected that a reasonable person in the company's circumstances would not have entered into such a transaction, having regard to the benefit and detriment to the company arising out of the transaction," s 588FDA(1).

CLERP 9 Legislation

This latest instalment in the CLERP legislation was released in September 2002. The CLERP 9 discussion paper sets out a number of proposals concerning amendments to the *Corporations Act* in respect of, among other things, auditor independence and the continuous disclosure of analyst independence.

Since September 2002, a number of events have occurred that have added momentum to the current corporate governance reform debate. These events include instances of large director and executive termination payouts and retirement benefits. In addition, the HIH Royal Commission Report contains a number of policy recommendations for reform.

In releasing the HIH Royal Commission Report, the Treasurer commented that the policy recommendations made by Justice Owen were generally consistent with the CLERP 9 proposals relating to corporate governance and financial reporting.[4]

Senator Stephen Conroy, on the other hand, has derided the Best Practice Recommendations as "lacking teeth", and has indicated that the Opposition will move amendments to the *Corporations Act* prescribing greater disclosure of executive remuneration and requiring listed companies to propose non-binding shareholder resolutions on a company's remuneration policies.[5]

Based on the discussion paper released last year, we do know that the final form of the CLERP 9 legislation will cover the following areas:

- Auditor independence, including the provision of non-audit services, auditor employment relationships with former audit clients and audit partner rotation.
- Continuous disclosure and providing ASIC with the ability to issue infringement notices where it believes an entity has failed to comply with the continuous disclosure provisions.
- Adoption of international accounting standards and giving audit standards the force of law under the *Corporations Act*, similar to the treatment of accounting standards.
- Greater disclosure concerning analyst independence.

It is unclear what the final form of the CLERP 9 proposals will take. The only certainty is that while markets languish and corporate governance remains a hot topic, it is likely that reform will continue. ■

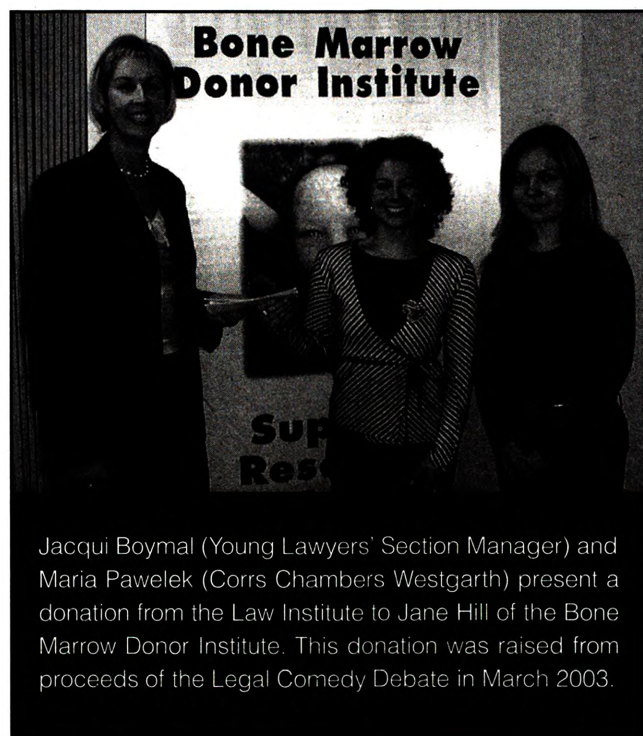
1 *HIH Royal Commission Report*, volume 1, pp104-5.

2 For entities with 30 June balance dates, this will mean that the annual report that is published for the year ending 30 June 2004 will have to comply with the Best Practice Recommendations. Entities within the ASX/S&P All Ordinaries Index must meet the Best Practice Recommendations relating to audit committee composition and functions at the *commencement* of the next financial year following the release of the Best Practice Recommendations.

3 Note 1 above, at p106.

4 Treasurer, media release, 16 April 2003.

5 Senator Stephen Conroy, media release, 31 March 2003.



Jacqui Boymal (Young Lawyers' Section Manager) and Maria Pawelek (Corrs Chambers Westgarth) present a donation from the Law Institute to Jane Hill of the Bone Marrow Donor Institute. This donation was raised from proceeds of the Legal Comedy Debate in March 2003.

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