ASIC

Australian Securities & Investments Commission

Monash Law School Foundation Lecture

Mr David Knott

Chairman
The Australian Securities and Investments Commission

Corporate Governance: 1980s Revisited?

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Introduction

Thank you for that generous introduction and for the invitation to present this lecture.

I confess that when I was appointed as ASIC Chairman last November, I did not envisage that this subject would be quite so topical. Naturally, I was very conscious of the new economy bubble having burst and my radar was attuned to a range of related governance and regulation fallout. But I did not expect to be confronted so soon by a series of corporate failures of a magnitude not seen for a decade. Reaction to these events has ranged from hysterical foreboding to wearied acceptance – but as time passes they will attract more considered and mature analysis.

You will understand that as these failures are the subject of official enquiry I will avoid any individual discussion of them tonight. However, I have already expressed the opinion that our recent spate of corporate failures does not have the appearance of a systemic collapse of good governance in Australia. I believe that the hysterics have been overdone; and I am equally critical of those who take on a world-wearied cynicism as if to say: "What else can you expect, nothing has changed".

The evidence contradicts the cynics.

In my view we can differentiate our current climate from the 1980s in some important ways. We do not have the endemic governance issues which confronted us a decade ago; although there are some signs of increased credit risk, we do not have the grossly inflated balance sheet asset values which then prevailed; we do not have the structural manipulation which profiled so highly in that decade; and we do not have a climate of high inflation and excessive commercial property values which contributed to the magnitude of the 1980s collapses.

We have done a great deal since that time to address all of these issues. Our institutions and standards of corporate conduct, taken over all, lose nothing in comparison to our peer group developed countries and are regarded as a benchmark by many of our neighbours. Our ability to withstand the Asian economic crisis of the later 1990s was in part attributable to the steps taken earlier in the decade to rebuild international confidence in the integrity of our markets.

These words of comfort are not intended to convey complacency about our markets environment. The best governed of companies can still succumb to competitive and economic forces. Good governance is of itself no assurance of corporate success, any more than corporate failure *necessarily* implies poor standards of governance. Throughout the 1990s there has not been a single year in which the number of corporate insolvencies, receiverships and administrations was lower than 6000 - and only a fraction of these can be attributed to failure of governance in the sense that we are talking about it this evening.

Businesses fail. They always have and they always will. The limited liability company remains the mainstay of our private enterprise system, a system based on the premise that failure alone is not culpable and that risk is to be acknowledged and shared.

We also know that business failure increases when economies contract. Accordingly, if international economic conditions get tougher we can expect insolvencies to increase, which will inevitably create additional focus on issues of governance. If that occurs it will not be confined to Australia.

A renewed debate

In the meantime, there can be little doubt that all the activity of the past six months has caused the community to refocus on questions of corporate governance with renewed intensity. Some old agendas have been revived; some new contributions made. One year ago a speech on governance would have been prescribed to cure insomnia. Out of adversity the subject is again enlivened – back on Boardroom agendas with a vengeance.

Many of you will have noted a speech made by the Minister for Financial Services and Regulation, the Honourable Joe Hockey, to the Australian Shareholders Association last week. It canvassed a number of important subjects directly related to corporate governance. You will have also observed references to governance matters in policy statements issued by the Federal Opposition in anticipation of the election later this year.

I was personally pleased to hear the Minister reject the notion of a separate corporate governance board, arguing that good governance "needs to be integrated into the whole rather than being 'handed-off' to a separate body". I respectfully agree with that view and, for similar reasons, I am a supporter of the Anglo-Saxon model of the unitary Board over the European model of double-tiered Boards. I would like to expand on that point because I believe that we are likely to hear more about the alternative models as part of this renewed debate in coming months.

Models of board governance

The use of the terms "Anglo-Saxon model" and "European model" are non-pejorative shorthand which I use only as general labels to facilitate this discussion. Differences certainly exist within the models between different jurisdictions, but the fundamental differentiation between the models is what counts most. The Anglo-Saxon model involves a single Board (usually consisting of both external and management representatives) which, together with shareholders, comprises the governing structure of the corporation. The European model involves both a Management Board (comprised entirely of management representatives) and a Supervisory Board (comprised entirely of external representatives). Proponents of this dual structure are often attracted by the notion that it more clearly differentiates the operational and business judgement responsibilities of management from the higher level policy and strategic role of the Supervisory Board. Some advocates also believe that this structural separation provides a more logical and transparent means for liability allocation.

It is difficult, however, to consider the European model without taking account of its history and, in particular, its aspirations for the cooperative participation of labour and capital in corporate management. It is common to find a requirement that Supervisory Boards must include employee representatives. For example, in Germany all public companies employing more than 2000 staff must have Supervisory Boards comprising 50% workplace nominees. In that country the doctrine of "co-determination" places great store on this avenue for integrating social and corporate harmony. It is important to recognise this major difference between the two models when assessing their relative merits.

It is also important to understand how these structural and social objectives play out in practice. In recent times there has been increased questioning within Europe about the governance implications of mandating compulsory Supervisory Board composition. It is understandable that entrenched positions may be taken at that level by the two camps for ideological or political reasons, which can have the result of weakening the governance effectiveness of the Supervisory Board and strengthening the hand of management. Some critics of the European model argue that, in reality, the Management Board controls the policy and governance framework (bearing in mind that Supervisory Boards tend to meet less frequently than their Management counterparts) and that the watchdog role of the Supervisory Board is largely illusory. Experience also suggests that when failures occur, members of the Supervisory Board are not immune from public opprobrium and cannot be certain of avoiding liability.

It is not necessary for me to describe to this audience the features of the Anglo-Saxon model. We have had some very interesting debates in Australia about the appropriate mix of management and external directors; their respective responsibilities and liabilities; and the importance of ensuring that the private interests of external directors are not conflicted with those of the company or its shareholders.

To the extent that one can discern a trend in the debate about the relative merits of the models, it appears to favour the increased adoption of the Anglo-Saxon model.

Globalisation of business, coupled with market imposed governance expectations, certainly point to the increased likelihood of convergence. I note in passing that the American version of the Anglo-Saxon model appears to be embracing the importance of independent directors more enthusiastically than in the past.

I believe that the unitary Board, comprising a mix of management and external directors, is an entirely appropriate governance structure, but one whose effectiveness can be further improved by increased attention to Board training and assessment. It seems anomalous that we invest huge sums into staff development and training but almost nothing into similar programs for the people who control our major enterprises. We also utilise sophisticated performance management techniques, involving targets and measurements, across most staffing levels of our corporations – but seldom extend the same disciplines at Board level. I am aware that some of our major corporations are giving these issues serious thought, not only as a means of raising Board efficiencies but also as part of their risk management frameworks.

From time to time we hear calls for the licensing of public company directors. Licensing regimes are common place in circumstances where reliance is to be placed on the experience or competency of the provider. We all accept it in the context of professional services, of skilled trades and in the arena of financial services – and in that latter instance ASIC is a licensor which pays appropriate regard to standards of training and competency. It may seem incongruous that companies which raise public moneys for investment in risk activities should escape a licensing regime targeted to the competencies of their directors. However, except in limited cases of public interest where a "fit and proper" test is applied, Board licensing has been viewed as overly intrusive. I would personally be disappointed if we were to reach the stage where formal licensing was considered necessary. However, I do reiterate my belief that more attention needs to be given to Board training and assessment, ideally by companies themselves and by organizations like the Australian Institute of Company Directors, Institutes of Management and other stakeholder groups.

Finally, on the subject of alternative Board models, I would contest the assertion that we need to move to a Supervisory Board system in order to better quarantine non-management directors from liability. In the first place, I believe that there is greater residual liability under the European model than is sometimes assumed. Secondly, and very importantly, we introduced the business judgement rule provisions into our Corporations Law last year after extensive community debate about the appropriate balance between risk taking and accountability. That debate took account of varying judicial decisions concerning the responsibilities of company directors and, in effect, codified the approach to be taken by the Courts in future. As you know, directors are now taken to have met their statutory requirements of care and diligence – and to have satisfied equivalent duties at common law and in equity – if they:

- Make the judgement in good faith and for a proper purpose;
- Do not have a material personal interest in the judgement;
- Inform themselves to the extent they reasonably believe to be appropriate; and
- Rationally believe the judgement is in the best interests of the corporation.

These provisions have not yet been tested by the Courts, but it is reasonable to predict that they will be judicially reviewed within the next couple of years. On the face of it, they provide a comprehensive shield against unwarranted liability for directors and officers who discharge their functions responsibly.

Thirdly, I believe that the Law adequately allows for the possibility that non-director officers of a corporation might in some circumstances be primarily responsible for misconduct. That is something that ASIC has been required to consider in the context of enforcement proceedings, for example, when instituting civil penalty proceedings against certain former officers of the GIO group in June this year.

In all those circumstances, I have difficulty in accepting that the dual Board model is a necessary or effective means of addressing the liability of non-management directors.

Auditors

There is one other aspect of the Minister's recent speech to the ASA that I would like to touch on – the role of auditors. It is inevitable in the wake of prominent corporate failures that there will be great focus on this issue. The Minister canvassed a number of aspects relating to auditors in his speech, including those connected with auditor independence. You will be aware that Professor Ian Ramsay is preparing a report on the matter for the Minister and that ASIC is conducting a survey of Australia's top 100 companies to derive better information on current practice.

I do not propose to dwell on these initiatives tonight, except to reiterate my view that community expectations of audit need to be examined from a broad perspective, not by assuming that independence is the only – or necessarily the most important – issue at stake. It is logical to assume that lack of independence may lead to a bad audit. But it is a non-sequitur to deduce that an independent audit will be a good audit. We need to question just how rigorous and investigative we want our audits to be; what we are prepared to pay for them; and how strictly we will hold the accounting profession to account for failing to detect and report when financial statements do not reflect a true and fair view of the enterprise.

The question of audit cost is one which I believe needs to be re-thought. Everyone in this room who has ever built or renovated a house knows how frustrating it is to spend vast amounts of money on works which will never be seen – beneath the floor; in the ceiling; behind the walls. We would rather be spending more on the visually exposed parts of the construction, but we accept the need to invest in safety and durability.

Yet it appears to me that business has placed decreasing value on audit and has become less willing to invest in it. One sometimes gains the impression that corporations regard audit as a necessary evil rather than a function that should be making a real contribution to shareholder value and security. I acknowledge that these comments are anecdotally based, although such published material as exists does indicate that business has been spending less, rather than more, on audit. I think it is timely that the directors of our public companies give renewed personal attention to this issue. Questions they might usefully ask themselves include:

- Does the scope of the company's audit receive the high level consideration which is applied to strategic decision making?
- Is the audit budget realistic to support a sufficiently investigative process?
- Is the Board sufficiently involved in agreeing the terms of the audit mandate?
- Is the Board sufficiently focussed on ensuring that substance is preferred over form in its financial reporting?

Unless Boards are committed to audits which are truly probative and comprehensive, we must accept that audit practices will fall short of their possibilities. The cost of supporting more effective audit has to be weighed up against the risks of potential shareholder loss and directors' liability which may follow from under resourcing the activity. Moreover, one might reasonably expect that better resourced and better quality audits will be valued by the market and lead to increased investor support.

The work that our accounting bodies are carrying out on the development of standards, particularly the new commitment to international harmonisation, is vitally important to the interests of Australia. Comparability and consistency of accounting treatment is not only of immeasurable value to the users of accounts but is fast becoming indispensable to the efficient conduct of business in a globalised world. The reinvigoration of the AASB and the outward looking charter of the Financial Reporting Council deserve the strongest possible support from our business, investor, academic and other stakeholder communities. In particular, I encourage business to identify the self-interest motive for supporting the funding of Australia's contribution to the development and adoption of international accounting standards.

One of the greatest challenges for the developers of standards is to guard against a triumph of form over substance. The laudable objectives of comparability and consistency tend to encourage a detailed rules based approach to standards which, although superimposed against the backdrop of a "true and fair view", place an increased compliance focus on technicalities and legalism. There is no easy solution to this dilemma, and as the regulator which ultimately must oversee compliance with Australian accounting standards we recognise the need to ensure that they are not so vague as to be unenforceable. On the other hand, it seems essential to me that the conceptual principles of the true and fair view, of substance over form, need to be reinforced as part of the total standards and legislative package, and as part of the way our accounting profession is trained. I note in passing that unlike accounting standards which have the force of law under the Corporation Act, audit practice standards are self regulatory. That is one of the matters we should re-examine as we review the role of audit over the next two years.

Importance of the investor

I have heard it said that continuous disclosure by listed companies has overtaken the significance of financial reporting. I do not agree with that proposition. I do not believe that continuous disclosure can ever fully substitute for a comprehensive independent assessment and statement of a corporation's worth and trading position. In my view the frequency of financial reporting is a separate issue, albeit one that certainly has relevance to the market disclosure debate. There has, for example, been much interest in the recent decision by the United States to combine a quarterly reporting regime with a continuous, or intervening, disclosure obligation.

Whenever we discuss these matters of disclosure and financial reporting, we need to remind ourselves that they serve vital economic and social purposes. The maintenance of investor confidence in our capital markets - and the encouragement of direct retail investor participation in traded markets – have long been considered matters of national interest. Indeed, Australia was one of the first countries in the world to prepare itself for direct retail market participation. We recognised that unless investors had confidence that the market was properly informed and that there was equal access to price sensitive information, we could not hope to attract and maintain investor support for our markets. In the early 1990s we engaged in a vigorous debate about the preferred nature of corporate reporting – whether it should be quarterly or continuous – and we introduced laws which were far in advance of the USA and the UK at that time, and have only recently been matched. We substantially beefed up our insider trading laws as a further demonstration of a national commitment to a market in which investors can trade on equal terms and with confidence in transaction transparency.

Against that background I last week expressed disappointment about the apparent disregard by some sections of our markets for observance not only with the letter of the laws of disclosure but with their underlying spirit and purpose. If we permit practices to exist which perpetuate the perception that wholesale market participants have privileged access to information and trading opportunity, we will lose the confidence of retail investors and undermine the considerable advances of the past decade.

Over the last 18 months ASIC has worked hard to promote practices which shore up investor confidence. We have intervened more directly to correct poor disclosure than ever before. We sponsored the "Heard it on the Grapevine" principles, particularly the discouragement of information distribution through selective briefings. In the main we have been encouraged by support from the business community. Yet we would all be deluding ourselves to believe that we have won this battle. This is about changing attitudes and cultures which have been around as long as the markets themselves – and in order to effect that change we need a commitment to voluntary compliance supported by effective regulatory sanctions against those who offend.

Ladies and Gentlemen, thank you for attending this Monash Law School Foundation Lecture. The Foundation has a reputation for energy and innovation, and for stimulating vibrant discussion. I am honoured to add my small contribution to that tradition and thank you for your attention.