Module 2 – Corporate governance

Self assessment questions for Chapter 12 – Fundamental concepts of corporate governance for accountants

Review questions

1. What is corporate governance?

Corporate governance is the system by which companies are directed and managed. It influences how the objectives of the company are set and achieved, how risk is monitored and assessed, and how performance is optimised.

2. Outline four key theories of corporate governance. What are their similarities and what are their differences?

Agency theory

The separate legal status of the corporation means that the control of the corporation is detached from the equity investment where we witness a separation of ownership from control. This theory relates to the importance of the board remaining independent of management so that they can exercise control on behalf of the owners.

Stakeholder theory

Stakeholder theory focuses less on maintaining and enhancing shareholder value and more on providing value to all the company's stakeholders. Many would argue that these are not mutually exclusive because shareholders, as the residual claimants of free cash flows, have a vested interest in ensuring the company uses its resources for maximum effect.

Team production theory

Team production theory proposes that corporations provide value by combining the key factors of production (i.e. labour or employees, capital or investors, debt or lenders and suppliers) in a manner that markets cannot. This theory sees the board as the ultimate power in the firm in contrast to both agency theory (which would portray the shareholders as holding that position) and stewardship theory (which would see various combinations of stakeholders as holding that position).

Resource dependence theory

This theory posits that boards (and corporate governance) exist to provide companies with the access to resources that they could not gain through market or management links. Thus, boards exist to provide access to capital, information, power and other important inputs that can assist the company to control its environment

Managerial and class hegemony theory

Both managerial and class hegemony theory are allied to resource dependence theory in the sense that all three share the concept of people providing access to resources. In contrast to resource dependence theory's focus on the company, however, class hegemony theory is a Marxist-based concept that conceptualises the upper class or business elite as a group manipulating the governance of corporations to perpetuate its power base.

Managerial hegemony theory is similar to class hegemony theory in that the governance system and board is seen as the tool of management. It argues that the real power in corporate governance lies with management and that they can take advantage of shareholder weakness to pursue self-interest.

3. What are the three main duties of directors and why are they necessary?

- Act in good faith for a proper purpose
- Not misuse the position or information (i.e. Avoid a conflict of interest)
- Act with due care and diligence

These duties are necessary because of the fiduciary relationship that forms the basis of the relationship between a director and the company.

4. What are the similarities and differences between a director's duties under sections 180 and 588G of the *Corporations Act*.

Both duties are derived from the common law duty of care and diligence.

The duty of care in section 180(1) provides that directors must apply a reasonable degree of care and skill.

Section 588G provides that if a director allows a firm to trade while insolvent, they will become personally liable for the debts incurred after the point of insolvency is reached. The duty extends to prevent a company from trading so as to become insolvent.

One difference between the 2 sections is that s558G applies to directors only and not to officers.

5. How are continuous disclosure and insider trading requirements similar, and how are they different?

Continuous disclosure represents the obligation of listed companies to ensure the market is notified of information that a reasonable person would expect to have a material effect on the price or value of the firm's securities.

Insider trading is the offence, which arises when anyone possessing information about a listed company not generally available to the market trade sin securities from that firm or "tips off" others to trade in the relevant securities.

One similarity between them is that they are both elements of market based regulation for listed companies, given legislative force via the Corporations Act. Another similarity is that there are a number of defences to insider trading and to continuous disclosure requirements for directors.

One key difference between them is that continuous disclosure is a disclosure requirement of people within the company while insider trading is an offence that outsiders can breach.

6. How can accountants contribute to effective governance?

Accountants must produce timely, accurate and reliable reports of the true position of the company.

The accounting function will need to provide directors (as well as senior managers) with insights into the strategic factors at play in their organisations.

Auditors play a key role in the external flow of information that they provide and the expectation that they will be independent and report breaches.

7. What are the different types of regulation and how are they related?

“Hard” regulation is also known as black letter law and comprises the legally binding obligations (such as directors’ and officers’ duties under the *Corporations Act, 2001*).

In contrast, “soft regulation” are non-binding obligations and would include items such as non-mandated industry codes of conduct, societal expectations and expert opinion on corporate governance practice.

Finally, there are various forms of “hybrid regulation” which are not strictly binding but generally entail some form of sanction if they are not followed. Examples of hybrid regulations would include the *ASX Principles of Good Governance and Best Practice Recommendations* or industry regulations where the self-regulation could involve some form of penalty such as a fine or suspension administered by a professional body.

These various forms of regulation are interrelated and vary from legal regulation with penalties to self-regulation with no penalties.

8. What is ‘soft’ regulation and what are its advantages and disadvantages when compared with ‘hard’ regulation?

“Soft regulation” is non-binding obligations and would include items such as non-mandated industry codes of conduct, societal expectations and expert opinion on corporate governance practice.

“Hard” regulation is also known as black letter law and comprises the legally binding obligations (such as directors’ and officers’ duties under the *Corporations Act, 2001*).

The advantage of “soft regulation’ is that it encourages self-regulation of companies to implement certain codes of conduct which can encourage social pressure and an application of the spirit of the regulation rather than strict adherence to the letter of the regulation. It is also less costly for society to implement.

The disadvantage is that there are no penalties with “soft regulation” and so it may lack impact.

9. Explain how the regulation pyramid is used by regulators to enforce regulation.

Regulations are interrelated – the various forms of regulation overlap and reinforce. Regulators can use a series of measures to enforce regulations ranging from encouraging self-regulation through to enforcement with mandatory penalties with no discretion.

Good answers would outline all the components of the pyramid and would also provide examples of the escalation of application.

Australia has numerous regulators including ASIC, ACCC, APRA, ASX and EPA

10. What is an independent director and how does this differ from a non-executive director? What are the advantages and disadvantages of independent directors?

Independent directors are those with no relationship with the firm that would, or could be perceived to, materially affect their decision making.

Independent directors are in fact a sub-set of non-executive directors. Non-executive directors are either independent or "grey" directors. Grey directors are those that may, at times, experience a conflict of interest due their positions with other organisations.

11. Why is section 588G a major section of importance for directors?

In essence, this section provides that if a director allows a firm to trade while insolvent, they will become personally liable for the debts incurred after the point of insolvency is reached. It is intended to engender in directors of companies experiencing financial stress a proper sense of attentiveness and responsible conduct directed towards the avoidance of any increase in the company's debt burden.

This duty is different from other director duties as courts will use an objective test in its application. This means that it is not a defence to show your background or circumstances meant you did not know the company was trading insolvently (with some rare exceptions provided for in the defence outlined in s588H); you are deemed to have the knowledge to understand the financial circumstances of the company.

12. What are the ASX Corporate Governance Council's *Corporate governance principles and recommendations* and how do they operate?

On 31 March, 2003 the ASX Corporate Governance Council released a 75 page document titled *Principles of good corporate governance and best practice recommendations.*

In August 2007, the ASX Corporate Governance Council issued a revised document titled *Corporate governance principles and recommendations* (the Principles), effective the first financial year beginning on or after 1 January 2008. The ASX noted that there were no drastic or wholesale changes to the corporate governance principles issued in 2003. Details of the revised Principles are available from: http://www.asx.com.au/about/corporate_governance/index.htm According to the ASX, ' "Best practice" has been removed from the title and the text of the document . . . to eliminate any perception that the Principles are prescriptive and so not to discourage companies from adopting alternative practices and "if not, why not" reporting where appropriate' (ASX Media Release, 'Revised corporate governance principles released', 2 August 2007).

The role of the principles is to provide guidance to companies and investors on best practice corporate governance and to increase the transparency of a listed company's corporate governance practices. As such, the guidance provided in the Principles is not mandatory; rather, the approach of the ASX is an 'if not, why not' approach where companies are asked to (1) detail whether they comply with each best practice recommendation and (2) explain why they do not comply if this is the case. The principles are examples of "hybrid regulation" which are not strictly binding but generally entail some form of sanction if they are not followed.

13. What have been the major changes brought about by CLERP 9?

The first involves a series of provisions to ensure improved auditing of company (particularly large listed company) accounts by strengthening the independence of the audit function.

Major recent changes governing auditors include:

1. A mandatory requirement for the top 500 ASX-listed companies to have an Audit Committee;
2. Composition requirements of the Audit Committee in the Top 300 ASX-listed companies (i.e. the members of the Committee must be independent directors) and
3. Non-audit consultancy income for auditors has been limited and must be clearly disclosed.

In addition to strengthening audit requirements, CLERP 9 increased disclosure requirements particularly around executive remuneration

14. What are the similarities and differences between the two major types of international systems of corporate governance?

The similarities between the Anglo and Pluralist systems are that both systems require robust societal legal structures and transparency.

The differences between them arise as a result of what is emphasised: Anglo systems (the basis of Australia's system) emphasise markets and shareholder rights as important legal requirements. Pluralist systems (which form the basis of many Asian and continental European systems) place a greater emphasis on stakeholders.

Discussion questions

1. Do you agree that a majority of directors of listed companies should be independent? Justify your argument, paying particular attention to the implications for the skills base of the board and the ability of the board to monitor management appropriately.

It is not necessary that a majority of directors of listed companies are independent. The more important factor is that the board members have a great understanding of the underlying business as well as being capable of 'independent thinking' particularly in relation to the responsibility to control agency costs associated with managers. (Academic studies have failed to find any consistent evidence of a relationship between firm performance and the independence of directors.) Good answers will note the ASX principles are "comply or explain" in approach and the soon-to-be-implemented changes to their Principles of Good Governance have moved away from definitions of independence to "indicators" of governance strengthening this view.

2. **If you believe that agency theory appropriately describes the corporate governance dilemma, what are the implications for what boards should do? How would this differ if you thought resource dependence theory was a more appropriate explanation? Do you think it is one theory or the other? Justify your response and discuss the implications for board structure.**

If agency theory is a key factor for corporate governance, boards should consider steps that can be taken to ensure board members remain independent of management so that they can exercise the control on behalf of the company's owners. One area that this would impact would be the structuring of the board in terms of the number of independent directors.

If Resource dependence is a key factor for corporate governance, boards should consider what additional resources they require that they could not gain through market or management links. Thus, boards exist to provide access to capital, information, power and other important inputs that can assist the company to control its environment.

In practice, both theories play an important role in the area of corporate governance. Two of the key functions that a board must fulfil are monitoring and control and access to resources.

Thus boards should consider these factors when appointing board members and ensure that there is an adequate 'independent' component as well as a broad knowledge base of the members that includes a good understanding of the central business involved.

3. **Why are continuous disclosure and insider trading provisions important to modern economies? What are the implications of these requirements for a board of directors of a listed company? What are some practical steps a board can take to ensure compliance with these provisions?**

The central idea behind both continuous disclosure and the prohibition on insider trading is to build a robust and efficient equities market in Australia because they allow the market to be as fully informed as possible when making investment decisions and provide the ability to rely on efficient provision of information.

Continuous disclosure is the specific requirement of listed entities under Listing Rule 3.1 (and given legislative force via section 647(1) of the Corporations Act) to keep the market informed of information likely to affect the price of its shares. If the information is confidential (i.e. not known outside the company) then a company may choose not to disclose if a reasonable person would not think it necessary to disclose and the information is insufficiently clear.

Obviously, this is a very wide obligation of disclosure and this requires considerable judgment from directors as to when to disclose and when not to disclose as virtually every decision made by a board of directors has the potential to affect the price of its securities. Therefore, listed companies must develop key information management systems that seek to manage the flow of information to the market.

4. Compare and contrast typical Anglo systems of governance with Pluralistic forms of governance. Which do you think is more effective and why? What are the implications of your choice for the legal system and capital markets?

The Anglo system of corporate governance is based on a well developed legal system, a mature market economy and the philosophy (or national culture) that the most important role of the board is to supervise management and reduce the agency costs associated with the separation of ownership from control. This protection of shareholder rights (particularly minority rights) is embedded in the legal system (e.g. directors' duties), capital markets (e.g. continuous disclosure requirements) and corporate and community culture (e.g. the predominance of shareholder value as the ultimate goal of the for-profit company).

The Pluralist system of corporate governance is based on a civil law system, a more stakeholder orientated relationship between shareholders, banks and the community, and a more public benefit or communal philosophy or culture. Under this system, a key role of the Board can be to ensure appropriate representation of stakeholders in the direction and control of the corporation. For instance in Germany, which operates a pluralist system, employees often have a right to have representatives sit on the supervisory board.

In relation to which is more effective, it is largely dependent on the legal system and cultural backgrounds as to which is more suitable.