

Australian Graduate School of Management

Corporate Governance: an Outline.

In the early Italian Renaissance, cities like Padua and Mantua used to hire governors to administer their affairs. These governors would be travelling experts with no fixed power base in the cities they ran. They were usually placed in a uniform so that they would be easily identifiable and put up in a fine palace where they could be watched and if need be guarded. All this was in the interests of accountability.

In his great work of 1513, *Il Principe* or *The Prince*, Niccolo Machiavelli demonstrated another way to rule. The prince had to do whatever was necessary to hold his state. This was another form of accountability. In the first, the 'owners' of the enterprise, the citizens, made sure that the manager did not do anything to seize power and usurp their rights by a system of close surveillance and accountability. In the second, the prince is given all power and that is all he has to keep him in his position. If he becomes a self-indulgent or excessive ruler in any way he will destroy his own power. This, believe it or not, is a form of accountability. It is closer to market forces than formalised methods of reporting.

I point this out only to suggest some parallels with contemporary thinking on corporate governance. Corporate governance is about the accountability of senior managers and directors for the use made of the owners' assets. It arises from the invention of the joint stock company, itself a derivative from guilds and partnerships formed under them. Obviously, sole traders and partnerships can regulate their affairs in a direct way: the managers and owners are the same people. But joint stock companies changed the ownership/manager relationship in significant ways. The joint stock company has flourished since the 16th century because it enabled the exploitation of new lands and resources and the development of new technologies and services. The finance required for most of these ventures was well beyond the means of individuals and even monarchs.

The joint stock company allowed many contributors to pool their capital, usually with monopoly rights as in the case of the Russia Company (1553), the East India Company (1600) or the Hudson Bay Company (1670). Such companies had other advantages over partnerships in possessing a corporate personality with a limited liability and allowing the transferability of shares. Owners of fully paid up shares have no liability in respect of their investments. On the other hand, a price they pay is not having much say in the running or management of the company. That must be delegated to a board and its managers. (Joint Stock Company Act 1856; Company Act 1862; House of Lords, Salomon v. Salomon & Co (1897)). The question increasingly asked is whether the modern corporation can deliver on its promise to ordinary investors, governments and society generally.

This has become a more pressing concern since the eighties and now that superannuation funds are swollen with compulsory contributions. When people like Christopher Skase do a bunk; or Robert Maxwell steals from a pension fund, thousands of people lose their retirement livelihood. Moreover, executive salaries and directors fees have increased dramatically, as the salaries of Blount of Telstra,

Trumbull of AMP and sundry other CEOs testify. So shareholders have an increasingly keen eye to corporate governance because a lifetime's investment could depend on it. They have not been happy with the incentives provided for under-performing executives. If they cannot get satisfaction from corporations, they will twist the arms of government to regulate business more tightly, and that is both expensive and inefficient.

In the UK, this has already happened in an indirect way. Public concern was so great that in 1991 the Financial Reporting Council, the London Stock Exchange and the accountancy profession established the Cadbury Committee to inquire into the financial aspects of corporate governance. The direct cause of this concern was that the audited returns of corporations seemed to show a healthy financial position for corporation after corporation that subsequently went bust. In Australia the same thing happened - see the excellent works of Sykes, and Clarke, Dean and Oliver¹ - for example with Osborne Computers, whose return for '92-3 showed excellent business growth but made no mention of a \$40 million hole which closed the company in 1995 after its margins were squeezed too thin to support its debt. But Cadbury went beyond the narrow terms of reference of financial reporting to more general issues.

The Committee's report recommended more transparent and fuller disclosure of financial information, boardroom checks and balances, and conformity with a voluntary Code of Best Practice which it had drafted. The first was necessary to enable stakeholders to have financial information necessary to exercise judgement and to inspire public confidence in the corporation. The second was to enable directors always to advance the best interests of the company and to avoid concentrations of power.

Cadbury recommended that there should be clear separation of the responsibilities of CEO and chair of the board of directors, ie. one person should not have both jobs. The role of non-executive directors needed strengthening, including a formal selection process, clear independence from the management of the company, and the absence of business interests which could conflict with those of the company. The establishment of an Audit Committee with at least 3 non-executive directors and access to independent audit advice was also recommended. This would bring greater objectivity and reliability to the auditing of company finances and engender greater shareholder and public trust in annual reports. As for the Code of Best Practice, the London Stock Exchange has since 1993, required listed companies to include in annual reports statements of compliance with the Code or, if that has not been possible or desirable, the reasons for not doing so.

In Australia similar developments have taken place. Following a spate of court decisions and enquires, the position of directors and the structure of corporate governance have come under increased scrutiny. The Senate has inquired into the Social and Fiduciary Duties of Company Directors (1989); the fiduciary duties of directors have been extended to include creditors, present and future (Kinsella & Anor v. Russell Kinsella Pty Ltd (in Liq.) (1986) 4 ACLC 215); and in 1989, a director of both Darlington Commodities and Bullion Sales International, Michael Oades, was ordered in the NSW District Court under section 229 (6) of the Companies Code to

¹ *Bold Riders, Corporate Collapse.*

pay \$6 million to the liquidators of both companies on the basis that he had breached his director's duties. Since 1 July, 1995, the ASX has required listed companies to state their corporate governance rules in their annual report (Listing Rule 3C (3)(j)).

Following overseas trends - notably the *General Motors Guidelines on Significant Corporate Governance Issues* - Australian thinking on independent directors is interesting. AIMA holds that a properly independent director is one who does not hold substantial shares in the company; has not been in its employment as an executive in the previous three years; is not a professional adviser to the company, either directly or indirectly; "has no significant contractual relationship with the company ..."; is not party to any business or other kind of relationship which could influence or be perceived to influence the director's judgement of the best interests of the company.²

Like the Cadbury Report, the Working Group on Corporate Practices and Conduct³, is concerned about concentrations of power. It endorses the separation of roles of CEO and Chair, and also the principle of an independent Chair. The Working Group supports the widespread practice of an audit committee on boards (in Canada audit committees are legally required). Unlike Cadbury but like General Motors, the Working Group recommends having a majority of non-executive board members. It supports the creation of Nomination Committees with a majority of independent non-executive members who will assess the performance of the CEO annually; assess the performance of the board and of individual directors; and find and nominate suitable candidates for board membership. In order to do this, nomination committees would need access to company officers and advisers, to company records and to such independent advice as it needs.

One thing which needs to be considered in all this is the demand on directors. They would be as busy as Democrats keeping the bastards honest, and could not really take on many directorships if they were to be done as diligently as proposed by the Working Group. On the other hand, directors performing their duties like an old fashioned servant of the Italian cities should be remunerated as they were. There are costs in securing high levels of trust in business.

The costs are clearly too high sometimes, and this can push proposals for reform of corporate governance face onto the rocks. In December 1994, guidance to the interpretation of the Cadbury Code was released in Britain. According to Ernst and Young's overview of the Guidance, "it is largely an attempt to water down the requirements of the Code". The Code had called upon the directors to report on the effectiveness of the company's system of internal control, the Guidance requires only that directors state the following:

- that directors are responsible for the company's system of internal financial control
- that such a system is only relatively secure, not absolutely so
- the most important procedures for internal financial control

² *Corporate Practices and Conduct*, 3rd edn. (South Melbourne: Pitman, 1995), p 13.

³ This working group produced *Corporate Practices and Conduct*. It comprised the Australian Institute of Company Directors, Australian Society of Certified Practising Accountants, Business Council of Australia, Law Council of Australia, The Institute of Chartered Accountants in Australia, and The Securities Institute of Australia.

- that directors have reviewed the system of control⁴

⁴ Ernst and Young, "The Cadbury Code's Requirements on Internal Control" at <http://www.ernsty.co.uk/accting/ifc/ifc2.htm>.