HIH Report and CLERP 9

The Report of the HIH Royal Commission was tabled in the Federal Parliament in April. Partner Richard Alcock and senior associate Carl Bicego explain that the report provides authoritative support for the one-size-does-NOT-fit-all policy foundation of the ASX Corporate Governance Council recommendations on principles of good corporate governance and best practice.

The report by Royal Commissioner Mr Justice Neville Owen into the circumstances surrounding the failure of the HIH Insurance Group was released on 16 April 2003. The report identified a number of possible breaches of the Crimes Act and the Corporations Act, which have been referred to the relevant authorities. It also included 61 policy recommendations.

The report’s Part Three, titled Directions for the future, includes chapters on corporate governance, and on financial reporting and assurance. Set out within these two chapters are 17 policy recommendations (a few being of limited application to the corporate governance of Australian Prudential Regulatory Authority (APRA) but most applying generally). For a link to the report, see our website at www.aar.com.au/corpgov/news/index.htm.

CLERP 9 law reform

The report’s policy recommendations on corporate governance and financial reporting and assurance will be considered initially in the finalisation of the Federal Government’s CLERP 9 amendments to the Corporations Act. When the CLERP 9 proposals were released in September 2002, the Federal Treasurer indicated that the proposals would incorporate the Government’s response to the report. Those inclusions are likely to be contained in the Bill, which is to be released in June/July in the lead-up to the Parliamentary Spring sittings, when the amendments are expected to be enacted.

The CLERP 9 legislation will also deal with continuous disclosure, including the introduction of personal liability for breach; auditor independence; accounting standards;
expensing of options; compliance controls; and encouragement of greater shareholder participation at meetings. For details, see our website www.aar.com.au/corpgov.

**Approach to corporate governance**

The report provides authoritative support for the one-size-does-NOT-fit-all policy foundation of the ASX Corporate Governance Council (CGC) recommendations on Principles of good corporate governance and best practice.

Mr Justice Owen’s observations will give ASX-listed entities considerable comfort in choosing the path of explanation rather than compliance with the CGC’s recommendations:

I think that any attempt to impose governance systems or structures that are overly prescriptive or specific is fraught with danger. By its very nature corporate governance is not something which ‘one size fits all’. Even with companies within a class, such as public listed companies, their capital base, risk profile, corporate history, business activity and management and personnel arrangements will be varied. It would be impractical and undesirable to attempt to place them all within a single straightjacket of structures and processes. A degree of flexibility and an acceptance that systems can and should be modified to suit the particular attributes and needs of each company is necessary if the objectives of improved corporate governance are to be achieved.

**Culture**

Mr Justice Owen emphasised the importance of culture on corporate governance:

I am not so much concerned with the content of a corporate governance model as with the culture of the organisation to which it attaches. For me, the key to good corporate governance lies in substance, not form. It is about the way the directors of a company create and develop a model to fit the circumstances of that company and then test it periodically for its practical effectiveness.

**Failure by middle management**

A significant focus of the report is on failure by middle management. Mr Justice Owen was frustrated by what he described as the disinclination of HIH middle managers to accept responsibility for undesirable practices. He identified the difficulties for the Royal Commission in considering conduct where middle managers had taken steps that resulted in the falsification of the corporation’s accounts or returns lodged with statutory authorities. In some instances, he observed, the existing law did not reach the intermediate conduct, for example, where someone prepared a report knowing it to be false but did not sign it. The more senior officer who then signed the document would assert as ‘reasonable’ his or her reliance on the more junior employee who prepared the report, to argue that the senior officer’s conduct did not constitute a breach of the law.

The policy recommendations include clarifying the legal duties of employees who are concerned in management but who are not ‘officers’.

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**Likely extension of persons subject to fiduciary duties**

Fiduciary duties bind directors, secretaries, and certain other officers, but those officers are a narrower class than existed under the Corporations Law prior to amendments made in 2000.

The report recommends expanding the class of ‘officers’ to include those who before 2000 were also ‘officers’ by reason of being ‘concerned in management’. Currently, the law provides that an ‘officer’ is an employee that ‘makes’ or ‘participates in making’ management decisions.

The policy recommendation goes further, however, by recommending that it is the performance of the relevant function that should attract the legal duty, not the precise relationship between the person performing that function and the relevant corporate entity. If adopted, this recommendation will extend fiduciary duties to consultants and independent
contractors who perform functions analogous to employees concerned in, or making, management decisions.

This functional delineation of the reach of fiduciary duty is likely to prompt a significant debate on the merits of extending duties beyond the employment relationship – and there is some ambiguity as to the intended scope.

Under the current law, an employee who is not an ‘officer’ is only liable for dishonesty under the Corporations Act if the dishonesty also involves a breach of any of the following duties which currently extend to all employees:

- the duty not to use their position improperly to gain an advantage for themselves or someone else or cause detriment to the corporation;
- the duty not to use improperly information obtained through their position to gain an advantage for themselves or someone else or cause detriment to the corporation; or
- the duty not to use their position dishonestly with the intention of gaining advantage for themselves or causing detriment to the corporation or recklessly as to the consequences.

It is proposed to add another duty similar to this last duty (with both civil and criminal sanctions). The new duty applies where an ‘employee’ acts dishonestly in respect of the performance or satisfaction of an obligation imposed upon the corporation under the Corporations Act or any other written law. Mr Justice Owen noted that the application of the existing law was not clear where an employee acted dishonestly without gaining advantage for themselves or without intending to cause detriment to the corporation. If the functional approach to the definition of ‘employee’ is used to apply to a wider class of personnel, this duty may attach also to contractors and consultants.

Duties to group companies

The report also recommends clarification of the duties owed to a group of companies in which an officer of one group company may be taking actions affecting another group company where the officer is neither an officer nor employee of the second group company. Extension of the fiduciary duty of the officer to both companies may be achieved if the recommendation based on functional delineation of duty is adopted.

Remuneration

Recommendation 1 of the report is the review, as a matter of priority, of the regulation of the disclosure of all remuneration and other benefits paid to directors in whatever form. Mr Justice Owen suggests that the review should cover the entire Corporations Act, the relevant accounting standards, and the ASX Listing rules.

The recommendation is consistent with the approach taken recently by the CGC and by the ASX in seeking disclosure of executive remuneration in announcements to the market when employment contracts are signed (for the Chief Executive Officer), and in the corporate governance sections of websites and in annual reports.

In this area, the report provides support to various initiatives already underway by the Federal Government, ASX and CGC.

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Financial reporting

Mr Justice Owen examined several issues relating to financial reporting and assurance. In relation to financial reporting, he discussed issues relating to the interpretation of accounting standards, adoption of international accounting standards from 1 January 2005 and the need for the Australian Accounting Standards Board and its Urgent Issues Group to be better able to provide more timely advice on difficult interpretation issues. Overarching these issues is that compliance with accounting standards, while a requirement of the Corporations Act, does not equate with the higher duty under the Act for the accounts to give a ‘true and fair view’ (and for any discrepancy to be explained in the notes to the accounts).
Audit function

Building on the work of the CLERP 9 discussion paper, Ramsay Report and Report of the Joint Standing Committee on Public Accounts and Audit, Mr Justice Owen made several recommendations aimed at enhancing the audit function, including in relation to the appropriate standard of independence, the provision of non-audit services, the relationships between the company and auditor, and useability of audit reports.

Any attempt to impose governance systems or structures that are overly prescriptive or specific is fraught with danger. By its very nature, corporate governance is not something which ‘one size fits all’.

Mr Justice Owen

Independence

Mr Justice Owen emphasised the importance of the audit function for the capital market as a whole and the reliance placed on the audit function by users of financial statements. Having regard to this, he considered that the standard of independence for auditors should be as high as it is for judges in avoiding the perception of judicial bias. In finding this, he thought that the CLERP 9 standard, which requires that a reasonable person, informed of all relevant circumstances, would conclude that the auditor is not independent, was too high. Rather, the standard should be stated in terms that an auditor would not be independent if a reasonable person might conclude that the auditor’s independence might be impaired.

Additionally, Mr Justice Owen considered that it was necessary to clarify that, when applying a standard to the auditor, the standard should be applied to individual auditors and the audit firm.

Non-audit services

The provision of non-audit services raises the possibility that an individual auditor may be required to review the work of the audit firm in the provision of other services (the ‘self-review threat’).

The self-review threat was addressed in CLERP 9 by requiring two things: mandatory disclosure in the annual report of fees paid for non-audit services in certain categories; and a statement from the audit committee, to be included in the annual report, that it is satisfied that the provision of those services is compatible with auditor independence. Those categories (set out in Professional Statement F1) are:

- preparing accounting records and financial statements of the audit client;
- valuation services;
- internal audit services;
- temporary staff assignments;
- litigation support services;
- legal services;
- recruitment of senior management for the audit client; and
- corporate finance and similar activities.

Without the benefit of a detailed study on competition effects of prohibiting such services, and cognisant of the government’s stated policy not to prohibit such services, Mr Justice Owen did not consider recommending a blanket prohibition. However, he noted that ‘categories’ did not provide sufficient information and recommended that the board (or audit committee as noted in his preceding discussion) should include a statement in the annual report that identifies each non-audit service, the fees set out and that states why this service did not compromise independence.

Mr Justice Owen considered that the provision of non-audit services also raises the possibility that the value to the audit firm of such other services may lead to cross-selling or the inference that preference should be given to maintaining a strong relationship with management. He noted that performance evaluation criteria that included ‘cross-selling’ should amount to professional misconduct under the disciplinary regimes of the professional accounting bodies.

Employment associations

Employment associations between the audit firm and a company can give rise to what is described as a ‘familiarity threat’. Mr Justice Owen considered that the CLERP 9 discussion paper recommendations were insufficient in this area and recommended that:

- lead engagement partner and review partner rotation after five years (as recommended in
CLERP 9) be extended to key senior audit personnel;
- the two-year waiting period for audit partners to join a company’s board or senior management be extended to four years and include key senior personnel of the audit firm involved in the audit;
- the two-year waiting period apply for partners of the audit firm that were not involved in the audit; and
- there be a prohibition on more than one former audit firm partner being a director or in senior management of the client at any one time.

He also recommended that restrictions be enforceable against the audit firm and relevant partner or senior employee.

Annual reports should include a statement that identifies each non-audit service, the fees for service, and a note on why the service did not compromise independence.

Useability of audit reports

While discounting concerns about increased exposure to liability, Mr Justice Owen supported suggestions that the audit report provide more information and be in plain English. He recommended that the audit should also cover the operating and financial review prepared by companies to be included in annual reports and that the audit report disclose:

- the impact of the position taken by the reporting entity where alternative accounting treatments are reasonably open from the reading of an accounting standard and the difference between those accounting treatments is material; and
- the significant matters arising in the audit process.

To address what has become known as the ‘audit expectation gap’ resulting from the lack of information in, and understanding of, audit reports, Mr Justice Owen further recommended that the Corporations Act 2001 be amended to require public listed companies to include a brief, plain English summary of the nature and scope of the audit services provided by the auditor for each year.

Conclusion

Generally, it can be said that many of the recommendations are aimed at recognising and addressing issues for the regulation of modern corporate groups and information disclosed in relation to such groups to the capital markets. The recommendations relating to financial reporting and the audit function further the current trend of increasing disclosure – disclosure of matters affecting audit independence, and disclosure of additional financial information.

The recommendations relating to duties of officers recognise that with large corporate groups responsibility is spread through long chains of management and that some of these functions are not necessarily performed by employees.

Subject to the Government’s adoption of these recommendations in the CLERP 9 amendments to the Corporations Act, they will change the way the law recognises the management and governance of companies and corporate groups.

Together with recent amendments to the ASX Listing Rules and the release of the ASX Corporate Governance Council’s Best Practice Recommendations, significant changes are being made to corporate governance disclosure and practice.
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