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# The concept 'corporate governance' and essential corporate governance principles

*It is necessary only for the good man to do nothing for evil to triumph.*

- Words attributed to Edmund Burke (18th-century English political philosopher)
- *The Australian*, Monday 6 December 2004, 4, reporting on the most favoured phrase of quotation-lovers as determined by an Oxford University Press poll.

## 1.1 The meaning of corporate governance

### 1.1.1 Generally

One thing that is clear about the concept of corporate governance is that there is no set definition as to what it means. Commentators often speak of corporate governance as an indefinable term, something – like love and happiness – which we essentially know the nature of, but for which words do not provide an accurate picture. Many have attempted to lay down a general working definition of corporate governance, yet one definition varies from another, and this often leads to confusion. Others, like the UK Cadbury Report (1992) and the South African King Report (1994), basically only say that corporate governance is 'the system by which companies are directed and controlled'. That seems not particularly helpful in clarifying the meaning of the term 'corporate governance'. Surprisingly, until quite recently, it was quite hard to find a formal definition of 'corporate governance', notwithstanding the 'voluminous literature' on this topic.<sup>1</sup>

Several recent reports dealing with corporate governance have attempted to clarify the concept. One, for example, said that:

<sup>1</sup> See James E Post, Lee E Preston and Sybille Sach, *Redefining the Corporation: Stakeholder Management and Organizational Wealth*, Stanford Business Books, Stanford (2002) 18.

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## 2 CORPORATE GOVERNANCE: AN OVERVIEW

Corporate governance refers generally to the legal and organisational framework within which, and the principles and processes by which, corporations are governed. It refers in particular to the powers, accountability and relationships of those who participate in the direction and control of a company. Chief among these participants are the board of directors, and management. There are aspects of the corporate governance regime that have an impact on the relationship between shareholders and the company.<sup>2</sup>

Justice Owen considered the meaning of the term ‘corporate governance’ in two different places in the Report of the Royal Commission set up to investigate the collapse of HIH Insurance Ltd, one of Australia’s largest corporate collapses. In the introductory part of the Report, under the catchy heading, ‘Corporate governance: a poor role model’, he reflects as follows on the phrase ‘corporate governance’:

I am becoming less and less comfortable with the phrase ‘corporate governance’ – not because of its content but because it has been so widely used that it may become meaningless. There is a danger it will be recited as a mantra, without regard to its real import. If that happens, the tendency will be for those who have to pay regard to it to develop a ‘tick the box’ mentality. The attitude might be, ‘Yes, we have a state-of-the-art corporate governance model; yes, it is committed to writing; and, yes, the company secretary has checked that each item is in place and has included a statement to that effect in the annual report. Therefore there could be no problem in the corporation’.

Corporate governance – as properly understood – describes the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations. Understood in this way, the expression ‘corporate governance’ embraces not only the models or systems themselves but also the practices by which that exercise and control of authority is in fact effected.<sup>3</sup>

Later in the HIH Royal Commission Report, Justice Owen focused on the meaning of corporate governance in particular:

While numerous renditions of the term can be found in the literature, many of them useful, corporate governance is not a term of art. At its broadest, the governance of corporate entities comprehends the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations. It includes the practices by which that exercise and control of authority is in fact effected . . .

The term corporate governance has a descriptive content, in the sense of denoting a simple statement of a governance model that is in place. It is also commonly used in an aspirational sense, by way of holding out a model which practice should seek to emulate. Reference can be made in this regard to various statements of corporate governance principles or guidelines on good corporate governance practice, some purely hortatory, others more prescriptive, that have been published or promulgated in recent years.<sup>4</sup>

<sup>2</sup> Background Paper 11 (HIH Royal Commission) *Directors’ Duties and Other Obligations under the Corporations Act* (November 2001) <<http://www.hihroyalcom.gov.au>> 27 para 76.

<sup>3</sup> *Report of the HIH Royal Commission* (Owen Report), (2003) <<http://www.hihroyalcom.gov.au/finalreport/index.htm>> xxxiii.

<sup>4</sup> *Ibid* para 6.1.

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The ASX's *Principles of Good Corporate Governance and Best Practice Recommendations* gives the following description of 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.

Good corporate governance structures encourage companies to create value (through entrepreneurship, innovation, development and exploration) and provide accountability and control systems commensurate with the risks involved.<sup>5</sup>

It will be clear from all these descriptions of the concept 'corporate governance' that there are indeed several differences, sometimes only subtle but in other instances more fundamental, as to what is corporate governance or what should be understood under the term 'corporate governance'. Before we attempt to give our own definition of the concept 'corporate governance', it is important to spend a few moments on the origins of the corporate governance debate and the origins of the stakeholder debate. Focusing on these aspects will enable the reader to view the concept 'corporate governance' with an open mind.

### 1.1.2 Origins of the corporate governance debate and the stakeholder debate

It is reasonably difficult to determine exactly when the corporate governance debate started.<sup>6</sup> However, there is little doubt that there were many factors that made the corporate governance debate prominent: the separation of ownership and control (so pertinently illustrated in 1932 by Berle and Means in their book, *The Modern Corporation and Private Property*) resulting in the so-called 'managerial revolution';<sup>7</sup> the pivotal role of the corporate form in generating wealth for nations; the huge powers of corporations, and the effects of these on our daily lives; and the enormous consequences that flow from collapses of large public corporations.<sup>8</sup>

It is also beyond dispute that the corporate governance debate became particularly prominent when the basic perception of the company changed. At first the only real concern for a company was the maximisation of profits.<sup>9</sup> Profits for whom? – the shareholders,<sup>10</sup> as they were seen as the 'owners of the company', the primary stakeholders and most important providers of capital to enable the

<sup>5</sup> Australian Stock Exchange (ASX), *Principles of Good Corporate Governance and Best Practice Recommendations* (March 2003) <<http://www.asx.com.au/about/13/AboutCorporateGovernance.AA3.shtm#>> 3.

<sup>6</sup> See John Farrar, *Corporate Governance in Australia and New Zealand*, Melbourne, Oxford UP (2001) 7–19.

<sup>7</sup> See, for example, Klaus J Hopt, 'Preface' in *Institutional Investors and Corporate Governance* (1994) I; and *OECD Principles of Corporate Governance* (April 2004) <<http://www.oecd.org/dataoecd/47/50/4347646.pdf>> 12.

<sup>8</sup> See generally Roberta Romano, *The Genius of American Corporate Law*, Washington, DC, AEI Press (1993); and David S R Leighton and Donald H Thain, *Making Boards Work*, Whitby, Ontario, McGraw-Hill Ryerson (1997) 9–10.

<sup>9</sup> Adolf A Berle, 'The Impact of the Corporation on Classical Theory' in Thomas Clarke (ed), *Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance*, London, Routledge (2004) 45, 49 et seq.

<sup>10</sup> Margaret M Blair, 'Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century' in Thomas Clarke (ed), *Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance*, London, Routledge (2004) 175, 181.

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company to conduct business. Gradually this perception changed. The company, especially the large public company, was seen in a different light. People started to realise that there were other stakeholders in a company too; that if the only purpose of a company was ‘the maximisation of profits for the shareholders’, the society as such could suffer tremendously – poor working conditions for workers, exploitation of the environment, pollution, and so on. Then came the realisation that

enterprise, private as well as public, because it both contributes to and benefits from society (local, national and larger), can be said to have rights and duties vis-à-vis that society in somewhat the same way as has an individual;<sup>11</sup>

and

[t]he limited liability company does not simply represent one interest. It represents an arena in which there is a potential clash of many interests. We may identify the interests underlying it as: (1) investors – share capital/loan capital; (2) outside creditors – commercial finance/trade creditors; (3) employees; (4) consumers; (5) the public.<sup>12</sup>

The whole concept of ‘managing the corporation’ then came to be expressed in terms of these other interests:

The balancing of the company’s responsibilities – to workers as members of the company, to consumers of the goods and services it provides, and to the community of which it is a citizen – with its primary one of operating at maximum efficiency and lowest cost, so as to make profits and discharge its obligations to its shareholders, represents the full scope of management.<sup>13</sup>

Thus, the concept of ‘corporate governance’ started to adopt this new articulation of ‘managing the corporation’, with a central focus on the interrelationship between internal groups and individuals like the board of directors, the shareholders in general meeting, employees, managing directors, executive directors, non-executive directors, managers, audit committees and other committees of the board. However, outside interests are also at stake, for example, those of creditors, potential investors, consumers and the public or community at large (so-called stakeholders). Traditional wisdom regarding shareholder primacy versus other stakeholders began to be challenged with statements like ‘managerial accountability to shareholders is corporate law’s central problem’<sup>14</sup> and ‘corporate law is currently in the midst of crisis, because of the exhaustion of the shareholder primacy model’.<sup>15</sup> Nowadays, it is fairly generally accepted that ‘in future the development of loyal, inclusive stakeholder relationships will become one of the most important determinants of commercial viability and business

**11** C de Hughton (ed), *The Company: Law, Structure and Reform in Eleven Countries*, London, Allen & Unwin (1970) 7.

**12** John J Farrar et al, *Farrar’s Company Law*, London, Butterworths (1991), 13.

**13** George Goyder, *The Responsible Company*, Oxford, Blackwell (1961) 45.

**14** David Millon, ‘New Directions in Corporate Law: Communitarians, Contractarians, and the Crisis in Corporate Law’ 1993 (50) *Washington & Lee Law Review* 1373, 1374.

**15** *Ibid* 1390.

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success',<sup>16</sup> and that 'recognition of stakeholder concern is not only good business, but politically expedient and morally and ethically just, even if in the strict legal sense [corporations] remain directly accountable only to shareholders'.<sup>17</sup>

The stakeholder debate, therefore, forms an integral and most prominent part of most of the recent corporate governance reports. We deal with stakeholders in greater detail in Chapter 2, but it is useful to refer at an early stage to some of the most prominent statements on the role and importance of stakeholders:

*Comparative Study of Corporate Governance Codes Relevant to the European Union and its Members* (January 2002):

Although the comparative corporate governance literature and popular discussion tend to emphasise 'fundamental' differences between stakeholder and shareholder interests, the extent to which these interests are different can be debated. The majority of corporate governance codes expressly recognise that corporate success, shareholder profit, employee security and well being, and the interests of other stakeholders are intertwined and co-dependent. This co-dependency is emphasised even in codes issued by the investor community.<sup>18</sup>

*King Report on Corporate Governance* (March 2002):

The inclusive approach recognises that stakeholders such as the community in which the company operates, its customers, its employees and its suppliers need to be considered when developing the strategy of a company. The relationship between a company and these stakeholders is either contractual or non-contractual.<sup>19</sup>

Australian Stock Exchange (ASX) Corporate Governance Council's *Principles of Good Corporate Governance and Best Practice Recommendations* (March 2003):

There is growing acceptance of the view that organisations can create value by better managing natural, human, social and other forms of capital. Increasingly the performance of companies is being scrutinised from a perspective that recognises these other forms of capital. That being the case, it is important for companies to demonstrate their commitment to appropriate corporate practices.<sup>20</sup>

*Report of the HIH Royal Commission* (Owen Report) (April 2003):

It is first necessary to identify the class or classes of 'those who have a stake in the company's success'. The answer is they include the policyholders, general creditors, employees, shareholders and the regulators. In a more indirect (but no less important) sense they include members of the public who may rely on the fact that the potential liability of a person to them is supported by the existence of insurance. The business

**16** David Wheeler and Maria Sillanpää, *The Stakeholder Corporation*, London, Pitman (1997) ix. See further Post, Preston and Sach, above n 1, 1–3; and Mark J Roe, 'Preface' in Margaret M Blair and Mark J Roe (eds), *Employees & Corporate Governance*, Washington, DC, Brookings Institute (1999) v.

**17** Leighton and Thain, above n 8, 23.

**18** *Comparative Study of Corporate Governance Codes Relevant to the European Union and its Members* (hereafter referred to as European Commission Comparative Study) (January 2002) <[http://www.odce.ie/\\_fileupload/services/EU%20Comparison.pdf](http://www.odce.ie/_fileupload/services/EU%20Comparison.pdf)> 4.

**19** *Executive Summary – King Report on Corporate Governance* (King Report (2002)), Parktown, South Africa, Institute of Directors in Southern Africa (March 2002) para 5.3.

**20** ASX, *Principles of Good Corporate Governance and Best Practice Recommendations* (2003), above n 5, 59.

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of HIH was primarily about the management of risk. The company had an obligation to see that the risk it assumed when it issued a contract of insurance would be met if and when a genuine claim was made by a policyholder. It had an obligation to manage those risks and its investment portfolio so that the interests of creditors, employees and shareholders would not be prejudiced. And it had obligations of disclosure to enable the regulator to carry out its statutory functions.<sup>21</sup>

*OECD Principles of Corporate Governance* (April 2004):

A key aspect of corporate governance is concerned with ensuring the flow of external capital to companies both in the form of equity and credit. Corporate governance is also concerned with finding ways to encourage various stakeholders in the firm to undertake economically optimal levels of investment in firm-specific human and physical capital. The competitiveness and ultimate success of a corporation is the result of teamwork that embodies contributions from a range of different resource providers including investors, employees, creditors, and suppliers. Corporations should recognise that the contributions of stakeholders constitute a valuable resource for building competitive and profitable companies. It is, therefore, in the long-term interest of corporations to foster wealth-creating co-operation among stakeholders. The governance framework should recognise that the interests of the corporation are served by recognising the interests of stakeholders and their contribution to the long-term success of the corporation.<sup>22</sup>

Because of the prominence of the stakeholder debate in recent times and the realisation that they form an integral part of any corporation's existence and long-term prosperity, some commentators have moved away from the traditional 'ownership-orientated' definition of the corporation to a broader 'stakeholder-orientated' definition. James E Post, Lee E Preston and Sybille Sach offer the following definition of a corporation:

The corporation is an organisation engaged in mobilising resources for productive users in order to create wealth and other benefits (and not to intentionally destroy wealth, increase risk, or cause harm) for its multiple constituents, or stakeholders.<sup>23</sup>

We deal with this expanded definition in much greater detail in Chapter 2.

### 1.1.3 Definition of 'corporate governance'

If one takes into consideration all these recent developments as explained above, corporate governance could be defined as 'the process of controlling management and of balancing the interests of all internal stakeholders and other parties (external stakeholders, governments and local communities – see Chapter 2) who can be affected by the corporation's conduct in order to ensure responsible behaviour by corporations and to achieve the maximum level of efficiency and

<sup>21</sup> Owen Report, above n 3, para 6.1.

<sup>22</sup> *OECD Principles of Corporate Governance*, above n 7, 46.

<sup>23</sup> Post, Preston and Sach, above n 1, 17.

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profitability for a corporation'.<sup>24</sup> Thus, the most important components of this definition are that corporate governance:

- is a process of controlling management;
- takes into consideration the interests of internal stakeholders and other parties who can be affected by the corporation's conduct;
- aims at ensuring responsible behaviour by corporations; and
- has the ultimate goal of achieving the maximum level of efficiency and profitability for a corporation.

What we need to establish is how these goals are achieved. This will become clear in the following chapters of this book.

## 1.2 Essential corporate governance principles

### 1.2.1 Generally

In recent years there have been several attempts to identify and explain essential corporate governance principles. Although there are numerous other examples,<sup>25</sup> the two best examples of identifying and extracting the essential principles of corporate governance are perhaps the South African King Report (2002)<sup>26</sup> and the Australian Stock Exchange (ASX) Corporate Governance Council's *Principles of Good Corporate Governance and Best Practice Recommendations*.<sup>27</sup> These two stand out because of the brevity and clarity of expressing the essential characteristics and principles of corporate governance.

### 1.2.2 The King Report (2002)

The King Report (2002) identifies seven characteristics of good corporate governance:

1. *Discipline* – the commitment by a company's senior management to adhere to behaviour that is universally recognised and accepted to be correct and proper. This encompasses a company's awareness of, and commitment to, the underlying principles of good governance, particularly at senior management level.
2. *Transparency* – the ease with which an outsider is able to make meaningful analysis of a company's actions, its economic fundamentals and the non-financial aspects pertinent to that business. This is a measure of how good management is at making necessary information available in a candid,

<sup>24</sup> For other useful definitions of corporate governance, see John Farrar, 'Corporate Governance and the Judges' (2003) *Bond Law Review* 49; and Güler Manisali Darman, *Corporate Governance Worldwide: A Guide to Best Practices and Managers*, Paris, ICC Publishing (2004) 9–11.

<sup>25</sup> See, for example, *OECD Principles of Corporate Governance*, above n 7, and *The Combined Code on Corporate Governance* (UK Combined Code (2003)) (July 2003) <<http://www.frc.org.uk/combined.cfm>>.

<sup>26</sup> King Report (2002), above n 19, para 18.

<sup>27</sup> *ASX Principles of Good Corporate Governance and Best Practice Recommendations* (2003), above n 5, 11.

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accurate and timely manner – not only the audit data but also general reports and press releases. It reflects whether or not investors obtain a true picture of what is happening inside the company.

3. *Independence* – the extent to which mechanisms have been put in place to minimise or avoid potential conflicts of interest that may exist, such as dominance by a strong chief executive or large shareowner. These mechanisms range from the composition of the board, to appointments to committees of the board, and external parties such as the auditors. The decisions made, and internal processes established, should be objective and not allow for undue influences.
4. *Accountability* – individuals or groups in a company who make decisions and take actions on specific issues need to be accountable for their decisions and actions. Mechanisms must exist and be effective to allow for accountability. These provide investors with the means to query and assess the actions of the board and its committees.
5. *Responsibility* – with regard to management, responsibility pertains to behaviour that allows for corrective action and for penalising mismanagement. Responsible management would, when necessary, put in place what it would take to set the company on the right path. While the board is accountable to the company, it must act responsively to and with responsibility towards all stakeholders of the company.
6. *Fairness* – the systems that exist within the company must be balanced in taking into account all those that have an interest in the company and its future. The rights of various groups have to be acknowledged and respected. For example, minority shareowner interests must receive equal consideration to those of the dominant shareowner(s).
7. *Social responsibility* – a well-managed company will be aware of, and respond to, social issues, placing a high priority on ethical standards. A good corporate citizen is increasingly seen as one that is non-discriminatory, non-exploitative, and responsible with regard to environmental and human rights issues. A company is likely to experience indirect economic benefits such as improved productivity and corporate reputation by taking those factors into consideration.

### 1.2.3 The Australian Stock Exchange (ASX) Corporate Governance Council's *Principles of Good Corporate Governance and Best Practice Recommendations*

This report identified 10 essential principles of good corporate governance:

1. *Lay solid foundations for management oversight* – recognise and publish the respective roles and responsibilities of board and management.  
The company's framework should be designed to:
  - enable the board to provide strategic guidance for the company and effective oversight of management;



- clarify the respective roles and responsibilities of board members and senior executives in order to facilitate board and management accountability to both the company and its shareholders; and
  - ensure a balance of authority so that no single individual has unfettered powers.
2. *Structure the board to add value* – have a board of an effective composition, size and commitment to adequately discharge its responsibilities and duties.

An effective board is one that facilitates the efficient discharge of the duties imposed by law on the directors and adds value in the context of the particular company's circumstances. This requires that the board be structured in such a way that it:

- has a proper understanding of, and competence to deal with, the current and emerging issues of the business; and
- can effectively review and challenge the performance of management and exercise independent judgement.

Ultimately the directors are elected by the shareholders. However the board and its delegates play an important role in the selection of candidates for shareholder vote.

3. *Promote ethical and responsible decision-making* – actively promote ethical and responsible decision-making.

The company should:

- clarify the standards of ethical behaviour required of company directors and key executives (that is, officers and employees who have the opportunity to materially influence the integrity, strategy and operation of the business and its financial performance) and encourage the observance of those standards; and
- publish its position concerning the issue of board and employee trading in company securities and in associated products which operate to limit the economic risk of those securities.

4. *Safeguard integrity in financial reporting* – have a structure to independently verify and safeguard the integrity of the company's financial reporting.

This requires the company to put in place a structure of review and authorisation designed to ensure the truthful and factual presentation of the company's financial position. The structure would include, for example:

- review and consideration of the accounts by the audit committee; and
- a process to ensure the independence and competence of the company's external auditors.

Such a structure does not diminish the ultimate responsibility of the board to ensure the integrity of the company's financial reporting.

5. *Make timely and balanced disclosure* – promote timely and balanced disclosure of all material matters concerning the company.

This means that the company must put in place mechanisms designed to ensure compliance with the ASX Listing Rule requirements such that:

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- all investors have equal and timely access to material information concerning the company – including its financial situation, performance, ownership and governance; and
- company announcements are factual and presented in a clear and balanced way.

‘Balance’ requires disclosure of both positive and negative information.

6. *Respect the rights of shareholders* – respect the rights of shareholders and facilitate the effective exercise of those rights.

This means that a company should empower its shareholders by:

- communicating effectively with them;
- giving them ready access to balanced and understandable information about the company and corporate proposals; and
- making it easy for them to participate in general meetings.

7. *Recognise and manage risk* – establish a sound system of risk oversight and management and internal control.

This system should be designed to:

- identify, assess, monitor and manage risk; and
- inform investors of material changes to the company’s risk profile.

This structure can enhance the environment for identifying and capitalising on opportunities to create value.

8. *Encourage enhanced performance* – fairly review and actively encourage enhanced board and management effectiveness.

This means that directors and key executives should be equipped with the knowledge and information they need to discharge their responsibilities effectively, and that individual and collective performance is regularly and fairly reviewed.

9. *Remunerate fairly and responsibly* – ensure that the level and composition of remuneration is sufficient and reasonable and that its relationship to corporate and individual performance is defined.

This means that companies need to adopt remuneration policies that attract and maintain talented and motivated directors and employees so as to encourage enhanced performance of the company. It is important that there be a clear relationship between performance and remuneration, and that the policy underlying executive remuneration be understood by investors.

10. *Recognise the legitimate interests of stakeholders* – recognise legal and other obligations to all legitimate stakeholders.

Companies have a number of legal and other obligations to non-shareholder stakeholders such as employees, clients/customers and the community as a whole. There is growing acceptance of the view that organisations can create value by better managing natural, human, social and other forms of capital. Increasingly, the performance of companies is being scrutinised from a perspective that recognises these other forms of capital. That being the case, it is important for companies to demonstrate their commitment to appropriate corporate practices.