

Role of the board in establishing a high performance business

My topic today is “the role of the board in establishing a high performance business”.

AICD believes it is about time we reminded people that companies and their boards are primarily about economic development and financial performance rather than whether or not they comply with a myriad of regulations.

In our political economy, the main engines of development are limited liability companies, and most of the biggest of these have large public shareholdings. They are the source of jobs, of economic growth more broadly and increasingly these days of retirement income. We need them to be entrepreneurial: prudent but adventurous: generating higher rewards through taking higher risks. And some will make mistakes and some will fail.

It is in that context that I want to talk about Board contribution to high performance.

Before I get on to that subject, there is one other, that if you will allow, I would like to develop for a few minutes. Directors in Australia – non-executive in particular – have got a real problem which we need to

recognise and confront, and which lies behind a lot of the inappropriate and excessive regulation of the last year or so.

In summary, the problem is that public expectations and beliefs about a Board, and its non-executive directors in particular, are way out of line with the role as it exists.

That expectations of non-executive directors are inconsistent with the role has been brought home by the myriad of additional legislation and rising expectations that has appeared in the last two years regarding requirements for board to be on top of, and ultimately responsible for, finite detail regarding issues as diverse as tax, risk management, HR, IT governance, industrial manslaughter, the introduction of international accounting standards, the preparation of incredibly detailed remuneration reports – not to mention handling a shareholder vote on their contents at the AGM..

This is in addition to standard requirements such as monitoring the performance of the CEO, and signing off on the company's strategic direction and financial reporting. Now is this appropriate and what is the board's role in all this as opposed to management's?

In general, weight of law increasingly says non-executive directors are accountable for everything, and non-executives are in charge of Boards. But let's look at non-executive directors:

- | | | |
|------|-------------|--|
| (i) | part-time | Say 250 hours a year in Australia vs less
in UK & USA

Low salary |
| (ii) | independent | No previous connection with company

Not employed by the company |

Reasonable expectations of these non-executives would be to contribute

- general experience, wise counsel
- integrity/social responsibility
- question and challenge.

But can a Board of such independent non-executives, as apparently is expected,

- control management
- set strategy
- accept hands-on responsibility for things such as accounts and tax and industrial safety.

A Board could do these things: but it would have to be a different Board

- directors would be expert/experienced in business
- less independent/directors would be executive or quasi executive
- more time/pay

- Note that
- UK has Executive Directors as +/- 50% of its Boards plus Executive Chairs
 - USA has management dominance through Chairman/ CEO

But in Australia, we insist on putting part-time independents in charge and then crucifying them if anything goes wrong. It is not a good recipe. Maybe the British and Americans have better models. From where they are starting, promoting the role of non-executives and independents makes sense. But we should be going in the opposite direction.

With that as background, let's look at what does make for an effective Board. *Harvard Business Review*, September 2002, has an excellent article by Jeffrey Sonnenfeld "what makes great boards great".

"We need to consider not only how we structure the work of a Board, but also how we manage the social system a board actually is. We'll be fighting the wrong war if we simply tighten procedural rules for boards and ignore their more pressing need – to be strong, high-functioning work groups whose members trust and challenge one another and engage directly with senior managers on critical issues facing corporations."

In the past few years we've had Sarbanes-Oxley, Higgs, ASX and the CLERP 9 Act telling us in detail how to organise our Boards, which Committees we need, who can be directors, and so it goes on. My thesis

is that this is the wrong war. Very little of this stuff is helpful: and some of it is wrong-headed. You won't be able to ignore it – compliance with the law is not optional. The important thing is that, despite all this prescription, you work out what suits your company's particular circumstances, and organise and plan your Board accordingly. Your compliance officer/company secretary will make sure you keep on the right side of the law: and for the rest, be prepared to say “why not” to the ASX guidelines if they don't suit you.

Two people who understand this in Australia, says AICD, are Wesfarmers director Colin Carter (joint author of *Back to the Drawing Board*) and Margot Cairns (author of *Boardrooms that Work*) and we commend their work to you.

Here are some of my own thoughts on what really matters at Board level (in addition of course to getting, evaluating and if necessary changing, the Chief Executive – nothing else comes close in importance to that primary function).

1. Choose the board's emphasis – develop delegation framework

The board must figure out the level at which it wants to engage with management of the company. What do we spend our time on? What do we leave to management? It must decide to what degree it will offer advice, provide oversight, and participate in the decision-making process.

The Board needs to have this discussion, and be very clear to itself and to management about what it decides.

Speaking to our members at a Perth function earlier in the year, Colin Carter described the now impossible nature of the normal description of the role of a director.

He said: “The job description (of a director) says he or she must review the strategy and approve budgets, monitor business performance, approve large investments and dividends, evaluate the chief executive, oversee management succession planning, approve executive compensation, ensure that major risks are identified and managed, and that there is accurate financial reporting as well as general legal compliance.” He described the enormity of the responsibilities as “ridiculous” and questioned how this could all be achieved in a few weeks of the year.

Delineation of the board’s role or charter should be noted in the company’s corporate governance statement, by the way. Directors must discuss, agree on and set out the scope of their responsibilities. In particular this will drive thinking on what directors you need: and how much time they will need to spend.

The sorts of issues that come up, and are not easy to deal with, are for example whether, in order to manage the workload and to ensure the work of the Board is done, the Board should divide responsibilities and

have each director focus on specific issues. After all, that is how sports teams work.

Most Boards do decide on some limited specialisation through sub-committees. More would be possible if desired: though few Boards go down this track.

2. Board Composition (1) - Balancing independence and knowledge

Board membership needs to balance independence and knowledge. Regulation such as CLERP 9 and the ASX Corporate Governance Guidelines is placing too much emphasis on board member “independence” as the solution to all governance problems – presumably on the assumption that ethical problems are the cause of recent difficulties.

Independence comes at a cost. The complication of independence is that individuals with a deep understanding of the company’s business are prevented from serving on the boards of companies where their skills could be best applied. Paradoxically, the more independent the director, the more reliant the director is on management for information about the business. How can an independent director without deep experience in the business seriously question the reliability of this information?

Former senior executives are typically reluctant to join the board of a competitor. They feel a sense of loyalty to their old institution. Without a cooling-off period of between three to five years, the skills of a former CEO or senior executive cannot be used by their former employee. As a result non-executive directors of these boards tend to be generalists or to come from the professions. Guidelines such as the ASX Corporate Governance Principles discourage senior legal and accounting practitioners from taking board positions with companies they know. There is a danger that anyone involved enough to really help will be disqualified!

I argue that independence is a “state of mind”. No list of criteria defining what amounts to independence can measure up to this commonsense notion: many people who would fail current independence tests are in fact just the directors you need. Conflicts can be managed. They should not be avoided at all costs by not appointing the people you need.

3. Board Composition (2) - More diversity on boards

Boards need to ensure they have directors who can bring different perspectives to boardroom discussion and that collectively there is reasonably complete coverage of issues. Yet they need to be small enough to be an effective working group, say 7-10 people.

To have been a former CEO is a very common specification – but there is also a need for accounting/financial, legal, technical, business sector knowledge: not to mention issues of gender balance, international experience and the like.

How do you achieve a Board which has International as well as an Australian perspective?

Diversity enriches a Board with alternative perspectives and experiences which offer the board processes a broader relevance. It is about capturing intellect and allowing it freedom of expression.

And of course, Board chemistry is important. Your directors have to be an effective group, which brings me to the fourth area.

4. Foster healthy board dynamics

Boards need to be strong, high-functioning work groups whose group members trust, challenge and engage one another. You can't put too much effort into creating a climate of trust and candour: of fostering a culture where it is OK to disagree and question.

One issue in this area of healthy board dynamics that got a run in the press over the last year was the suggestion of a director 'pre-nup

agreement’, which is a direct result of the NAB board dispute. This is a hotly debated move by some companies to avoid such a damaging public rift by requiring directors to sign agreements, under which they could be obliged to leave, if the chairman and majority of directors decide this is in the interests of the company.

The AICD believes such agreements are a step too far from shareholder interests. The formal power to remove a director should remain with the shareholders, as it currently is under the Corporations Act. This is an important principle of corporate governance that should be maintained and we also doubt whether such agreements are legally binding.

AICD also believes that to formalise a board’s power to remove a director would weaken the position of individual directors and potentially compromise the ‘independence of mind’ that is essential for many other aspects of corporate governance.

However, the means to deal with a board member who is not performing is a different, though related matter. A compromise approach, where a timely solution to poor director performance is addressed, but shareholders rights in their appointment and removal are still respected, could be to refer any wish to remove a director to shareholders at the next AGM, whether or not his/her time is up. No doubt this will continue to be debated in boards throughout the country.

There is a lot more that could be said under this heading: but let's leave it at that, save for the observation that hopefully your Board has some executive directors, and the foundation for healthy Board-management relationships is in that healthy Board dynamic.

5. More contact with senior executives

My final issue relates to getting out and about, kicking the tyres, seeing the operations, meeting staff and customers.

Directors must be willing to drill down into the business and have a feel for what happens on the ground. Directors can add value by seeing for themselves the integrity of the business, its ethics in decision making, and its culture and values. This requires time, effort and energy in liaising with executives: it requires an open, tolerant attitude from top management: and it needs disciplined, good behaviour from non-executive directors (no getting into management issues!).

Can I underscore that a close examination of the boards of Enron, WorldCom and Tyco reveals no pattern of incompetence and corruption – members attended meetings, had invested personal money in the company, audit and remuneration committees were present, the balance of independent and executive directors was adequate, and codes of ethics were posted on websites. The “recipe” of good corporate governance had been followed.

The key to good corporate governance is not structural, it is social. Good corporate governance processes depend upon people – what distinguishes exemplary boards is their ability to foster mutual respect, trust and open debate in the boardroom.

Before I wrap up I'd like to share with you the AICD's views on a couple of emerging issues that continue this theme and that are particularly relevant to this audience.

The first is the move by APRA into the regulatory space with the publication of their guidelines for APRA regulated entities. Fundamentally AICD has reservations about APRA operating in the corporate governance area as this is already adequately filled by other bodies such as the ASX Corporate Governance Council. APRA's presence leads to inevitable confusion, overlaps and differing interpretations as financial institutions and insurance companies attempt to interpret various sets of regulations and guidelines.

However, as APRA have outlined their firm intention to remain in this area, the AICD strongly believes that they should adopt the ASX Corporate Governance Principles and Recommendations' flexible "if not, why not" approach which preserves the important principle that companies know what structure is best for their circumstances and shareholders.

Unfortunately APRA appears to be taking a rather inflexible approach which is a concern. Evidence is already emerging in the US where the stricter black letter approach of Sarbannes-Oxley is having serious unintended consequences in terms of the cost of compliance without necessarily providing the hoped for benefits.

Legislators and regulators often tend to favour the “one size fits all” approach to new corporate regulation. While this is understandable, it can also be counter-productive in terms of a producing a tick the box compliance mentality.

If APRA fail to adopt an ‘if not, why not’ approach, and they are giving every indication that this will be the case, the AICD believes that, at the very least, companies should be able to seek permission from APRA for a particular non-compliance for good reason. This particular non-compliance needs to be accompanied by full disclosure to the market as to why the exemption from APRA’s public standards has been granted.

Our recent submission to APRA expands upon these points and we are awaiting their response.

The second is the push from various state governments for an amendment to the Corporations Act in response to the James Hardie case to alter directors’ duties to enable them to take into account the needs of stakeholders other than shareholders in making their decisions.

Now the duties of directors are the very heart of the free market system. Under the current Act, a director must act in the best interests of the company. This means, primarily, the interests of its shareholders.

AICD's view is that the duties as currently defined are correct. We oppose the change proposed by the States, not because we do not care for community interests but because the present system works well in the interests of all Australians and far better than the likely alternatives.

The key is to think long-term. Companies exist forever, not one year at a time. Directors must act "in the interests of the company", under the Corporations Act and if they do this with a long-term perspective, they will naturally have regard to the company's reputation, its relationships with customers and suppliers and its environmental risks. Such matters will become embedded into their thinking.

The AICD worries that if an explicit legal duty to the community were added to that to the company, the job of directors, already very difficult, would be made next to impossible. Directors would be faced constantly with trade-offs between the interests of the community and those of shareholders. There is no rational way these can be resolved. It would be like trying to serve two (or more) masters. Accountability would be blurred. Pressure groups would have a field day. It is not clear to us that the Hardie situation would have turned out any better under such a regime. What is apparent, however, is that the international

competitiveness and long-term financial performance of Australian companies would be diminished.

Once again, governments are considering changing the law in an important area because of a specific case. This would be a mistake. The duties of a director are well defined now and the existing law that should be applied. It is clever and subtle, and it works remarkably well.

In conclusion Ladies and Gentlemen, can I invite you to speak up and help the AICD to try and push back this avalanche of regulatory black letter law. We need Boards that can encourage great entrepreneurial enterprises. The way we are headed, Boards are in danger of becoming risk-averse trustees, and their companies of generating utility rates of return.

This will be BAD FOR THE ECONOMY
 FOR SUPERANNUATION INCOME
 FOR JOBS
 FOR QUALITY OF LIFE

We need to speak up !

Thank you.