

GIOO Congress Speech

Catherine Walter AM, Westin Hotel, Sydney 27 September 2004

It is often said that people get the politicians they deserve.

I'm not sure if anyone has ever said shareholders get the directors they deserve.

But I know that there are many reflective directors beginning to think that they get the corporate regulation they deserve.

Tonight I want to talk about:

- how that combustible mixture of democracy, what shareholders want and corporate regulation is affecting Australian business; and,
- some suggestions about what we need to do if we are to maximise our influence on the future direction of regulation and governance.

Whenever we pick up the financial press there are articles – including quotes from business leaders – decrying the cost of compliance with the CLERP 9 reforms.

While the reforms are the latest point of contention for directors, similar reactions greeted the release of the ASX corporate governance guidelines.

There is, however, a certain irony to the controversy over the regulatory regime facing Australian companies.

Directors and executives are no strangers to the force and impact of globalisation. They often invoke globalisation when justifying corporate down sizing or out sourcing. It is also axiomatic

that any enterprise which wishes to maintain competitive advantage ignores global influences at its peril. Directors and executives – including me I must say – have been saying for some time that these global influences make change necessary not only for business but for governments, unions and staff as well.

We have even assured the Australian community that, while some of the change would be painful, globalisation made it both inevitable and worthwhile.

It is therefore surprising to me to hear directors - who I personally know to be intelligent, insightful and sophisticated - decrying the influence of global corporate governance standards. When independence of auditors and directors, the heightened power and responsibilities of audit committees and the trading of translucence for transparency in the context of executive remuneration become global catch cries - how could we hope to ignore their influence, possibly even their inevitability, in our own market?

To reflect for a moment on the question of inevitability.

Let's just imagine for a minute that CLERP 9 doesn't exist?

But let's also recognise that recent history in Australian business and the world has continued to exist.

...and when we review that history what important events do we see?

A quick selection would include:

- (a) some of our companies wished to raise funds in the US market and so became SEC registrants;

- (b) companies took on DLC status in the hope of either higher P/E ratings or wider capital raising potential;
- (c) many of our shareholders themselves became global players as fund managers consolidated;
- (d) global sector investment in best of class became a fund manager focus over specific geographic asset allocation; and
- (e) the emergence and assertiveness of proxy services with international reach.

As you tick off each of the events the conclusion is obvious – the trend towards globalisation of regulation was inevitable.

Whether it was also going to be painful but worthwhile are questions to which I want to turn.

Once global corporate governance standards became relevant to Australian companies, the question then became one of the most fundamental questions about competitive positions in global market places: whether, in the context of such standards, Australia was to be a price maker or a price taker?

Was Australia's influence in the global corporate governance debate such that as a price maker, we could impose our standards, or was it the case that Australia was a price taker in the corporate governance world where it had to accept other's corporate governance standards.

In one of those convenient convergences of logic and intuition most of us would assume we would just have to be a price taker.

On a simple numeric test for instance - our exchange rates around 2% of the MCSI index, while the US stands around 55%, the UK around 11% and Japan around 10% - we would obviously be a corporate governance price taker.

But in what is doubtless a credit to classic Australian innovation, marketing and – dare I say it - sheer chutzpah - Australia's influence is, to quote Maurice Newman, Chairman of the ASX, “punching above its weight” in corporate governance influence.

So – despite what logic and intuition suggests - Australia is probably somewhere between a price taker and a price maker in the corporate governance space.

The natural price maker in the corporate governance space has been the US, with more than half of the MSCI index and with its dramatic and pervasive Sarbanes Oxley legislation passed unanimously by Congress.

SarbOx may have been a reaction to Enron, Tyco and WorldCom - but in changing the face of the US corporate governance it changed the face of global corporate governance as profoundly as Coca-Cola and US sitcoms changed world drinking and viewing habits.

So SarbOx elevated to national consciousness and attention issues including auditor independence; corporate responsibility for financial reports; management assessment of internal controls and whistleblower protection.

What was Australia to do? Ignore these issues? Create prescriptive legislation along similar lines? Wait and see the reaction to the US SarbOx legislation? Or devise a conceptually sympathetic but idiosyncratically Australian solution?

I believe Australian legislation and regulation has largely achieved the outcome of being conceptually sympathetic but appropriately Australian in context.

The two giant steps for Australian corporate governance in this regard have been the ASX Corporate Governance Guidelines and the recent CLERP 9 reforms.

The hallmark of the ASX Corporate Governance Guidelines has been the principles based approach to corporate governance flowing from a recognition that one size does not fit all companies in corporate governance terms. They set down articulations of what are currently perceived to be best practice.

They were forged from the creative tension engendered by the relevant stakeholders in the corporate governance arena namely: bodies representing super funds and trustees, investor relations, company directors and secretaries, shareholders, accountants, actuaries, internal auditors, lawyers, BCA, ASX and SIA and of course the G100!

The Guidelines have been subject to close scrutiny and an Implementation Working Group reviews their efficiency and recommends adjustments where necessary. A recent example has been guidance in the interpretation of Principle 7 which deals with recognising and managing risk to make clear that CEO and CFO sign off of effective operation of the control systems is sufficient to address efficiency of operation and that such a sign off is to be interpreted as a reasonable but not absolute level of assurance.

This is a marked improvement on the US system which seemed to have been originally politically motivated by the hope that symbolic TV picture opportunities, rather than meaningful

corporate regulation, would erase memories of previous malfeasance. Instead, it transmogrified into highly prescriptive and onerous regulation.

The Guidelines have led, a year or so later, to listed companies now publishing for shareholders a range of documents including their committee structures and charters; board independence, review and renewal processes; policies re continuous disclosure, risk and remuneration; and codes of conduct.

Of course, there was a flurry of corporate activity in creating such charters, policies, procedures and codes where they did not already exist or refining them where they did. Every board I was on during this time felt it was spending a disproportionate period of its time on these governance issues. The ASX included!

But any time there is a step change in community expectations, this is what happens.

The institution has to catch up with the community's standards and close the expectation gap.

But a byproduct of the need to articulate what the individual companies did in the context of these guidelines led to very useful introspection and debate as to whether the articulated best practice was actually best practice; and, whether even if it were, it was applicable to the company's own context and what solution it was seeking to the issue in question.

Boards suddenly took control of the governance debate - assisted of course by selfless consultants like lawyers and others thinking only of corporate governance good and not their own fees – and it was at board level, in my experience, that the decisions about individual company's governance characteristics were made.

SarbOx was passed in August 2002 and became applicable to SEC registrants from early 2003. The ASX Corporate Governance Council was formed in August 2002 and the ASX Corporate Governance Principles became applicable for the first financial year after 1 January 2003.

Thus the US corporate governance price maker initiative of the highly prescriptive SarbOx was in the same time period addressed by an Australian corporate governance price taker response of a principles based best practice regime. This regime encouraged companies to either adopt the guidelines suggested or explain why some of the corporate governance principles did not apply. The so called “if not, why not” regime.

Resisting highly prescriptive Australian legislation mirroring that of SarbOx was an achievement we should recognise and congratulate ourselves on .

I would like to turn now to parts of the legislative response of CLERP 9 touching upon audit which may be of interest to you - illuminated (if that’s the right word) by some of my recent experiences.

Forgive me for sounding a bit didactic but I can really recommend a very careful reading of the Treasurer's Explanatory Memorandum to those of you who, like me, see themselves labouring in the corporate governance vineyard for some time to come.

It provides an interesting insight into the options available in terms of legislative solutions to the articulated governance problem. The options chosen represent sometimes less prescriptive legislation and other times more.

It is it also useful to reflect, as you read the Treasurer's memorandum, on whether any of the particular legislative solutions could have been averted by different conduct by Australian company directors and auditors.

I must confess that as I read it I came to the conclusion that perhaps quite a number of CLERP 9 reforms represent the legislation we deserved as corporate players.

By this, I am not only thinking of that part of corporate Australia - the HIH and OneTels- who were primarily responsible for getting us here, but all of us as a collective.

Could we, by way of regulating ourselves, have avoided some of this legislative prescription?

Let's go back to our thought experiment about globalisation and apply our imagination to some of these audit issues.

For example,

1. ***NON AUDIT SERVICES***. Should we have restricted non-audit services more than we did and so have avoided requirements to provide detailed description of each item of work and fee? Should we have taken these steps when the SarbOx rules became prevalent? Should we have had the insight that continuing to justify multiples was not going to cut the mustard? (why was 2 times, for example, fine when 3 times wasn't!) . Should we be grateful that non-audit services have not been outlawed altogether? Why did we hear fewer arguments from first principles as to preservation of auditors independence ie whether services constitute an auditor reviewing its own work, being an advocate of the client or having mutual or conflicting interests with the client? Why instead did delegation of approval of non-audit services tend to be quantum based ie approval by CFO or management if below a dollar threshold? Did we not get it that independence could be compromised no matter what the dollar figure of the non-audit service? And did we not get

it that as non-executive directors or audit committee members we should not have been delegating these matters?

One of the benefits of prescriptive and onerous legislation is that it promotes dramatic paradigm shift and future mental clarity on the particular issue. For example, after SarbOx prescribed its list of prohibited non-audit services, discussion around SEC registrants' boardroom tables on topics of non-audit services suddenly elicited far greater attention.

Going forward maybe the focus of shareholders questions at AGM's might point the way to boards as to emerging corporate governance concerns and we might take our own pre-emptive action.

2. AUDITOR PARTNER ROTATION to promote freshness of approach is another area companies, and for that matter audit firms, might have alerted themselves to and so obviated the need for the specific 5 year rotation that CLERP 9 has now imposed on lead and review partners. In a similar vein, it may be that rotation of audit firms, resisted by CLERP 9, might well be adopted voluntarily by companies to avoid the potential for future legislation in this area.

3. The CLERP 9 requirement for COMPULSORY AUDITOR ATTENDANCE AT AGM'S reflects in part a codification of the best practice that many companies had adopted. The added shareholder ability to submit questions, and have an expectation of their being answered, represents a logical extension of enhancing shareholders' right to know and reminds auditors of their accountability to shareholders. The way companies and auditors deal with this issue in future AGM's may well obviate the need for greater specificity of future legislation in this space. It really shouldn't be necessary to remind ourselves that auditors are in place to protect shareholders, but then again perhaps it is. I was surprised to

read in a US survey of May 2004 by Foley and Lardner that a company executive complained that its outside auditing firm couldn't be used "as a business adviser as in the past"! The old "we've always done it that way" dies hard.

4. Interesting too is the recognition that self- regulation of the auditing profession has run its race and that overview of the monitoring and advising on AUDITORS' INDEPENDENCE is now to be ceded to ASIC and FRC. Again, global pressure over global audit firms' independence requirements being overseen by an external body such as the PCAOB in the US would make it unsustainable for us not to go a similar route. Ideally the US would accord our independence review system mutual recognition. But in any event, the benefit of the US regarding ASIC and FRC as effectively tier 1 partners of PCAOB in reviewing our audit independence regime is infinitely to be preferred to Australia's bodies being relegated to some lesser category. But the question we ought to ask is whether self regulation ran its race because it was no longer appropriate or because the auditing profession failed to keep up with the pace the self-regulation race required?

5. The AUDITOR OBLIGATION TO REPORT TO ASIC attempts to "unduly influence, coerce, manipulate or mislead the auditor" should be embraced by audit committees, non-executives and executives alike. Certainly it is a larger impost than the previous s. 311 of the Corporations Act but the Clerp 9 amendments may have been seen to be necessary because of the paucity of reporting under this section. So to go back to my thought experiment: we need to ask ourselves how auditor reporting to ASIC ever came to be imagined as a potential issue in corporate governance? Could we have avoided it? Whether we could or not, we are probably left with a quite reasonable position: a position in which if it never happens it will never be an issue and if it does happen it should most definitely be an issue.

6. WHISTLEBLOWER PROVISIONS mirror the sentiment of the SarbOx provisions and presumably result from concerns that companies have either not had policies in this area, or have had policies which have been inadequate. Indeed whistleblowing could be seen to be, when all else fails, the ultimate form of internal audit.

Not having had to be a whistleblower myself, I have no precise experience in this regard. But I do know a little bit about how difficult it is to be the harbinger of discordant news to those who have no particular desire to hear it. Strengthening whistleblower protection may, ironically, render it unnecessary. Corporations which have much greater clarity in their whistleblower policies, protecting and indeed encouraging such individuals, may create cultures in which there are fewer whistleblowers in the traditional understanding of the term. In simple terms, speaking up for what is in the company's interests may become integral to the culture rather than an apparently disruptive event.

I have traversed some only of the audit reforms of CLERP9 so as to illustrate my central thesis that maybe we do get the legislation and regulations we deserve. I have sought too to indicate that we can, if you like, change our luck in this regard.

That is to say, we can envisage for ourselves a different legislative and regulatory future by imposing on our corporate selves the behaviour that our shareholders and other stakeholders seek. We can anticipate their needs and address them.

Let me just give one example which goes to the core of corporate life:

LIMITED LIABILITY STATUS FOR COMPANIES:

We take for granted that limitation of liability of the corporate structure suspends, in favour of officers and promoters of the company, the natural consequences of tort, contract and property law.

But companies have been reminded in recent times that the benefit of such a licence or concession carries with it obligations to behave appropriately.

The law addresses the boundary of where, on the one hand, corporate liability should remain limited and, on the other hand, where cases and legislation should permit piercing of the corporate veil. Trading while insolvent carrying with it, as it does, potential personal liability of corporate officers, is an obvious legislative example. But, this boundary of natural disputation around preservation of limited liability is becoming the domain not only of judges and legislators but more recently the community.

The James Hardie case provides a salutary example where the community, former employees, product users, unions etc - bought in, with considerable success, to the limited liability issue. It could even be said that the company itself, perhaps in response to community pressure, is seeking to have its shareholders reverse moves which have had the effect of removing asbestos liability from the company. A company itself seeking to pierce its own corporate veil is I think a unique but fascinating development.

Companies will learn that they ignore the 'social' or community licence consequence of limited liability at their peril. And of course, where one company brings limited liability into question, the consequence can be felt by very many companies.

So, as a group of company executives and directors, we all have a stake in ourselves maintaining and advocating good behaviour. We need to constantly remind ourselves that the limited liability company – however fundamental to an entrepreneurial economy - is not a natural creature. It is a legislative construct, which can be legislated away if we are careless of its benefits and responsibilities.

AND SO IN CONCLUSION:

The world has gone through one of its periodic dramatic economic expansions – driven by technology, globalisation, the progressive liberalisation of once totalitarian nations, dramatic developments in ways to form and direct capital and so on. In more recent years things have been tougher but the basic trends which have underpinned a decade of growth never before seen in the world are still apparent.

As with all such periods the exuberance was – at times and in places – not quite as rational as it might have been.

Sadly the irrational exuberance has been met with the traditional response – a new approach to regulation.

The fundamental difference between this bout of regulation – and that which came after the South Sea Bubble, the Great Crash and other similar events – has been the global nature of that response.

It is inherent in what has driven a period of unparalleled global business growth and expansion. It has been – as we have told governments, unions and staff – inevitable.

But while globalisation of standards may be inevitable the precise form of that regulation is not pre-ordained. We still have power over its shape and direction.

We can increase our power over the shape and direction of regulation by recognising that winning consent to our regulatory preferences comes not from opposing all regulation and change, but by anticipating the needs of the various interest groups who give that consent and developing robust alternatives before the demand becomes too great to resist.

If we are concerned today about the cost to shareholder value of compliance then we ought to remember that more focus on shareholder and stakeholder values may have avoided some of the regulations with which we have to comply.

And just as the concepts of consent – a sort of licence to operate – and shareholder and stakeholder values shaped the current environment so our approach to them can shape any future regulatory environment.

At the very least the wisdom of desisting from stridently haranguing corporate reform certainly commends itself to me - for reasons both philosophical and practical.

So in a fortnight's time someone or other will try to explain away the election result by claiming that people get the politicians they deserve.

In the next few months, at AGMs throughout Australia, some shareholders will be adamant that they are not getting the directors they deserve.

But hopefully in years to come, with some reflection and foresight, directors will be saying that we are finally getting the regulations we want and need rather than those others think we deserve.