

## Corporate Governance in Australia: Some Recent Developments<sup>1</sup>

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### 1. Comparative corporate governance

Corporate governance is at or near the top of the list of issues of practical importance to most economies in the world. Deficiencies in corporate governance have been blamed for the Asian financial crisis of 1997. Stern criticisms of Japanese corporate governance practices are linked to Japan's current economic malaise, where the market value of corporations, as measured by the stock markets, has retreated to 1983 levels. President Bush has spent much of his recent domestic agenda berating his corporate sector for its misbehavior, which has seen the US economy slump dramatically, and its share markets lose most of their gains of the 1990s. Australia is not insulated from these problems, as we shall see.

Within the last year the United States has responded to recent perceived failures in corporate governance with the Sarbanes-Oxley legislation,<sup>2</sup> which has had repercussions world wide. The attempt to impose the US view of regulation of corporate governance by prescriptive, penal legislation on reporting entities in the USA in relation to their enterprise activities outside the USA is a study in itself. In January 2003 the Department of Trade and Industry in the United Kingdom published the Higgs Report<sup>3</sup> on the impact of non-executive directors on corporate governance and the Smith Report<sup>4</sup> on Audit Committees. Both Reports have been the subject of a critical press. They contrast with the US approach by their non-legislative approach. Instead they continue the UK regulatory tradition of establishing guidelines that companies need not adopt, but which require listed companies that do not adopt them to justify their decisions to their shareholders. In Japan a series of legislative amendments have been adopted to strengthen corporate governance.<sup>5</sup> A feature of these changes has been a trend to adopting US management models.

This paper outlines recent Australian developments to a Japanese audience and attempts to place them in the context of both recent developments in Australian companies law and developments in the USA, the UK and Japan. In the Australian case, a national government Report in September 2002<sup>6</sup> set out a blueprint for improving corporate governance and disclosure. On January 1, 2003 new continuous disclosure rules were imposed on listed companies by the Australian Stock Exchange ( ASX )<sup>7</sup> This has been followed in April 2003 by the publication of new corporate governance principles by the Australian Stock Exchange ( ASX )<sup>8</sup> that will bind listed companies. These requirements were drawn up by a committee of representatives of all major peak organizations that

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have an interest in corporate governance. This is an interesting contrast to the US and Japanese legislative approaches and the English executive government approach. The 2003 Australian response is a private sector attempt to gain control of the corporate governance agenda, or at least to postpone government action.

This paper will introduce Japanese readers to key developments in Australian company law and regulation over the past five years, identify some key areas of failures in the Australian corporate governance system, introduce data on five recent major corporate failures which illustrated failures in corporate governance,<sup>9</sup> and outline the parts of the September 2002 Government Recommendations and the 2003 ASX response which are relevant to those failures. In the last part of the paper a tentative evaluation is attempted of the different regulatory responses evident in the Australian and US approaches to the current corporate governance debate.

### 2. Corporate governance and managing a company

A distinction needs to be made between corporate governance, which addresses systems to control the managers and make them accountable, and management systems that control employees (including executive managers in their roles as employees). In earlier work on derivatives, I was struck that the spectacular losses recorded by financial institutions in the early 1990s were all failures of management systems, not of the underlying securities or financial instruments themselves. I refer to Barings Bank in Singapore, Daiwa Bank in the United States and Sumitomo Copper. In each case, the management system placed an individual in a situation where he could both trade in the security and at the same time be the supervisor of the trades. Obviously, the individual was in a position to act fraudulently and to cover up that fraud. A proper supervisory structure that made it impossible for the person responsible for policing trading to also trade, would have avoided all those cases. This was management failure, not a failure of the underlying products. In the Daiwa Case, a Japanese court has traced responsibility from the initial supervisory failure to a failure of systems of accountability by managers to the Board, and then the Board to the shareholders.

As we shall see, in the Australian case, in five recent corporate failures the deficiencies found to be present in each case did relate to governance failures.<sup>10</sup> This highlights the areas in Australia in which reforms to governance practices can be made. It remains for subsequent investigations to demonstrate whether governance failures helped employees to perpetrate breaches of the laws.

The main areas of contention in governance practice in Australia have been identified as:

1. Ownership structures (including those of listed companies) have been dominated by a

shareholder or shareholders with effective control.

2. A lack of independent members of Boards of Directors-instead boards may be dominated by founders and their families, former audit firm personnel and large shareholders.
3. Audit Committees are not independent and have included persons related to the audit firm.
4. There are major problems with related-party transactions involving companies that have representatives on the Board, indicating perhaps a poor appreciation of conflict of interest. This may be part of the culture in Australia.<sup>11</sup>
5. There is weak shareholder control through the lack of use of the power to dismiss at elections of directors or through takeovers.
6. Remuneration packages for CEOs have been poorly planned, leading to allegations of excessive payments to failed executives, but at the failed companies investigated in the Report, only a small amount of remuneration was subject to performance criteria.
7. There is a problem with handing on public companies to the children of their founders in Australia.

In the following sections, I will discuss each of these areas of governance in turn in relation to examples of the problem and the proposed reforms.

### 3. Australian corporate governance-the new legal environment

Australian regulation of companies has taken on some interesting features over the last decade. At the level of governing laws, a three-decade long process culminated on 15 July 2001 with the replacement of State laws with a national law, the Corporations Act 2001 (Cth).<sup>12</sup> For the Constitutional lawyers, this was achieved by a seldom-used power of States to refer their powers to the national Parliament. Although a complex system of cooperation with State authorities continues, for the first time Australia has a really national companies system, from incorporation to dissolution. A great deal of related legislation was also passed, including a national Financial Services Reform Act, 2001 (Cth) which impacts on corporate financing. The new Corporations Act reflects the work during the 1990s to simplify the legislation, and the removal of complex wording designed to accommodate the former co-operative system further enhances the “user friendly” aspects of the legislation.

Second, during the 1990s the national government moved the responsibility for corporate law reform from the Attorney-General’s Department to the Treasury. Company law was identified as predominantly economic law.

Third, the Corporations Act is intended to be a code. It has subsumed the former law that was

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found in the cases, although the courts still refer to the old cases. In the area of corporate governance, there is now a code of minimum directors' duties that has both civil and criminal consequences.<sup>13</sup> However, a company may impose standards that are higher than those prescribed by law.<sup>14</sup> There also is an extensive code covering financial auditing.

The same regulator has, since 1998, been responsible both for supervising corporations and securities laws, and also the financial sector. It is now known as the Australian Securities and Investments Commission (formerly the Australian Securities Commission). In recent years, Australian company practitioners have taken to referring to Australia's approach to regulation as "principles" based, in contrast to the American approach which they term "rules" based. This has emerged quite strongly in the contrast between Australia's September 2002 and April 2003 proposals for reform of corporate governance with the earlier Sarbanes-Oxley legislation in the United States.

With the extensive privatization of government corporations in the 1990s, most notably the national commercial bank (the Commonwealth Bank), the national airline (Qantas), and the national telecommunications company (Telstra) the percentage of the population holding shares has increased significantly. Indeed, Australia's current Prime Minister has expressed the ambition to make our nation a nation of small shareholders. Privatization has been allied with a national superannuation policy under which, in addition to government pensions, companies and employees are now compelled by law to invest in superannuation. The everyday Australian is today linked to the capital markets as never before. There is a real interest in the proper management of companies.

### 4. Recent developments in Australia: Auditing, Conflicts of Interest and Remuneration

#### i. Audit failure

When responsibility for corporate law reform moved to the Treasury Department in the 1990s, the Corporate Law Economic Reform Program (CLERP) was established. The program has published nine Reports to date, all of which have had far-reaching consequences for the Australian corporate and financial sector. The impetus for the most recent Report, CLERP 9, has come from our own equivalents to the USA cases of spectacular corporate collapses, frauds or corporate battles. While the USA has its Enron, WorldCom, Global Crossing and Tyco, Australia has produced its own big failures: HIH,<sup>15</sup> Paminco,<sup>16</sup> Harris Scarfe,<sup>17</sup> Centaur Mining,<sup>18</sup> and Onetel.<sup>19</sup> The report by the Institutional Analysis group indicates that the five shared a number of similar failures of governance.<sup>20</sup>

The true picture in the five failed companies is still emerging. Under Australian law the insolvency process involves public examinations before a court at the initiative of the liquidator. Such proceedings are in train with Harris Scarfe, One.Tel and may be triggered with Centaur. A Royal

Commission was set up into HIH, which is a special inquiry commissioned by the national government and headed by a Judge, who reported to the government on April 4, 2003.<sup>21</sup> The Report of the Royal Commission was published by the government on April 16, 2003. The Commissioner recommended that 56 possible breaches of the criminal and civil law be investigated, involving eighteen possible defendants, and that sixty-one policy changes to the law be adopted. The Commissioner also recommended the effective dismissal of the independent government regulator, which had failed to properly administer the company.<sup>22</sup> Pasmenco was restructured, so is no longer under investigation.

The fact that these five examples do involve spectacular corporate losses, partly attributed to audit failures, resulted in the commissioning of a special report to the government by my colleague and current Dean at the Law School at the University of Melbourne, Professor Ian Ramsay. His report on “The Independence of Australian Auditors” was published in October 2001. Unlike many reports to government, his recommendations not only received widespread support, but now look like being largely implemented.

In parallel, the Corporate Law Economic Reform Program (CLERP) undertook an investigation that reported in September 2002. It has adopted the thrust of many of Professor Ramsay’s recommendations.<sup>23</sup> Meanwhile, the Royal Commission established into the collapse of HIH, and the very public investigation by the liquidator of One.Tel has ensured that the Australian financial press has not been short of interesting material in relation to audit failure.

#### ii. Directors’ conflicts of interest

A second general area of concern demonstrated by several of the five companies that failed, and by a major governance battle at Coles Myer<sup>24</sup> in 2002, is the issue of directors’ conflicts of interest. Coles Myer is not a case of corporate collapse, but is a very unusual case of infighting on the board of a major retail company that resulted in shareholders being asked by a majority of the board to vote to dismiss two directors at the November 2002 AGM. One of those directors was a former Chairman of Coles Myer, and a major shareholder with about 6% of issued share capital, whose own companies have supply contracts with Coles Myer worth \$60-70 million per annum. In the run up to the AGM the former Chairman increased his shareholding and held a substantial number of proxies, but it was not enough to fend off defeat. However, the current Chairman who initiated the battle also resigned, with a substantial payout.

#### iii. Remuneration

The other major issue of concern to the financial press in Australia in recent times is the scale of executive remuneration in Australia. During the 1990s there was a massive increase in executive

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rewards, including a new reliance on share options. This may have been related to a trend to import US executives on huge rewards to manage some of our largest companies, particularly if they were not performing. Examples included Telstra, the national telecommunications company, WestPac, one of the big four banks, BHP, the largest of our mining houses, and Coles Myer.

In the next section I will relate the recent Australian reform proposals to these issues of corporate governance.

### 5. CLERP9 and the ASX “Essential Corporate Governance Principles”

In September 2002, the Corporate Law Economic Reform Program issued its ninth report (CLERP 9). The Report lists forty-one recommendations, which can be grouped around audit independence, executive remuneration and the independence of remuneration committees, protection to whistle blowers, and the establishment of new powers for an existing regulator. In response, the ASX Corporate Governance Council, which was established just one month prior to the publication of CLERP9, has published ten “essential corporate governance principles”<sup>25</sup> and has required listed companies to indicate in their disclosure documents if they have adopted them, and if not, why not. The government has yet to introduce a draft Bill to implement CLERP9.<sup>26</sup> The ASX Ten Principles apply to the listed company’s first financial year commencing after January 1, 2003. This means that companies are not required to report until 2004.<sup>27</sup> How do CLERP 9 and the Ten Principles relate to the problem areas outlined above?

#### i. Ownership structures.

Of the five companies that failed, Institutional Analysis reported that three had problems in their ownership structures in that they were effectively controlled by one shareholder. CLERP 9 does not directly address this issue, but its recommendations about independent oversight of accounts should make it more difficult for future abuses by controlling shareholders. The twelve recommendations about continuous disclosure<sup>28</sup> and the five recommendations<sup>29</sup> about shareholder participation and information,<sup>30</sup> should also improve the situation. These latter recommendations include the establishment of a Shareholders and Investors Advisory Council chaired by the Parliamentary Secretary to the Treasury, which will consult on all disclosure related reforms from the viewpoint of retail investors.<sup>31</sup>

At the end of the day, however, a controlling shareholder is in a powerful position to steer the direction of the company. It is reported that of the 100 companies that make up the Standard and Poors Australian Stock Exchange Index, 39 have controlling shareholders.<sup>32</sup> This should be of great interest to the students of Japanese ownership structures, which are supposed to be takeover proof

due to cross-shareholdings. The same situation applies to a very high percentage of Australia's major companies, so long as the controlling shareholder does not sell, creating doubt as to Australia's proper classification as a shareholder model rather than a control model of corporate governance.<sup>33</sup>

The ASX's Ten Principles do not directly address the issue of controlling shareholders. They are more directed at the division of authority between the Board and Management and the provision of information to small shareholders. Principle 1, which is to "Lay solid foundations for management and oversight" says the company's framework should "be designed to...ensure a balance of authority so that no single individual has unfettered powers."<sup>34</sup> Principle 1 is thinking of the board and management, not the shareholders and management. Principle 5, which is to "Make timely and balanced disclosure" includes the requirement for mechanisms that ensure "all investors have equal and timely access to material information concerning the company-including its...ownership and governance."<sup>35</sup> This may prove to be of assistance in the future if it involves a clear disclosure of the identity of a controlling shareholder in an accessible form.

#### ii. A lack of independent members of Boards of Directors

The Institutional Analysis report also indicated that instead of the recommended shareholder governance model of independent directors controlling executive directors, in the five companies under consideration, four boards were dominated by founders or their families, or audit firm personnel and large shareholders. The report concluded that only 24 percent of directors of these companies were truly independent, compared to 45 percent of directors in the Standard and Poors Australian Stock Exchange 100 companies.<sup>36</sup> Given the talk about corporate governance in countries like Australia, the fact that in the S&P/ASX 100 companies, a majority of directors are not independent is striking. The statistics could be manipulated to make things look even worse, as they do not say that 45% of boards are independent, rather that 45% of directors overall are independent. There could be a very high percentage of independent directors in a much smaller percentage of companies.

The report also makes the point that at these failed companies the independent, non-executive directors had twice as many directorships in other companies as is usual in the business community (an average of 2.7 appointments to 1.3)<sup>37</sup> This suggests either that their vote could be bought, or that they were not devoting as much time to their directorship with the failed company as it required in fact. The fact that they were not serving on the audit committees of four of the five may explain why they had time to serve on other boards.

CLERP9 does not address the issue of independent directors. Principle 2 of the ASX's Ten Principles is most relevant here. It says that the board should be so structured that it can exercise

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independent judgment and, in recommending how to achieve best practice, Recommendation 2.1 says that “A majority of the board should be independent directors.”<sup>38</sup> The recommendation includes a seven-part definition of “independence.”<sup>39</sup> Further, the recommendation indicates that the governance section of the Annual Report should identify those directors thought to be independent by the board. Whether independent or not, the recommendation requires that “All directors should bring an independent judgment to bear in decision-making.”<sup>40</sup> This is a substantial step forward. Recommendation 1.1 in relation to Principles 1 and 2 also envisages the possibility of a “lead” independent director.<sup>41</sup> This can be compared to the UK Code’s “Senior Independent Director.”<sup>42</sup> The ASX embraces the Higgs recommendation that the company’s Chair should be an independent director and that the roles of the Chair and CEO should be filled by different people.<sup>43</sup> This is in contrast with the US situation, where it is reported that only about one-fifth of US listed companies separate the two roles.<sup>44</sup>

### iii. Audit Committees were not independent

The Institutional Analysis report claims that there were no independent members at all on the audit committees of four of the five companies, Centaur, Harris Scarfe, HIH, and One.Tel, and at only two were the audit committees composed of non-executive directors. In contrast, the Report asserts that 90 per cent of the S&P ASX 100 companies have audit committees comprised entirely of non-executive directors.<sup>45</sup> Here, the Report does mean that 100% of audit committee members at the 90 per cent of companies are all independent in the wider sense used in the Report, ie: “...meaning they were not financially or otherwise dependent on management or affiliates, they were not on the executive team and were not part of some business contracted by the company.”<sup>46</sup> In contrast, the Report indicates that at HIH three members of the audit committee were former partners of the audit firm and at Harris Scarfe there were two. At One.Tel, the same two directors were the sole members of the audit, remuneration and corporate governance committees, and neither was an independent director.<sup>47</sup>

The CLERP 9 reforms do not address the structure of the audit committee, but do make it compulsory for the 500 largest companies listed on the ASX ( which make up the All Ordinaries Index ) to establish audit committees. The ASX has agreed to amend its listing rules to require this,<sup>48</sup> although the accounting profession fought the requirement of audit committees for all listed companies, as recommended by the Ramsey Report. The ASX Corporate Governance Council’s Principle 4 “Safeguard integrity in financial reporting” sets out the requirements in relation to audit committees in Recommendations 4.2 to 4.4. These Recommendations set out the ASXs guidelines for best practice standards for audit committees, and the recommended composition of audit committees excludes executive directors and requires that there be a majority of independent directors and an

independent chair, who is not the chair of the board.<sup>49</sup> In establishing these guidelines, the profession is stressing their importance as principles, not as rules, as in the USA.<sup>50</sup>

iv. There are major problems with related-party transactions involving companies which have representatives on the board

In my view Australians today have a poor identification of conflict of interest, which may be becoming a cultural trait in Australia. Examples abound in all areas of activity, not just the commercial area. In the Coles Myer situation, the majority of directors ( 8 of 10, including the Chair and the CEO ) took the extra-ordinary step in mid-October 2002 of sending a letter to all shareholders in which they opposed the re-election of a ninth director. As mentioned above, this director was a former Chairman and the issue was that his companies supply \$60-70 million of goods each year to Coles Myer. His reported response was to challenge the board for not raising this at any time since his last election to the board, with its support, in 1999.<sup>51</sup> He had in fact been a director for over 10 years, during which time his companies had always traded with Coles Myer. By law, if his interest was declared, and if he did not participate in any decisions relating to his companies' dealings, then he has committed no breach of the law, unless the transaction was known by him to be not in the best interests of Coles Myer. In that case he would have had a duty to warn the board against the transaction.<sup>52</sup>

The majority also raised the allegation that several of the director's companies directly competed with the business of Coles Myer. Again, his response was that this had never been raised at the board. The issue was resolved at the AGM on November 20, 2002 when he was not re-elected.

Another instance from our five companies that may have later repercussions emerged in the evidence to the HIH Royal Commission. It seems that one director, on the evening before the company went into insolvency, billed HIH for \$181,445.39 for services provided by his consultancy company to HIH. Although the banks had closed, an HIH employee was dispatched across Sydney to a special clearinghouse to clear the payment into the director's account. He succeeded. The director claimed to have no knowledge of this special treatment.<sup>53</sup>

Meanwhile, in the five failed companies, overall, as an average, related party transactions in value exceeded 10% of market capitalization. This compares with less than one percent at the top 100 listed companies in Australia.<sup>54</sup>

CLERP 9, in recommendation 40, proposes an amendment to the law to require directors of listed companies to report details of all other directorships held at the time of the annual report of directors

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and for the two previous reporting periods (effectively for a three year period) The ASX Ten Principles deal even more directly with the issue. Principle 3 “Promote ethical and responsible decision-making” recommends the establishment and publication of a Code of Ethical Conduct by each listed company and suggests a list of issues to be covered including managing conflicts of interest and preventing usurping corporate opportunities.<sup>55</sup>

v. There is weak shareholder control through the power to dismiss at elections of directors or through takeovers.

The Coles Myer example may prove to be an exception to the long-standing experience in Australia that General Meetings seldom, if ever, dismiss directors. At law, a director can be ejected at the normal election for his or her position, or a by a resolution under section 203D.<sup>56</sup> The resolution is an ordinary resolution requiring a simple majority, though special notice is required. While the directors of a private company themselves can remove another director, this is not possible in a public company. This is why the majority of the Coles Myer directors took the extraordinary action of writing to the shareholders to recommend they vote against another director at the normal elections for the board. In that case, as an ordinary election was due, a resolution under s.203D was not necessary. In practice, the boards of public companies in Australia nominate a slate of candidates equaling the number of vacancies and the Chair usually receives sufficient proxies to ensure the slate is elected. Unlike the United States, but as in the United Kingdom, there is no cumulative voting for the board in Australia.<sup>57</sup>

The CLERP 9 recommendations and the ASX Ten Principles have nothing to say on this issue.

vi. Remuneration packages for CEOs have been poorly planned

The practice of executive share option schemes, and general executive remuneration packages, drew sharp criticism in the round of Australian Annual General Meetings which began in September, 2002. Several companies said they would no longer use option schemes. The CLERP 9 proposals deal with the problem at an accounting level. CLERP9 recommends that the force of law be given to the International Accounting Standards Board (ISAB) standard requiring that the expense of these option schemes be declared in the accounts.<sup>58</sup> This has not been done to date in Australia. The ASX Ten Principles deal extensively with remuneration in Principle 9, but not the accounting treatment. Principle 9 stresses full, transparent and effective disclosure. This disclosure should occur in the governance section of the Annual Report and via continuous disclosure under ASX Listing Rule 3.1. The ASX recommends disclosure at the time remuneration agreements are fixed, not just when they become payable. Stock option schemes are accepted for executive directors but discouraged for non-executive directors.<sup>59</sup>

Some examples of the controversy surrounding remuneration at the Commonwealth Bank in late 2002 and early 2003 highlight the problem. The chief executive of the Commonwealth Bank publicly supported the elimination of option schemes in the future at his company's AGM in September 2002 ( though he kept about \$80 million worth of options he had already been allocated ) He was then embarrassed when it was revealed at the same AGM that he was being paid a long service leave bonus of \$4.65 million for ten years' service. The payment had been agreed at the time of his appointment, but never disclosed to the company's shareholders, or the public. Since this equaled two years leave on his full base full salary, his employees were less than impressed, as they are entitled to just 65 days leave after ten years. His company used to have a rule, when it was owned by the national government, that the CEO should receive no more than ten times the wage of the lowest paid teller. Those days of proportionality between executives and wage earners have now disappeared in Australia.<sup>60</sup> Subsequently, more controversy emerged in 2003 when it was revealed that an executive in the smaller Colonial Bank, that had been taken over by the Commonwealth Bank, was entitled to \$A31 million in termination benefits under his contract with the prior employer. These payments were performance related.

Other aspects of the criticisms of remuneration relate to bonuses paid by reference to share price and not profits, and termination payments. The former problem was highlighted at One.Tel where the two senior executives were paid \$7 million each as performance bonuses based on the company's share price just before the collapse of the telecommunications market in Australia. Within weeks of the payment, their company had collapsed through their alleged mismanagement. Other directors have accused them of misleading them about the financial position of the company at public hearings held by the liquidator. They have refused to repay the money. The Institutional Analysis Report indicates that only 10.73 percent, on average, of directors' remuneration at the five failed companies was related to performance, compared with an average of almost 33 percent at the top 100 companies. Their interests were not closely aligned with shareholders' interests.<sup>61</sup>

The other problem is the size of termination payments paid to departing executives who have effectively been fired. The feeling expressed in the financial press is that the larger the loss you inflict on your company, the larger the termination payment offered by your board to induce you to go away.<sup>62</sup>

A recent survey of the top 250 companies by the University of Newcastle, which rated them according to their corporate governance practices, found only nine deserved a five star rating. Seventy-three failed the test. Another sixty only just passed with three stars. In total more than a

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majority of the top 250 companies are borderline. Another University of Melbourne study reportedly found that in the top 100 companies there was “no correlation whatsoever on the amount paid to the CEO and the results of the company.”<sup>63</sup>

vii. There is a problem with handing on public companies to the children of their founders in Australia.

The One.Tel disaster revealed another part of Australian corporate culture: the persistence of family dynasties in some of our largest public companies. Two key actors in One.Tel were board members Lachlan Murdoch, representing News Corporation which is controlled by his family, and James Packer, representing the Packer family media company PBL. These two are the sons and anointed heirs to the management of the family businesses, which have significant public investment. Together they lost \$950 million of their companies' money in One.Tel, which was the brainchild of two close social acquaintances. The extent to which they failed to read the drift of the financial affairs of the company is still being determined. However, this issue is one of the tests of governance that gave News Corporation a low score in the University of Newcastle survey. Neither CLERP9 nor the ASX Ten Principles really address this issue.

## 6. Other areas covered by CLERP 9

### i. Independence of auditors

The most important area taken up by CLERP 9 and not covered directly yet in this paper is the independence of auditors. In many of the problem cases of the 1980s, when Australia had a reputation for pirate entrepreneurs, and the late 1990s, audit failure was identified as having contributed to the problems. The Ramsay Inquiry and his subsequent Report focussed on audit processes. Although this topic is a little dry, it reflects both our business culture and approach to rules in Australia.

Public companies and large proprietary ( or private ) companies are required by law to appoint an auditor and present audited accounts.<sup>64</sup> For listed companies, the listing rules on auditing of the Australian Stock Exchange are also relevant, as are the professional standards of the Australian Accounting Standards Board, which are given the force of law by s.296(1) of the Corporations Law,<sup>65</sup> and the standards of the Auditing Standards Board, which are enforced by the two professional accounting bodies. There are special provisions for small, non-reporting proprietary companies. There may also be requirements as to audits in the Regulations to the Corporations Law. The auditors are appointed by the company and existing law prevents the appointment of an officer of the company, a partner, employer or employee of an officer of the company, or a partner or employee of an employee of an officer. This provides a sliding scale of rules. At the professional level, the profession emphasizes the nature of the rules as principles, not rigid rules, as they perceive the situation in the United

States.

The CLERP 9 recommendations will introduce a legal requirement that the auditor be independent. This will include a restriction for two years on accounting “amakudari”<sup>66</sup> and tighter rules on investments and loans between the audit client and the auditor or her family ( recommendations 2-5 ) The recommendations also attack a perceived problem with large audit firms that offer other services to the client. This is thought to lead to the possibility of conflict of interest. Accordingly, the audit firm will be restricted in the sorts of non-audit services it can provide by a statutory requirement to comply with the Professional Statement F1 on Professional Independence, in the Joint Code of Professional Conduct of the two professional bodies. There will also be a requirement to disclose the nature of any relationships in the annual report and explain why the provision of non-audit services does not compromise independence ( recommendation 7 ) Finally, the government has resisted calls to force companies to tender for new auditors every five years, but will require the audit partner within the audit firm to rotate every five years ( recommendation 9 ) This compromise was welcomed by the audit firms.

Auditors will have to attend the AGM to answer questions; they will have to meet new competency standards for appointment; and will be able to incorporate to limit their liability. The government also plans to discuss the introduction of proportionate liability to mitigate the impact on auditors of very large collapses where other parties are also clearly liable ( recommendations 9-13 )

Finally, audit standards will be improved by the adoption by Australia of the standards of the International Accounting Standards Board by 1 January 2005. This will bring Australia into line with Europe ( recommendation 14 )

#### ii. A new standards body

The government will set up a new body to oversee auditor independence. The existing Auditing and Assurance Standards Board ( AuASB ) will be brought under the umbrella of the Financial Reporting Council, with a government appointed chairman ( recommendation 1 )

#### iii. Independence of financial analysts

Recommendations 17 and 18 will impose a general duty to provide advice “efficiently, honestly and fairly” as well as a requirement to disclose any financial interest they may have in their recommendations. This will affect financial services firms that provide multiple services.

#### iv. Protection of “whistle blowers”

Recommendations 33 and 35 strengthen the position of auditors, or company employees, who feel pressured not to report a breach of the law. Recommendation 33 requires auditors to report to the ASIC any attempt “to influence, coerce manipulate or mislead” them. Recommendation 35 protects company employees against retaliation against them in their employment if they report, “in good faith on reasonable grounds, a suspected breach of the law”.

### 7. Comparisons to the Sarbanes-Oxley<sup>67</sup> legislation in the United States

There is not time to go into a detailed examination of similarities and differences in detail between the CLERP 9 recommendations and the ASX Ten Principles in Australia and the Sarbanes-Oxley legislation adopted in June 2002 in the United States. It is generally thought in Australia that the new recommendations, coupled with existing structures, will cover much the same ground as the US legislation. Two areas invite comment at this stage.

First, the explicit extra-territorial application of the US law to foreign auditors has been strongly condemned in Europe. No such concern has been raised yet about the Australian approach. This may be because very few foreign companies would have their world-wide operations affected by compliance in Australia, although News Limited, the Murdoch entity, is a notable exception. It should be stressed that the Australian government does have the constitutional power to apply the corporations law in an extra-territorial fashion. It becomes a question of interpretation whether the Parliament has intended an extra-territorial effect. This will appear from the specific drafting.<sup>68</sup>

The second point brings us back to a discussion on regulatory style. The proposed changes to the laws in Australia will focus on institutional regulatory law, as affected by understandings at the more general level of business culture. In this regard, Australian accountants are making unified and strident claims for a particular approach to this new regime. For example, Price Waterhouse Coopers Australia had this to say about the proposed guidelines on auditor independence.<sup>69</sup>

“It is important however that such guidelines do not turn into excessively prescriptive rules.”

Further, in analyzing the US Sarbanes-Oxley treatment of the provision of other services by the audit company, it continued:

“In dealing with the provision of non-audit services, the ( Sarbanes-Oxley ) Act resorts to the traditional US reliance on highly prescriptive, detailed rules. This is despite the widespread failure of

the prescriptive rules-based approach that has been evident in recent times. It is now generally agreed that the habits of mechanical compliance have done little to encourage independence, or high standards of corporate governance and financial reporting more generally.”

The argument is then made for leaving the responsibility to the audit committee applying their best judgment of what is in the shareholders’ interests, concluding:

“In our view, corporate governance policies should be based on common sense principles that benefit the company and the shareholder, not rules for rules’ sake.”

The difference in approach to regulation was noted by the former Chief Accountant at the US SEC, Professor Lynn Turner. Professor Turner was in Australia when the CLERP 9 recommendations were published. Professor Turner branded them as a “light touch” regulatory regime. He said the proposals were unlikely to strengthen auditor independence.<sup>70</sup>

This emphasis on principles and not rules in a comparison of Australia and the United States could be taken from a foreigner’s Japanese “law and society” manual. Japan is usually accused of a ‘light’ approach in this area by the United States. The implications of the CLERP9 approach have been demonstrated in the very recent ASX Ten Principles, discussed in this article. The underlying approach is to set standards and make recommendations for good governance. Individual companies can then make a business decision about which principles to adopt and which recommendations to follow. However, in the case of listed companies it will be a requirement of the continuous disclosure rules of the ASX that a company must disclose its corporate governance policies and justify any conscious departure from the Governance Principles.

This approach has been generally supported in the short time since the Ten Principles were published.<sup>71</sup> Justice Neville Owen, the HIH Royal Commissioner, has lent his support in a recent address to the Commonwealth Law Conference in Melbourne, Australia. He is reported to have said that “a new layer of regulation was unnecessary as it was likely to be unproductive and ultimately self-defeating.” A “one size fits all” approach would not suit Australia, which has a wide range of enterprises, and “The law may be too blunt (and expensive) an instrument to deal with corporate governance problems.” He was reported as favouring a market based control system.<sup>72</sup> However, in his Report on HIH, published just a few days later, he recommended that at least eighteen people be investigated for breaches of existing criminal and civil law rules on governance. He also called for a strengthening of corporate law rules on dishonest behavior by directors and management.<sup>73</sup>

## Corporate Governance in Australia: Some Recent Developments

A report of a recent study by Deloitte consulting also reveals a marked divergence in views between Australian and US Chief Financial Officers about the capacity of laws to prevent corporate frauds. While a majority of US CFOs feel legislation will be effective, less than one-third of Australian CFOs share that confidence.<sup>74</sup>

These very contemporary indications of regulatory approaches and regulatory expectations among key company executives and professionals in Australia and the USA indicate a widening gulf on the best approach to corporate governance in these two common law, capital market economies organized under federal systems of government. This article has focused on recent reform proposals in Australia. There is a great amount of interesting contemporary material in Australia that can be usefully contrasted with law and practice in the United States. The material may also be useful to Japanese policy makers as they chart future directions in Japan.

### Notes

- 1 . This paper started life as a lecture to the GSID, Nagoya University, October 30, 2002. An amended version was delivered to the Nagoya Chamber of Commerce & Industry, on December 6, 2002. Both events occurred during a period of research leave at Nagoya University sponsored by GSID, for which I am most grateful. The current paper has benefited from the comments of two anonymous reviewers, who pointed out the need to refocus the paper onto the Australian developments and abbreviate some thoughts on comparative law issues that I had introduced into the lectures for discussion purposes.
- 2 . [http://www.arcpa.org/Sarbanes\\_Bill.htm](http://www.arcpa.org/Sarbanes_Bill.htm)
- 3 . Derek Higgs, "Review of the role and effectiveness of non-executive directors", Dept of Trade and Industry, January 2003, [[www.dti.gov.uk/cld/non\\_exec\\_review](http://www.dti.gov.uk/cld/non_exec_review)].
- 4 . Sir Robert Smith, "Audit Committees: Combined Code Guidance" a report prepared for the Financial Reporting Council, UK, January 2003 [[www.frc.org.uk](http://www.frc.org.uk)].
- 5 . For a recent summary see M.Janssen, F.Koma, S.Kuroda, and P.Schimmann, "New Rules for Share Structures and Governance of Japanese Corporations", ( 2002 ) 13 *Zeitschrift fur Japanisches Recht* 253.
- 6 . [www.treasury.gov.au/documents/403HTML/docshell.asp/URL=Summary.asp](http://www.treasury.gov.au/documents/403HTML/docshell.asp/URL=Summary.asp) downloaded 22/09/2002
- 7 . "New Disclosure Rules bad for Business: Lawyer" *The Age*, April 11, 2003, pB2,col.8.
- 8 . ASX Corporate Governance Council, *Principles of Good Corporate Governance and Recommendations for Best Practice*, April 3, 2003 [<http://www.asx.com.au/about/pdf/ASXRecommendations.pdf>].
- 9 . Institutional Analysis "A Report on Corporate Governance at Five Companies that Collapsed in 2001" ( Melbourne, August 2002, on file with author )( hereafter "Report 2002" )
- 10 . Leon Gettler, "Failures have lots in common" *The Age* Friday August 9, 2002, Business 3, col.1, citing a report by the company Institutional Analysis "A Report on Corporate Governance at Five Companies that Collapsed in 2001" ( Melbourne, August 2002, on file with author )( hereafter "Report 2002" )

- 11 . eg Coles Myer \$60-70million pa. In Report 2002, *ibid*, it was reported that at the five failed companies such transactions amounted to more than 10% of market capitalization.
- 12 . For a detailed explanation of the new legislation, see HAJ Ford, RP Austin and IM Ramsay, *Supplement to Ford's Principles of Corporations Law 10<sup>th</sup> Edition* ( Butterworths 2002 )
- 13 . Ford *ibid*, 362, para 8.65.
- 14 . *Ibid*, 176-177
- 15 . \$A5.3 billion in losses by a general insurance company. HIH was Australia's largest General Insurer. A Royal Commission was set up by the national government to inquire into the circumstances of its demise. The Royal Commission reported to the government on 4 April 2003. see: [www.hihroyalcom.gov.au](http://www.hihroyalcom.gov.au)
- 16 . Capital value destroyed by hedging mistakes in foreign exchange markets by a mining company. An Administrator was appointed 19 Sept, 2001.
- 17 . \$A93 million owing to unsecured creditors and \$A50 million in corporate debt. Harris Scarfe was a 150 year old Adelaide based department store chain which had entered into discount marketing. An administrator was appointed 3 April 2001. The CFO was jailed for six years on 27 June 2002 after pleading guilty to dishonesty offences relating to misrepresenting accounts. He pleaded guilty to 19 counts of failing to act honestly as a corporation officer, six counts of using his position to gain advantage or cause detriment, and seven charges related to giving false information to the Australian Stock Exchange ( ASX ) It was reported that: "The South Australia-based retailer, which recently acquired doomed e-tailer Dstore, said directors had discovered 'shocking' accounting irregularities which it claims were kept from the board by management for up to six years." Preliminary investigations uncovered a significant deterioration in the net asset position of the company, consisting of both overstatement of stock and understatement of liabilities.
- 18 . Defaulted on June 15, 2001 on \$US12.5 million interest payment on a \$US 225 million debt. Controlled by controversial businessman Joseph Gutnick, the joint administrator is reported to have said there is a compelling case for insolvent trading if the company is wound up.
- 19 . \$A600 owed to creditors and capital of over \$A1 billion lost by a mobile phone service provider. The co-founders were joint CEOs and were paid \$A14million in performance rewards by the Board just prior to the collapse. Australia's two richest media families, the Murdochs and the Packers were major shareholders and lost \$950 million. The two heirs represented their families' companies on the Board and what they knew is of major interest to the liquidators. Public examinations are in progress.
- 20 . Above note 9.
- 21 . see [www.HIHroyalcomm.gov.au](http://www.HIHroyalcomm.gov.au) for details of the terms of reference.
- 22 . *The Age*, April 17, 2003, p.1, 8 & 9.
- 23 . In this paper I will focus on the CLERP 9 recommendations.
- 24 . One of Australia's oldest and largest retail Department Store and Supermarket chains.
- 25 . Above note 8.
- 26 . As at April 15, 2003.

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- 27 . ASX Corporate Governance Council, "Corporate Governance in Australia", 6 April 2003.
- 28 . [www.treasury.gov.au/documents/403HTML?docshell.asp?URL=Summary.asp](http://www.treasury.gov.au/documents/403HTML?docshell.asp?URL=Summary.asp) downloaded 22/09/2002, Recommendations 19-31
- 29 . *ibid*, Recommendations 36-41
- 30 . *ibid*, Recommendation 36.
- 31 . Legislation to establish this Council is yet to be placed before the Parliament.
- 32 . Gettler, above n.10, Report 2002 above n.9, 5-6.
- 33 . Cheffins ( 2001 ) 30 *Journal of Legal Studies* 459.
- 34 . Above note 8 at 15.
- 35 . *Ibid*, 35.
- 36 . Report 2002, above n.9, 6-8.
- 37 . *Ibid*, 7.
- 38 . above note 8 at 19.
- 39 . *Ibid*, 20.
- 40 . *ibid*.
- 41 . *ibid*, 15 and 20.
- 42 . Above note 3, 31.
- 43 . Above note 8, 21, Recommendations 2.2 and 2.3.
- 44 . Above note 3, 16, para 2.9.
- 45 . *Ibid*, 8, Gettler, above n.10.
- 46 . Gettler, above n.10, and see Report 2002 above n.9 at 7.
- 47 . Report 2002, above n.9, 8.
- 48 . See now ASX Listing Rule 12.7.
- 49 . above note 8, 30, recommendation 4.3.
- 50 . see final section below.
- 51 . Eric Johnston, "Eight Coles Myer Directors Urge Ouster of Rebel Member" *Asian Wall Street Journal*, October 16, 2002, 3, col. 1.
- 52 . see generally, Ford, above n.12, chapter 9, 379-380, 391-392.
- 53 . "Dash for HIH chief's cash before fall", *The Australian*, September 25, 2002, 3, col. 1.
- 54 . Report 2002, above n.9, 10-11.
- 55 . Above note 8, 25-26.
- 56 . Ford, above, n.12, 238-9 ( para 1.230 )
- 57 . There is a fairly recent empirical study of listed companies in Australia: Geof Stapledon and J.Lawrence, "Board Composition, Structure and Independence in Australia's Largest Listed Companies" ( 1997 ) 21 *Melbourne University Law Review* 150.
- 58 . CLERP 9 recommendation 15.

- 59 . Above note 8, 56, Box 9.3 Guidelines for non-executive director remuneration.
- 60 . Adam Shand, "Payoffs on greed street" *Australian Financial Review*, September 28-29, 22 at 23 col1.
- 61 . Report 2002, above n.9, 9-10.
- 62 . Ibid and Geoff Elliott, "Director's Cut" *The Weekend Australian*, September 28-29, at 19.
- 63 . Ibid, Elliott, 22, col 1 and 23 col.7.
- 64 . Ford, above n.12, 159 and 510.
- 65 . Ibid, 478 ( 10.170 ) and 86 ( 3.370 )
- 66 . The Japanese term referring to bureaucrats descending from heaven ( the public service ) to the companies they formerly regulated.
- 67 . [http://www.arcpa.org/Sarbanes\\_Bill.htm](http://www.arcpa.org/Sarbanes_Bill.htm)
- 68 . see *Supplement to Ford's Principles of Corporations Law 10<sup>th</sup> Edition*, 18-21.
- 69 . <http://www.pwcglobal.com/Extweb/pwcpublishations.nfs/docid/851260553AO53EE9C> 22/09/2002
- 70 . Tom Ravlic, "Regulator slams 'soft' audit reforms" *The Age*, September 23, 2002, Business 1, col. 2. The Australian government hit back the next day, saying punitive regulations had failed in the past. "Australia stands up to US corporate governance rebuke" *The Age*, 24 September 2002.
- 71 . e.g., Peter Weekes, "A new balance of Power", *The Age*, Money Manager, 14, col 1, March 31, 2003;
- 72 . David Elias "HIH Commissioner urges companies to reveal advisors: *The Age*, April 15, 2003, B1, col.2.
- 73 . above, note 22.
- 74 . "Laws not the way to avoid failures, say CFOs" *The Age*, April 15, 2003, B4, col.7.