A Report on Corporate Governance at Five Companies that Collapsed in 2001

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ABOUT IA research

IA research is a Melbourne-based advisory and research firm, specialising in corporate governance. The firm’s professionals have economics, finance and/or legal training. The firm’s principals are Dr Geof Stapledon and Jonathan Bates.

IA research has a global affiliation with Institutional Design Limited – a London-based consultancy which also specialises in corporate governance. Jonathan Bates is principal of Institutional Design.

IA research has a proprietary database system which enables rigorous and timely analysis of governance-related issues as they arise at S&P/ASX 200 companies. The database also enables the firm to provide objective and reliable analysis of relative governance performance among S&P/ASX 200 companies

IA research and Institutional Design have had a range of mandates in the corporate governance area, some of which have involved:

- Providing proxy voting reports covering the Top 200 Australian companies, in alliance with SIRIS: www.siris.com.au
- Developing and evaluating governance structures and board processes for a major UK listed company.
- Developing an electronic voting platform.
- Analysing trends in key governance structures / practices for an Australian industry body.
- Advising an institutional investor industry association on the different features of governance in listed property trusts, compared to listed companies.
- Advising the UK government on corporate governance and company law reform.
- Evaluating the governance of Russian companies for an international ratings agency.
- Evaluating the corporate governance environment of an Eastern European country for a multilateral financial institution.
- Advising an institutional investor industry association on the impact of takeovers laws on collective action by institutional shareholders.

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SECTION 1 - Executive Summary

The failed companies analysed:

- One.Tel (Telecommunications)
- HIH (Insurance)
- Pasminco (Resources)
- Harris Scarfe (Retailing)
- Centaur (Resources)

The paper compares the core dimensions of corporate governance performance at five failed companies with the average corporate governance performance of the 100 largest companies by market capitalisation on the Australian Stock Exchange.

Our analysis revealed that a majority of failed companies were characterised by an ownership structure dominated by a single shareholder with effective control: 60% of the failed companies had a single shareholder with effective control, compared with 39% of companies in the S&P/ASX 100.

Boards at the failed companies tended to contain a below average number of independent directors. Founders and family members of founders, audit firm personnel and large shareholders were over-represented on the boards of the failed companies.

Analysis of the composition of audit committees at the failed companies revealed an above average number of audit firm personnel and former audit firm personnel. Big Five firms performed audits at only 60% of failed companies. By contrast, 99% of S&P/ASX 100 companies use a Big Five firm for their audit.

One.Tel's governance performance was particularly poor. There were major gaps in its reporting of information about directors' shareholdings, and 3 of its committees – audit, remuneration and corporate governance – were comprised of the same 2 board members – Rodney Adler and John Greaves. Neither was an independent director.

A substantially lower proportion of the remuneration package for CEOs at the failed companies was "at risk" in the form of options, compared to the average remuneration package for S&P/ASX 100 CEOs.

Related party transactions comprised over 10% of market capitalisation on average for the failed companies. Related party transactions were less than 1% of market capitalisation for the average S&P/ASX 100 company.

SECTION 2 – Ownership Structure

Key Finding: 60% of failed companies had a single shareholder with effective control. 39% of the S&P/ASX 100 companies have a single shareholder with effective control.

Corporate governance at an entity with a single dominant shareholder is often of below-average quality. The interests of minority and small shareholders can be sacrificed in order to promote the interests of the single dominant shareholder. The dominant shareholder may actually hold less than 20% of the total shares in the company, but this may be enough to deliver effective control. With effective control, the dominant shareholder can bypass the normal checks and balances, and processes of oversight that an effective board regularly uses to protect shareholders' interests.

SECTION 3 – Board Composition

Key Finding: Boards of several failed companies were dominated by founders or relatives of founders:

- HIH and One.Tel both had 2 founders on the board. (In HIH's case, one of the founders retired from the board about 6 months prior to the company's collapse.)
- HIH also had Rodney Adler on its board. Adler is the son of the founder of FAI, one of the core HIH businesses.
- HIH and One.Tel both had a CEO who was a founder.
- Harris Scarfe's board included two family members of the person who bought effective control of the company in the 1970s.

Founders and their family members often hold substantial shares in the business and do have aligned interests with shareholders in this sense. But they also bring to their board duties several potential conflicts of interest. They also tend to have loyalties to the company history and reputation which may colour their judgement. For example, they may be more concerned about the long-term survival of particular brands or business units (perhaps because they see them as part of their family's legacy) than the profitability of the company as a whole.

Key Finding: Non-executive directors at the failed companies had two times as many other company directorships as the average non-executive director in the S&P/ASX 100.

On average, the non-executive directors of the failed companies held 2.7 other board seats at ASX listed companies. However, among non-executive directors of Top 100 companies, the figure is only 1.3 other positions on average.

A non-executive director with many other directorships is "time poor". The amount of attention given to each company must fall every time a new position of responsibility is taken on.

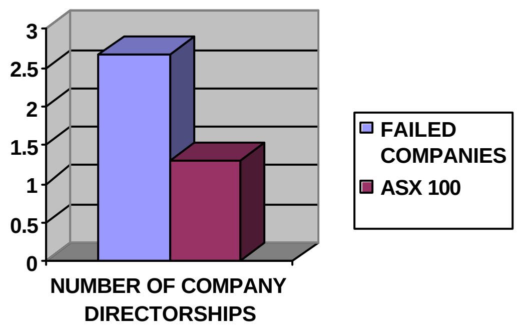

__Figure 1. Number of Other Directorships Held By Non-Executive Directors__

A non-executive director with many other directorships is "time poor". The amount of attention given to each company must fall every time a new position of responsibility is taken on.

Key Finding: Only 24% of directors of the failed companies were independent. In the S&P/ASX 100, 45% of directors are independent.

What is an "independent director"? An independent director:

- is not financially or otherwise depending on the company's management, controlling (dominating) shareholders, large counterparts and competitors

- is not at the same time a member of the executive team
- is not financially or otherwise depending on the company's affiliated persons (owners of 20%+ votes, members of the Board of Directors, auditor,...)
- does not represent consultants or other businesses which are or have been contracted by the company

The presence of a strong block or majority of independent non-executive directors increases the likelihood that tough, though important, decisions are made, and followed through. This is especially the case when a poorly performing company needs a radical restructure of its business units, management team or customer relationships. If the board is dominated by directors with a vested interest in the current structure, there will be inherent bias away from these radical but important restructuring decisions. The long-term viability of the company may be harmed as a result.

Key Finding: In 85% of S&P/ASX 100 companies the Chairman is a non-executive director, but the figure for the failed companies was only 40%.

Key Finding: There were no women on the failed companies boards. The S&P/ASX 100 average is approximately 10% female.

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SECTION 4 – The Composition of Committees

Key Finding: Audit firm personnel were heavily represented on failed company boards.

- HIH had 3 former partners of its audit firm, Arthur Andersen, on its board. Two of these, Geoffrey Cohen and Justin Gardiner, were non-executive directors, and the third, Dominic Fodera, was the Finance Director. Fodera resigned 5 months before HIH collapsed. Cohen chaired the Audit Committee and Gardiner was a member of the Audit Committee.
- Harris Scarfe had 2 former partners of its audit firm on its board.

Key Finding: 60% of the failed companies used a Big Five firm as auditor. 99% of S&P/ASX 100 companies use a Big Five (now Big Four) firm as auditor.

Key Finding: 90% of S&P/ASX 100 companies appoint exclusively non-executive directors to the audit committee. At the failed companies, only 40% of audit committees were composed exclusively of non-executive directors.

The role of the auditor is to provide shareholders with a clear, unbiased picture of the financial position of the company. Auditor independence is therefore crucial to the quality and clarity of the market's information about the performance and prospects of any company.

The substantial presence of personnel from audit firms on the boards of failed companies draws into serious question the independence and overall quality of the audit information that was reported by these companies. The below-average representation of independent directors on the audit committees at the failed companies adds further weight to these concerns.

Key Finding: There was not a single independent director on the audit committee of One.Tel, Harris Scarfe, HIH or Centaur.

Key Finding: One.Tel's audit, remuneration and corporate governance committees were composed of the same two directors – neither of whom was an independent director.

The same two non-executive directors, Rodney Adler and John Greaves, were the sole members of the audit, remuneration and corporate governance committees. Each of these men had business connections with One.Tel which meant they were not independent directors. These committees met only once during the 2000 financial year.

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SECTION 5 - CEO Remuneration

Key Finding: At the failed companies, the average percentage of CEO pay that was "at risk" was only 10.73%. At S&P/ASX 100 companies, the average is 32.95% "at risk".

At-risk pay is that part of a CEO's remuneration that is contingent on one or more performance hurdles being met.

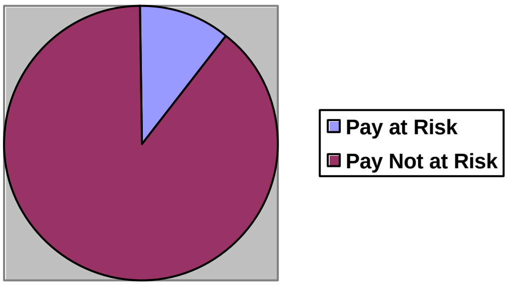

Figure 2: Failed Companies: Proportion of CEO Pay that was "At Risk*"

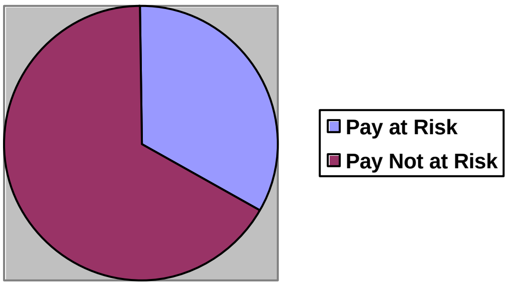

Figure 3: ASX 100 Proportion of CEO Pay that was "At Risk*"

(*Contingent on some company performance indicator; eg – options)

SUPPORTING DATA
Figure 2 - Failed Companies
At risk 10.73%($167,766) - Not at risk 89.27% ($1,852,169)
Figure 3 - ASX 100
At risk - 32.95% ($871,389) - Not at risk 67.05% ($1,773,004)

The higher the proportion of a CEO's remuneration that is "at risk", the more closely aligned are his or her interests with those of shareholders. A good years' performance for shareholders would feature financial performance that is good relative to industry peers, and share price appreciation. A bad year's performance for shareholders would feature relatively poor financial performance and share price depreciation. If a CEO's pay doesn't fluctuate greatly between good and bad years, there is no tangible incentive for the CEO to make the changes necessary to improve overall company performance.

Key Finding: The remuneration committee consists exclusively of non-executive directors at 87% of S&P/ASX 100 companies. Only 40% of the failed companies had

remuneration committees consisting wholly of non-executive directors.

What does the Remuneration Committee do?

The Remuneration Committee is typically engaged with the task of overseeing the structuring of senior management pay – to ensure that these individuals are motivated sufficiently to produce optimal results for shareholders. The closest possible alignment between senior executives' interests and shareholders' interests is ideal.

Conflicts of interest occur when the individuals setting remuneration policy are themselves beneficiaries of that policy. Thus, the optimal arrangements are when the Remuneration Committee is comprised wholly of independent non-executive directors who don't stand personally to receive significant benefits from remuneration policy.

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SECTION 6 – Disclosure

Key Finding: In several cases overall reporting of governance information was very poor.

Substantial shareholdings of directors of One.Tel were not disclosed as required by the Corporations Act. Directors' shareholdings were reported in a confusing way that meant it was impossible to determine how many shares each individual owned in isolation. Attendance at board committee meetings was not reported.

Centaur's 2000 annual report did not include directors' biographies (showing qualifications, experience and other roles). And it did not disclose the other directorships of Centaur directors.

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SECTION 7 - Related Party Transactions

Key Finding: The value of related party transactions* represented over 10% of market capitalization for the failed companies.

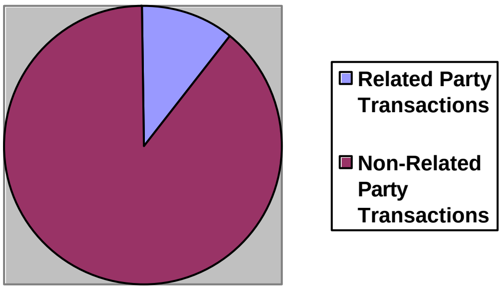

Figure 4 – Failed Companies: Related Party Transactions* Represented 10.76% of Market Capitalisation

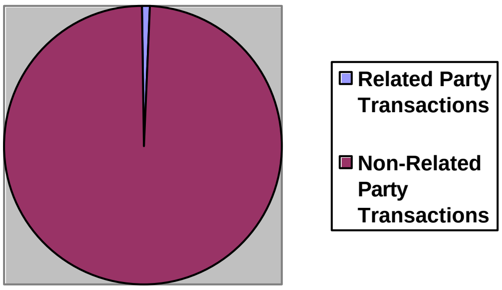

Figure 5 – S&P/ASX 100: Related Party Transactions* Represented 0.7% of Market Capitalisation

(*Dollar value of business transactions with directors and their associates (average per company))

There can be cause for concern when a company earns a high percentage of its revenues from related party transactions. If, for example, several board members also sit on the board of or own substantial shareholdings in a company which is a major client of the entity, these board members may end up facing substantial conflicts of interest when there is a dispute or other issue with the major client. It may be in shareholders' interests to end or change the terms of the relationship with the major client, but for the board members with a stake in the related party, other contradictory concerns may come into play.

SECTION 7 - Conclusion

In recent years, the Australian Stock Exchange and others have frequently asserted that there is little value in corporate governance guidelines because even poorly governed companies can abide by them easily. The argument is that it is easy to put formal structures in place that enable all the relevant boxes to be ticked, with shareholders getting a false sense of security as a result.

This study belies that claim.

Four of the five companies that failed in early-to-mid 2001 exhibited very poor governance structures and processes – both in an absolute sense and relative to the S&P/ASX Top 100 companies as a group.