EFFECTIVENESS OF CORPORATE GOVERNANCE

Two things that highlight the difficulties in determining the effectiveness of corporate governance systems are:

1. The actions of non-executive directors suffer from the same regulatory problem as auditors in that their actions are not observable.
2. Companies in their annual reports must describe their corporate governance practices. There is a fear that these descriptions are written 'creatively'.

Three issues central to effectiveness of corporate governance are independence of non-executive directors, skills of non-executive directors and non-executive director's access to information. These issues will now be discussed.

An audit is conducted to add credibility to financial statements prepared under the directions of directors. The results published in an annual report are a form of self-assessment on directors' management abilities, and hence lead to incentives for directors to improve those results. Executive directors, like the managing director or finance director, take a more active role in the management of the company and thus have greater incentives to manipulate results. The non-executive directors are more removed from management duties. However, for corporate governance to be effective, the non-executive directors must be independent of executive directors. For example, if the non-executive directors owe their appointment to executive directors, their independence is questionable, leading to ineffective corporate governance practices. Main (2003) suggests that this is a big issue that the Corporate Governance Council, which is preparing the ASX's best practice guidelines, has to confront (p. 10).

Some anecdotal evidence relating to director independence was reported in *The Australian Financial Review* article 'Blue-chip investors see red over directors' club' (Ryan and Shand, 2002). The points made in the article are as follows.

- As boards should be consensual and speak with one voice, they have a club-like mentality.
- The club-like mentality leads to like-minded people being appointed to boards. An attitude of 'not rocking the boat' follows.
- Speaking out can lead to a lack of appointments to other boards, and thus the system leads to directors being silent on issues.

Also, as modern financial statements report on complex operations, non-executive directors need accounting/auditing skills for corporate governance to be effective. There is a fear that there will be difficulties finding such suitably qualified directors to sit on audit committees.

Rob Ward of PricewaterhouseCoopers stated that 'in Australia the pool of independent and financially literate directors suitable for membership of audit committees is not unlimited' (Buffini, 2002, p. 64).

It was further suggested in this article that companies would have to look 'outside their usual circles for candidates who are independent and financially literate' (Buffini, 2002, p. 64). This search for suitable candidates may be hindered by the onerous legal duties independent and financially literate directors assume by becoming a member of an audit committee.

The Ryan and Shand (2002) article makes some interesting points on directors' access to information. The article states that:

- Information given to boards is filtered and not timely.
- The CEO is the one source of information and it is not etiquette to seek downward any further information.
- Any request to speak to company staff must be made through the CEO.
- Deals were being rushed with directors being shown documentation at the last minute.
- A critical factor in access to information is the transparency of the relationship between the board and the CEO.

References

Buffini, F 2002, 'Shake-up looms for boardrooms', *The Australian Financial Review,* 20 September, p. 64.

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