The role of the CFO in corporate governance

An address by Jillian Segal, Deputy Chair, Australian Securities and Investments Commission, to the Financial Executives International Luncheon, Sydney, 13 May 2002

Introduction

Thank you for inviting me to join you today. It is a pleasure to be here.

The role of the CFO is probably a pretty interesting one in most companies at the moment. Traditionally, the primary function of the CFO was that of 'finance' wherein the CFO's responsibility was to ensure that the company stayed financially healthy and could meet its obligations at any time – the CFO was in other words the "guardian of the books". While this responsibility remains an important one today, the evolution of the CFO's role has embraced a wider and more common range of responsibilities such that today's CFO has to be sensitive to many factors other than the financials of an organisation. Issues such as corporate governance, risk management and the maintenance of effective systems of internal control have emerged as essential. Globalisation and the acceptance of globally harmonized reporting standards in the future are bound to have other consequences for the CFO in years to come.

Before I talk about some of the more general aspects of corporate governance and ASIC's thoughts in relation to governance, I would like to spend a few minutes on the duties of the CFO, as an officer of a corporation, under the Corporations Act (the Act). While I am sure you are all aware of these duties, recent events suggest the need to refresh some memories.

Duties of company officers under the Corporations Act

Chapter 2D of the Act, relating to officers and employees, has some recent origins in the Corporate Law Economic Reform Program Act 1999 (CLERP). Apart from inserting more familiar provisions relating to the appointment and removal of company officers, CLERP also introduced provisions designed to improve corporate governance practices.

Division 1 of Part 2D.1 of the Act sets out some of the most significant duties of directors, secretaries, other officers and employees of corporations. Other duties are imposed by other provisions of the Act and other laws (including the general law).

Some of the key obligations of officers, as prescribed in Divison 1 of Part 2D.1 of the Act, include:

1. Duty to exercise care and diligence (s180), subject to the statutory business judgement rule [s180(2)];

2. Duty to exercise powers and discharge duties in good faith in the best interests of the company and for a proper purpose (s 181);

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3. Duty not to improperly use their position to gain an advantage for themselves or someone else or cause detriment to the company (s 182); and

4. Duty not to improperly use information obtained as a result of their position to gain an advantage for themselves or someone else or cause detriment to the company (s 183).

The message is clear – responsibility for corporate activities is not confined to directors, but can extend beyond the board of directors to individual directors, executives, officers and employees of a corporation. It is not only directors of a corporation who owe the aforementioned duties. Officers of a corporation, including CEO's and CFO's, are equally bound by the these duties.

As I mentioned earlier, the CFO's role has evolved to embrace issues such as corporate governance, risk management and the maintenance of effective systems of internal control.

Corporate Governance

These are certainly interesting times to be discussing corporate governance. The corporate collapses of the past eighteen months have inevitably raised questions about the state of corporate governance and the role of directors and officers in discharging their responsibilities and duties to shareholders and the wider community.

The present stage of the economic cycle certainly indicates that we are going to see more companies in difficulty (perhaps more ending in receivership and liquidation), more concerns from consumers about investments, and more complaints generally about disclosure, advice and scams.

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As we have seen, when a company collapses, the perception amongst the public is that there has been a breach of the law. Although each year we experience approximately 7000 corporate collapses, increasingly significant collapses are being referred to the corporate watchdog, and it is fair to say that a number of major collapses recently have directly affected many Mums and Dads – air travel, communications, and insurance products are all utilised by the average household. Clearly, these types of failures have a significant impact on the level of confidence that investors have in our markets. It is not surprising, therefore, to read about calls from some sectors of the community for some form of regulatory intervention, while others warn against the danger of more prescription.

ASIC has repeatedly acknowledged that the best governed of companies can still succumb to competitive and economic forces, and that corporate failure does not *necessarily* imply poor standards of governance. However, it is important not to be complacent about governance. Regulatory investigations of recent collapses have revealed key governance failures.

The law requires corporate officers to assume responsibility for the actions of the company, and as the regulator, it is our responsibility to ensure that the integrity of the law is maintained and that those who breach the law are made accountable for their actions. Consequently, we must continue to be vigilant in identifying problems and seeking to improve the integrity of our corporate environment. Having said that, more laws and prescriptive rules are not necessarily the answer. We need to develop a *culture* within the business community about the value of good corporate governance and its contribution to company performance and shareholder value.

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Corporate governance describes the principles and practices adopted by a company to ensure sound management of the company within the letter and spirit of the law. It affects and defines the relationships between the board, management and auditors, and includes obligations of the board and management to manage the company so as to protect and enhance shareholder wealth as well as meet the company's obligations to all parties with which it interacts. There continues to be considerable discussion and debate about the necessary and/or desirable elements of good corporate governance. Without canvassing the full spectrum of elements, it is generally suggested that a reasonable system of corporate governance would at a minimum cover matters such as:

- the mix of executive, non-executive directors and independent directors, and the role of a non-executive chairman;
- procedures for appointment and retirement of directors (criteria for appointment, analysis of the skills needed on the board);
- an audit committee to oversee the introduction and operation of compliance systems and accounting and financial controls;
- the composition, function and procedures of other board committees (e.g. remuneration committee and nomination committee);
- allocation of responsibility between the board, its committees and management and reporting requirements;
- directors' access to senior management and internal and external auditors;
- management's access to non-executive directors (through an audit committee or otherwise);
- the company's approach to identifying and managing risks inherent in the business;
- the existence of effective checks and balances such as internal control systems; and

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- access to management information, particularly accurate financial information and up-to-date information regarding debtors and cash flows.

Good corporate governance also involves an understanding of, and commitment to, the *outcomes* of corporate practices rather than simply a focus on the *process* of compliance. It requires the development of more than a checklist mentality approach. In essence, it is a philosophical approach to doing business in that it recognises that corporate practice does not simply involve *conformance* but also *performance*. A good performing company or market will not simply comply with the relevant rules and regulations. It will be engaged in practices, which promote a *culture* of good governance and effective checks and balances. As such, we need a firm commitment from all market participants including CFO's to improving the *substance* of governance, which will necessarily involve a commitment to strong internal controls, audit efficacy and independence, the improvement of actual disclosure practices and the empowerment of non-executive directors. An important part of governance for any board is to ensure that non-executive directors have appropriate access to important information and management within the organisation. Internal audit is also a significant part of governance. I believe for internal audit to work effectively, we need cross-organisational checks and balances (e.g. separate reporting lines are necessary so that information is fed directly through to top executives through an audit committee made up of independent directors).

When talking of governance, it is very easy for company officers to take comfort from the existence of governance structures. However, the structures will only work if individual company officers ensure that they exert "the Power of One" and use them to ensure accurate financial and management information is always provided to the board and the auditors, and that matters of concern are raised with the board (including the independent directors) as well as management.

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For a company to be well managed, an effective system of corporate governance needs to be present and functioning properly. ASIC's investigation into Spedley Securities before 1998, for example, revealed a system, which did not work effectively because of the absence or ineffectiveness of the required elements. Although the investigation dates back to 1998, the lessons are not dated. The following lessons – and I quote directly from ASIC's published report into the investigation dated December 1998 – indicate some of the deficiencies in Spedley Securities' corporate governance practices:

1. "**The dominant director:** If any one director has undue control over a listed company's assets and affairs, there is a dramatically increased risk of:

   (a) the company being party to non-commercial transactions, which favour that director's interests;
   (b) the company not making full and fair disclosure of its financial position; and
   (c) the company's funds being misused or stolen

2. **The role of non-executive directors:** Non-executive directors must be active in carrying out their duty of ensuring that directors and management are accountable for the management of the company. They must follow up on matters, which come to their attention and require explanation.

3. **Senior executives must be vigilant:** Senior managers have an independent responsibility to report concerns as to improper behaviour by directors or other managers of listed public companies. Well-managed

companies will have independent directors, audit committees and the like to whom such concerns can be taken.

4. **Effective internal controls are essential:** Internal control comprises the systems, methods and procedures adopted by management to assist in achieving efficient conduct of its business, adherence to management policy, safeguarding of assets and the prevention and detection of fraud and error. Internal control procedures commonly include checking the arithmetical accuracy of the records, preparation of reconciliations, using control accounts and trial balances, approval and control of documents, conducting cash, security and inventory counts, limiting direct physical access to assets and records and comparison of results with budget.

5. **The auditor must maintain an independent outlook and fulfil all responsibilities:** Auditors of public listed companies must carry out their responsibilities to users of audited accounts, including shareholders, creditors and regulators, by drawing public attention to significant or material matters, which have aroused their suspicion and about which they have had no satisfactory explanation."

As you can see, the Spedley investigation provided some significant lessons in corporate governance. ASIC's report into the Spedley investigation was published to share those lessons with the wider community.

A number of corporate governance issues were also drawn out of ASIC's investigation into the $700 million writedown of assets by Burns Philp in September 1997. Our inquiry raised issues about the adequacy of the steps taken by the board of Burns Philp to ensure the accuracy of the reported value of the herbs and spices assets, and about the corporate governance practices of the

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company. Although ASIC concluded that the commencement of legal proceedings was not justified, the report is nonetheless useful in providing guidance to the market about appropriate standards of conduct.

The report into the Burns Philp investigation was published in December 1998 and outlined a number of corporate governance practices of the board of Burns Philp. Some of the key corporate governance issues included – and I quote directly from ASIC's published report into the investigation dated December 1998:

1. "The need for adequate reporting by management to the board.

2. The need to ensure that shareholders are properly informed about the strategies adopted by a company, the risks associated with those strategies and the results produced by those strategies. In the case of Burns Philp, there was no segmented reporting of the investments in and the results of the herbs and spices businesses in the published financial statements.

3. The difficulties that can arise with the appointment of CEO as Chairman. Previous strategies may not be reviewed and there can be a lack of independent leadership of the board.

4. The use of optimistic accounting treatments, which can disguise the true performance of the business and delay remedial action."

ASIC's report into its Burns Philp inquiry also outlines a number of guidelines for all participants in Australian corporate life. Again, I quote directly from our published report into the investigation:

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1. "**Directors are responsible to ensure that the board functions effectively:** The Chairman of the board in particular, and all the board members, are responsible to ensure that:

    (a) the board works as an effective team;
    (b) on a regular basis, the board critically reviews the effectiveness of business strategies and the effectiveness of senior management;
    (c) progress is monitored and swift action is taken to remedy any deficiencies.

2. **Directors are responsible to ensure they are appropriately informed about business performance:** It is part of good corporate governance for directors to have up-to-date and reliable information about the performance of all components of the business.

3. **Directors must question and evaluate key features of asset valuation reports:** Directors cannot rely solely on the asset values determined by independent experts. The directors themselves must understand what the valuers are saying.

4. **Directors are responsible to ensure that shareholders are appropriately informed:** In fulfilling their corporate governance responsibilities, directors must ensure that reliable information is provided in a timely manner to shareholders.

5. **Auditors must question and evaluate material asset valuations**."

Ultimately, we need to recognise that corporate governance is not a static concept. Good corporate governance is an ongoing process and is not an end in

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itself. Like the market environment in which corporations operate, factors that influence corporate governance are constantly changing and, therefore, the regulatory framework and best practice also need to evolve. However, many of the lessons from past corporate collapses ring true today and I would ask you to consider these factors in relation to the following collapses and current enquiries by ASIC. Obviously, I cannot comment in any detail on current investigations, but enough is publicly known for each of you to consider the governance issues.

GIO

On 20 June 2001, ASIC commenced civil penalty proceedings against three former officers of GIO Insurance Limited (GIO Insurance). The proceedings allege that the respondents, Geoffrey Vines, Frank Robertson and Timothy Fox, breached their duties as officers of GIO Insurance during the course of AMP's 1998-99 takeover bid for GIO Australia Holdings Limited (GIO Australia).

The alleged breaches centre on the actions of the respondents in advising GIO Australia and its Due Diligence Committee on the financial outlook for the group's reinsurance business.

ASIC alleges that the respondents improperly used their positions and failed to exercise the duties of care and diligence required by the then Corporations Law when preparing forecasts and other relevant information for consideration by the GIO Australia Board and the Due Diligence Committee.

ASIC further alleges that, as a consequence of the respondents' failure to properly discharge their duties under the Law, information was released to shareholders of GIO Australia that was seriously defective and misleading.

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HIH

A decision was handed down by Mr Justice Santow of the NSW Supreme Court on 14 March this year in ASIC's civil penalty action against former HIH director Mr Rodney Adler, former HIH CEO Mr Ray Williams and former HIH CFO Mr Dominic Fodera.

The Court found that the three former directors had breached their duties as directors in relation to a payment of $10 million by an HIH subsidiary (HIH Casualty and General Insurance Ltd) to Pacific Eagle Equities Pty Ltd, a company of which Mr Adler was a director. The Court also found that Mr Fodera, the former CFO of HIH, breached section 180 of the Act. As discussed previously, section 180 of the Act requires a director or other officer of a corporation to exercise his or her powers and to discharge his or her duties with the degree of care and diligence that a reasonable person would exercise.

This ruling is an important one. It reinforces the expectation that directors and other officers of a corporation should observe proper standards of conduct, and should not place personal interests ahead of those of the company. A decision regarding penalty is still to be handed down.

The decision is being appealed.

Harris Scarfe

On 19 April this year, Mr Alan Hodgson, the former CFO of Harris Scarfe, pleaded guilty in the Adelaide Magistrates Court to 32 charges laid down by ASIC after ASIC's investigation into the Harris Scarfe group. Mr Hodgson pleaded guilty to 18 counts of failing to act honestly as an officer of Harris Scarfe, 6 counts of acting dishonestly as an employee of Harris Scarfe and 8

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counts relating to the dissemination of false information to the Australian Stock Exchange (ASX).

ASIC alleges that Mr Hodgson procured the making of false entries in the books of account of Harris Scarfe, which had the effect of increasing the level of profits in the consolidated accounts of Harris Scarfe. The alleged conduct occurred during the period from August 1996 to January 2001 and affected profit figures shown in monthly financial reports to the Board, and the half-year and end-of-year financial reports to the Board and to ASX. Mr Hodgson was committed for a sentencing hearing in the District Court, which is due to take place on the 27th of this month.

One.Tel

On 12 December 2001, ASIC announced civil proceedings against Messrs Rich, Keeling and Silbermann of One.Tel, and former chairman of One.Tel, Mr John Greaves. ASIC is seeking declarations of contraventions, bannings, and damages of between $30 million and $50 million in compensation for the reduction in One.Tel's value over an eight-week period from 30 March 2001 to 29 May 2001. This matter is due to go to trial mid-year.

Conclusion

To conclude, I believe there needs to be strong commitment from the corporate community to the fundamental principles of corporate governance. Good corporate governance practices and standards will contribute to improved corporate performance, provide increased access to capital markets, more efficient financial markets and improved competitiveness as a consequence.

As noted previously, the CFO has an increasingly important role in corporate governance. ASIC will remain active and energetic in pursuing breaches of the

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law and in enforcing the minimum standards of corporate behaviour. We will continue through our Policy Statements, Practice Notes and our educative role to attempt to instil and promote a culture of compliance and disclosure amongst companies, directors and other officers. It will, however, be for those within the corporate sphere to ensure that the high standards of business practice, which the investing community has a right to expect, become a reality in Australia's boardrooms and in the Australian financial services sector.

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