



## How to hit your corporate governance targets

**Several mid-cap companies were identified in a recent survey as having excellent corporate governance. Domini Stuart discovers what is needed for companies to achieve top marks for their corporate governance efforts.**

For the last five years, Horwath Chartered Accountants and Management Consultants have been taking a close look at how well large companies – measured by their market capitalisation – are managing their corporate governance requirements. This year they turned the microscope on smaller companies for the first time – and what they found could sound like cause for concern.

Independently conducted by The University of Newcastle Associate Professor Jim Psaros, the Horwath 2006 Corporate Governance Report reviews the 2005 publicly reported corporate governance structures for companies ranked 251-400 in market capitalisation on the Australian Stock Exchange.

Of the 150 surveyed, just four companies achieved the ultimate accolade of five stars - Tasmanian Perpetual, Home Building Society, Coventry Group and Gallery Gold Limited.

50 rated two stars or less. According to Horwath (Vic) Director Andrew Pearce, these companies are falling short of the mark for what is generally considered appropriate corporate governance behaviour for a listed company.

Where are so many mid caps going wrong? And what can they do to put it right? Paul Dwyer, Director of Risk Management Services, Horwath (NSW), identified the biggest problem is wide-ranging lack of independence.

“In some organisations we found that the remuneration paid to auditors included other services outside external auditing such as taxation advice, risk management and other accounting functions,” he says. “The problem here is that, if the people doing the auditing are dependent on the company for a large chunk of their fees beyond the audit, they may not be quite so tough and impartial.”

Many boards were also found to fall short of the ASX recommendation that the majority of directors should be independent.

“Many directors have an association with the company,” Dwyer continues. “They may be a previous CEO or a major shareholder, or have been a consultant or a professional service provider. It’s understandable that organisations become aware of the skills of a particular person then invite him or her on to the board, but that may not meet the strict ASX criteria on which our own were based.”

Professional Independent Director and Principal of Pacific Growth Duncan Schultz says there’s no question that every board needs someone with a more accurate global picture of where the company sits.

“Independent thinking means being able to see the wood for the trees,” he says. “It also brings a level of challenge which makes thought processes, strategy and management more robust. But I don’t believe independent directors necessarily need to be in the majority.”

“When it comes to mid caps, I feel that the ASX definition of independence may be a little extreme. Many mid caps are in the process of moving from a majority executive board structure, or even a board made up entirely of executives. They may still be grappling with growth – perhaps accelerated growth – and, in this case, they need people with a background in the company to facilitate quicker decision-making. There’s a lot of good talent that can be a little bit closer to a company but still provide some solid, independent thinking.”

Schultz says he would feel less than comfortable on the board of a smaller company where the majority of directors were independent.

“As an independent director my role is providing the voice of challenge and an outside perspective,” he says. “But I also want to listen to executives in the business and be guided by their experience. There’s lots of hands-on work to be done, and we need people who know the business well in order to get on with it.”

“I’d go so far as to suggest that just one independent is enough for the board of the smaller mid caps. That doesn’t mean changing rules, just acknowledging that guidelines which make sense for larger companies won’t always make sense for the smaller ones.”

Schultz is concerned by the finding that only 45 per cent of chairmen were independent.

“There is a very strong case that the first independent on any board should be the chairman,” he says. “The relationship between the chair and the CEO is very important. The CEO needs access to a third party perspective to strengthen his or her decision-making.”

Independence has never been an issue for the five-star Home Building Society. “The company was founded as a mutual organisation so we’ve never been owned by an individual, and we’ve always had an independent corporate culture,” says Chairman Tony Howarth. “But independence by itself is not good corporate governance – and lack of independence doesn’t automatically mean poor performance.

“Packer, Murdoch and Gerry Harvey are all very strong without being independent,” he continues. “In fact people investing in those companies are often investing in the people themselves. And, if you take the argument for independence to the extreme, you could have a whole lot of people associated with an organisation who know nothing about it. I believe good governance is about having the right culture, and people who are independent of thought.

“As a mid cap, if you don’t exactly fit the standard I say take the opportunity to explain why you believe the decisions you made are better for the company. Then you’re providing an opportunity for investors to agree or disagree. But there’s no question that Corporate governance must be taken particularly seriously by companies in our position, irrespective of what they do, because we’re charged with looking after other people’s money. Even the giant institutional investors are made up of individual shareholders. The wealth of corporate Australia largely lies with the people of Australia, and corporate governance is the way of openly showing how we run the business and how we manage ourselves. It’s not just about ticking boxes, it’s about how open, transparent and well run your business is.”

### **Hard to find**

Paul Dwyer acknowledges that even with the best of intentions, mid caps may struggle to attract good, independent directors to their board.

“There isn’t a pool of people out there with appropriate experience and runs on the board just waiting to be recruited,” he says. “Another problem is that really good people aren’t always willing to work as directors because of the risk involved. They’re starting to ask themselves whether it’s worth it. There’s a big personal risk involved – and it can ruin your reputation if you serve as director with the wrong organisation.”

Tony Howarth is also concerned that, unless the risk reward:ratio changes, more potential directors will be deterred in the future.

“The concept of the limited liability company has been a fundamental plank in the growth of private enterprise over the last 200 to 300 years,” he says. “If directors keep getting attacked, particularly with hindsight, we could see a serious weakening of that system.

“Free enterprise is about an opportunity to make money, not a guarantee of making money. Directors need to base their decisions on to what they believe is right for their company -- that's what they're charged with. They shouldn't be penalised for decisions that seemed good at the time that, with hindsight, are not so good. Sometimes companies do lose money. Directors can't be right 100 per cent of the time and that level of expectation could rob us of entrepreneurial spirit.

“It's a balance between performance and conformance,” he continues. “For a financial institution, conformance needs to be high because you're looking after both shareholders' and depositors' money.”

### **The weight of compliance**

Andrew Pearce acknowledges that, for mid-caps, corporate governance is a major challenge. “They're dealing with similar exposures, risks and penalties to larger listed companies but with fewer resources,” he says. “New anti money-laundering and counter-terrorism legislation, in addition to CLERP 9 and other recent requirements, continue to add to the corporate governance responsibilities for mid-caps. Clearly these companies need to find best-fit solutions that achieve reasonable governance protection and control without unnecessary bureaucracy or cost.”

Mark Scanlon, MD of Tasmanian Perpetual Trustee Limited, the overall highest-scoring company in Horwath's survey, agrees that Boards are being confronted with a growing burden of responsibility.

“These days, sitting on a board is not a supplement for a pension,” he says. “There's an onus at the legal level and there's also the expectation of shareholders and other investors. And there's no doubt that the relative burden on mid-caps is much larger than on larger companies in the establishment phase.

“Legislation has been constructed to fit the industry without taking into account the relative sizes of the organisations, and this is definitely a bigger challenge for smaller businesses. However, once the procedures are in place I believe that the culture which drove the implementation makes the on-going maintenance of good corporate governance very do-able. We're an example of a mid cap company that proves that good corporate governance can be achieved with limited resources and steadfast determination.

“Nevertheless, legislation can be the most difficult aspect of daily life – just keeping up and complying with it,” he continues. “Surveys have show that,

these days, compliance is the number one issue for CEOs. That wouldn't have been that case 10 years ago."

"Compliance with all legislation is quite large and something that takes a lot of time," agrees Chris Glen, Managing Director of the Coventry Group, another company awarded five-stars in the Horwath report. "There is a raft of legislative requirement – OHS, ASIC, state legislation and so on – and larger firms have dedicated resources to take care of that."

"In our company, our managers take on various aspects of the legislation as part of their normal duties. We try to keep it as simple as possible by establishing clear processes around it and it just becomes one of those things you do. But then we have 2200 employees. I'm sure that smaller companies than ours carry a relatively bigger burden of compliance."

### **The commercial upside**

If the weight of legislation is the downside of corporate governance, is there a commercial upside when you do it well?

"Our approach reflects the values of our company," says Chris Glen. "We manage proactively and meet the requirements. For some companies it's all too hard – they just go for the 'please explain' option. But that way you get no returns. Our attitude is that we have a corporate governance regime to work to so, rather than just seeing it as administration to do and manage, how can we use that to improve our business?"

"Good corporate governance and the fostering of a risk and compliance culture are critical to the well-being of any financial institution," says Mark Scanlon. "If shareholders, investors and creditors know that your corporate governance regime means there are processes and systems in place in which they can be confident then, clearly, this has a positive commercial impact. Furthermore, having a robust governance structure allows more time to be spent on building the business rather than looking over your shoulder."

"Corporate governance is protection," agrees Andrew Pearce. "Having insufficient corporate governance does not mean a company will fail, nor stop a company from being profitable. But – as HIH, Enron and allegedly Westpoint show – lack of good corporate governance can mean board and investors find out too little too late when a company is in trouble. Equally, lack of good corporate governance controls can hinder a company from capturing key opportunities during times of growth or product/business model maturity."

### **Increasing returns for investors**

A new research report from Goldman Sachs JBWere suggests that there is also a link between good corporate governance and share market performance. Produced in association with Corporate Governance International (CGI), *Good Corporate Governance = Good Investment Returns*

finds that companies exhibiting elements of good corporate governance were likely to outperform the market, and that similar gains were achieved if companies that rated poorly were sold short.

“The combined long/short strategies all achieved positive alphas – return above a passive market return – with the strongest being board skills, overall governance, overall board and remuneration,” says author of the report Andrew Grey. “During the 2006 financial year, the top-rated companies in these areas have outperformed and, conversely, the bottom rated stocks under each of these categories have underperformed.

“Specifically, we find that an investment strategy investing long in top rated companies and selling short bottom rated companies would have generated the following alpha for each governance category: board skills +11.0 per cent overall board +9.9 per cent, overall governance +6.5 per cent, remuneration +5.7 per cent. audit +2.0 per cent. With no reason apparent for these relationships to break down in the future, we believe governance is a factor investors should incorporate in their investment thinking.”

For this survey only large caps were examined, though CGI have plans to include some mid caps in future research. Tony Howarth sees a clear link between shareholder value and bad corporate governance, but believes any link with good corporate governance would be much more tenuous.

“At the end of the day, performance is all about the quality of decision-making and the way the business is managed and grown, and that isn’t at the heart of corporate governance,” he says. “But good governance does give more transparency. Where you have transparency you tend to have a good culture and good culture is fundamental to shareholder value.

“Any link with share value would be long term,” adds Chris Glen. “It calls for good policy and practice across a whole range of things. But I do think that, in the future, when fund managers and investors are assessing or analysing a company, they will want to know that they can rely on the company’s information. A good culture brings a high level of confidence.”

### **Where next?**

While Tasmanian Perpetual, Home Building Society and Coventry Group are understandably pleased to have their commitment to corporate governance recognised, what of the companies who were shown in a less favourable light?

“We’ve had some feedback from CEOs and CFOs on some issues,” says Paul Dwyer. “When we explained how the stars were awarded they all understood the reasons why they hadn’t scored more highly. They may not have agreed with specifics like the definition of independence, but there was a general acceptance that, in principle, each of the measures used in the survey were reasonable.

“All of the organisations included in the survey can have access to details of the criteria and their rankings against the criteria. I think it’s also important for them to see their rankings within their industry grouping. There is significant variation between, say, finance companies and mining. As industry sectors, finance and insurance are particularly well developed in terms of the structures they have in place while, for a number of different reasons, mining is less so. I think it’s valuable for companies to compare themselves with their peers to get a clearer idea how they’re performing.”

Mark Scanlon believes that mid caps struggling with the issue of corporate governance need to start by getting the board culture right. “Without buy-in from all of the directors the burden falls to a few, which is overwhelming. In particular, the resolve of the chairman in showing leadership in this area is imperative if companies are to achieve the highest standard of corporate governance.”

### *Break out box*

The Horwath Australia Corporate Governance report used an objective model for comparing the structures of key listed companies. Using publicly disclosed information, the report assigned a rating of 0-5 stars according to factors such as independence of board directors; separate audit and remuneration committee structures; external auditor independence; the existence of official codes of conduct; and other generally accepted corporate governance protections.

Below are the guidelines used for assessing the board of directors.

#### *Most desirable*

- a board with the majority of independent directors
- an independent chairperson
- met at least 6 times annually.

#### *Least desirable:*

- a board with no independent directors
- the CEO as chairperson
- met less than 6 times annually.

#### *An independent director is defined as someone who:*

- is not a member of management
- is not a substantial shareholder of the company, or otherwise associated directly or indirectly with a substantial shareholder of the company
- has not been employed in an executive capacity by the company in the last decade

- is not an original founder of the company
- is not a principal of a professional adviser to the company
- is not a significant supplier or customer of the company, or otherwise associated directly or indirectly with a significant supplier or customer of the company
- has no significant contractual relationship with the company, outside of their directorship
- is free from any interest or relationship, which could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company a director for ten years or less.