THE CHALLENGE OF CORPORATE GOVERNANCE

An Australian Perspective

By Paul Reid

The collapse of Lehman Brothers in 2008 gave renewed energy to the debate about the quality of governance of corporations—particularly the governance of financial institutions—around the world.

For those who had seen corporate collapses over the decades, the sense of déjà vu was strong and accompanied by a disapproving—“When will they ever learn?”—might have been muttered by whichever children of the 60s were still engaged in the cut and thrust of international capital management and investment.

Global political leaders who navigated earlier crises were determined to float oil over troubled international financial waters and, as has happened many times in the modern history of Western commerce, they used global political forums to give sweeping mandates to international regulatory organizations to force the pace of change.

Corporate governance became an area of particular focus for improvement. But why, especially given the recommendations from investigations into the scandals of the early 2000s (and we in Australia had our share via HIH, OneTel, etc.)? What new lessons needed to be learned? More particularly, why has this focus endured for the past six years, capturing headlines and demanding constant discussion between company boards and regulators?

In Australia, our two principal regulatory agencies, the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC), and their masters in the government’s Treasury have been very vocal in demanding improvement in corporate governance. They also all have “up-close and personal” relations with their international counterparts. They often, unashamedly, seek to set the pace for global change in this aspect of corporate life.

What are the corporate governance issues facing Australia? Readily named are: appropriate diversity in personnel (across the spectrum of age, race, gender, sexual orientation, religion); effective risk management; justifiable executive remuneration; customer centricity and conduct (and the culture of ethical corporate behavior); and transparency in the reporting of accountability for delivery against corporate strategy.

The above issues would not be surprising to any observer of Organisation for Economic Co-operation and Development (OECD) capital markets. But some, in my view, are occupying more agenda space in the boardroom: effective risk management; executive remuneration, customer centricity, and transparency in reporting.

Effective Risk Management

Boards grapple with this issue due to the proliferation of new regulatory literature on the topic as much as anything else. Attempts to define the corporate risk appetite, establish an effective risk management framework, and implement clear and understandable risk management reporting systems never seem to meet expectations. Perhaps this issue is a great example of one of Albert Einstein’s sayings: “If you can’t explain it simply, you don’t understand it well enough.”

For rudimentary risk managers, being able to answer the following questions used to be sufficient to evidence effective risk management:

1. What is it that we do?
2. What could go wrong, and what opportunities might we miss?
3. How do we prevent things going wrong and missing opportunities?
4. How do we know that prevention measures and mechanisms for capturing opportunities are working?

This simplicity of process seems to have eluded management, boards, and regulators alike. Sophisticated models that quantify financial risk and associated capital requirements have stood in its place and, judging by performance, often not to great effect.

Perhaps the greatest need is for clear and succinct risk reporting systems. If companies could show that quantitative and qualitative risk measures effectively nest within each other (like a set of Russian dolls) as they report up the chain of command/supervision, then executive management and the board might have an easier time managing and be more confident about the information presented to them. Consequently, being confident to attest that executive management and the board were operating within risk appetite (and if not why not) might not be as challenging as many within corporate Australia find it to be today.

Executive Remuneration

This issue is as perennial as the grass. The views of the mum-and-dad shareholder, which are forcefully put at annual general meetings in Australia, are that a significant number of senior executives are paid excessively for their roles and responsibility. The same often is said of board members as well.
The institutional investor, however, exhibits an air of acceptance of the fact that market forces set the benchmarks in this contentious area and, unless there has been some egregious behavior by the board in recommending certain remuneration arrangements, they will accept those market-driven outcomes.

Regulatory developments, however, aim to better align remuneration with long-term performance by way of partial deferral of short-term incentives. This approach gives prominence to risk management and cultural or ethical considerations in the assessment of management’s performance before finally awarding incentive payments.

Better risk reporting systems can capture relevant management information to assist in assessing senior executive performance in the current year and prior periods. This can enable fair assessment of whether short-term incentives should be paid or withheld.

Remuneration will be a continual challenge for boards and senior executives of listed companies as well as regulators and those charged with fiduciary responsibilities across the global capital markets, such as pension fund trustees, asset management organizations, etc. As more remuneration becomes performance-based and the war for talent continues, firms may have to adjust previously awarded incentives where appropriate, based on unbiased and well-supported evidence captured by effective risk reporting systems. Such an outcome requires a mix of systems capability and integrity of governance.

**Customer Centricity**

Anyone who hasn’t heard phrases such as “putting the customer at the forefront,” “customer focused,” “client at the center,” etc., obviously has been in a coma for the past 15 or 20 years. The real puzzle is why so many companies have failed to actually embed this concept into the daily activities of their employees.

Many Australian and international chief executive officers have espoused the virtue of “delighting the customer.” But the competing forces of achieving corporate goals that at times seem in conflict with customer-related goals (or risk-related goals for that matter) seem to create a barrier to behavioral change. Could it be that by simply showing the positive correlation between good customer feedback, improved risk management key performance indicators, and financial performance, these barriers could be broken down?

Better risk reporting systems can capture relevant management information to assist in assessing senior executive performance in the current year and prior periods.

Once again, it would appear that improving the quality or capability of management information systems could contribute to solving this dilemma.

When you consider the significant increase in regulatory intervention in Australia on behalf of customers in seeking compensation or redress for past unconscionable behavior by companies toward their customers, it would have to be obvious that a great many companies have not succeeded in getting their executives and staff to really embrace the concept of customer centricity or manage the risk of poor conduct in mis-selling products and services.

This poor management of conduct risk is not just an issue down under; it has been regularly on the front pages of the financial press worldwide. The billions of euros, pounds, and dollars that have been paid to government agencies on behalf of consumers or as a result of legal sanctions in the European Community, the United Kingdom, and the United States has been the subject of much of the financial and popular press this past two or three years. The challenge for boards in this environment is how to change behavior among senior executives and knowing that senior executives have been effective in generating change among the front line staff.

In Australia the mood among politicians is mixed—on the one hand, a desire to promote increased economic activity without increasing red tape in the financial sector has meant cutbacks in initiatives designed to put customers’ interest first. Despite the protestations of media commentators and even some industry participants themselves, confusion about what is the right thing to do abounds.

In Australia, ASIC and APRA have taken action of their own accord. In the financial services sector in particular, they have challenged boards to be more questioning about the nature of the products put out into the market place: Are they meeting/exceeding your customers’ needs/expectations? How do you know this? What customer survey information/market data/“big data analytics” are you basing your decisions on?

APRA has specifically requested the entities it regulates to incorporate the risk of “inappropriate behavior to customers/failing to meet customer needs” right up to the top of key risks faced by those organizations.

**Transparency in Reporting**

Nearly 10 years after the adoption of International Financial Reporting Standards (IFRS) in Australia, the new game in town is “integrated reporting.” This global initiative has a number of major listed companies participating in various “trial runs” that substantially revise the format and content of current financial and nonfinancial annual reports to shareholders. The aim is to ensure that companies provide their stakeholders with a thorough accounting of the stewardship of the company’s resources as it pertains to the achievement (or lack thereof) of its strategic objectives. Some have likened this type of reporting to annual (or even half-yearly) scorekeeping against a rolling prospectus.

But this is not the sole initiative to have arrived on the scene. The Australian
Securities and Investments Commission has been actively monitoring and reporting its views on the quality of financial reporting by companies. For listed companies in particular, the ability to ensure which financial reporting is based on IFRS concepts, which is based on industry norms, or which is company-formulated now has many companies highlighting a variety of terms and concepts such as “underlying profit” and “cash earnings.”

ASIC also has forced listed companies to enhance the detail and quality of commentary surrounding operating performance and the risks associated with business strategy. Some larger companies had been fairly expansive on these matters in their annual financial reports, but a number of smaller companies were seen wanting in these areas. Hence, the last two reporting periods have had focused attention from boards on these issues.

Whether integrated reporting takes root in the short or medium term is not the issue. Boards must find ways to manage the volume of reporting to the market place and present a coherent, consistent picture of immediate and longer-term business plans, performance against those business plans, and consequences to senior executive remuneration of any variance to expected results.

If greater transparency is required, then increased verbosity is to be avoided. Boards must be satisfied with the governance over the information subject to audit in financial statements, as required by law, as well as the governance of information released to the public voluntarily (this has been the subject of a recent revision to the Australian Securities Exchange’s Corporate Governance Principles).

Some companies already have put in place these governance processes, but in the eyes of the regulators, if the process isn’t documented and reviewed, then it can’t be taken as having happened.

Summary

Those children of the ’60s who populate the boards of corporate Australia might reflect on the fact that “the times they are a-changing.” Companies need to be agile in their responses to the mega forces shaping their industries, those seismic shifts in demographics, the environment, technology, social values, behaviors, and ethics.

In his February 2013 speech to the Australian British Chamber of Commerce, the then chairman of APRA, John Laker, said: "... the topic of regulation continues to fill the column inches in media and industry commentary … it can reinforce the impression that regulation is still the ‘main game in town.’ It is not."

Laker went on to outline the importance of the quality of corporate governance as a differentiator between companies that weathered the financial crisis after the fall of Lehmann Brothers and those that faltered.

Of the many topics pertaining to corporate governance, the four issues briefly discussed in this article will continue to generate discussion at the board level, among regulators, and within the capital markets generally.

The boards and executives of those companies that can weave together the common threads from those four broad issues and deliver operating models that demonstrate they can manage operations to meet or exceed expectations will differentiate themselves from competitors.

The evidence of their collective output to various stakeholders—investors, employees, customers, and regulators—must be showcased to succinctly and transparently demonstrate the benefits derived from good corporate governance.

Paul Reid recently retired after a 25-year career as an audit partner with KPMG Australia, where he specialized in the financial services industry. He also has been actively involved in advising non-audit clients on developments in the area of risk management. He earned a degree in accounting and is a member of the Institute of Chartered Accountants in Australia and CPA Australia. Contact him at pmreid@kpmg.com.au.
