



"CORPORATE CITIZENSHIP"

A NEWSLETTER OF
THE AUSTRALIAN COUNCIL OF SUPERANNUATION INVESTORS

2002 - CORPORATE GOVERNANCE AWAKENS

On 4 December 2002, we mark the first anniversary of the collapse of the US based ENRON Corporation.

As Ralph Willis outlines in an overview of the US corporate governance scene in this edition of "Corporate Citizen", ENRON represented only the "tip of the iceberg" of the disorder and excess that has since emerged across many listed corporations across the world.

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In the case of Enron that excess fostered corruption that extended beyond the company itself.

Much of 2002 therefore can be characterised as a period where these practices were revealed, only after a downturn in the company performance or as a consequence of a collapse. It had taken the collapse of WorldCom for legislators and stock exchanges to introduce any meaningful reform in the disclosure and accounting rules.

In Australia, we continue to deal with the ramifications of major failures in HIH, Ansett, Pasmico and OneTel. The Federal Government has released a series of proposed reforms through CLERP 9 aimed at improving disclosure and promoting shareholder activism. As a direct consequence of these international and local collapses, institutional investors including superannuation funds have now become more active in exercising their proxy votes or engaging with companies on corporate governance issues.

Indeed since these collapses, the "awakening" of shareholder interest in corporate governance, has been geared towards pressing for clearer and transparent corporate accounts that properly reflect the state of a company's health. Remuneration practices that apply to executives and directors have also come under closer scrutiny, particularly around disclosure of their value and their

linkage to performance outcomes of the corporation.

In response to this increased level of activism, ACSI has worked closely with a significant number of superannuation funds this year, assisting them with the development of a policy framework on corporate governance issues that arise in the companies in which they invest. These funds now have a practical platform on which to respond to corporate governance issues that arise.

ACSI will continue to present research to trustees (our research agenda is contained on page 8), that is relevant to superannuation funds to assist with their individual fund objectives on corporate governance. The launch of our information and education service also marks another important step for ACSI who will provide trustees with a targeted and affordable corporate governance advisory service.

We thank all members for their support throughout 2002 and look forward to continued strength in our collective endeavours to ensure that we are better equipped to monitor the corporate governance practices of companies, throughout the whole investment cycle- during bad and good times.

Best wishes for the holiday period.

Michael O'Sullivan
President

RESPONSE TO SWG RECOMMENDATIONS – WHAT DOES IT MEAN FOR ACSI MEMBERS?

Like US Regulators, APRA holds the view that the right to vote shares owned by a fund is itself an asset of the fund.

At the ASFA conference on 13 November 2002, Charles Littrell, Executive General Manager for APRA had this to say about investment management plans, "...the intrinsic value attaching to voting equity should be captured, via direct voting policies or by instructions to fund managers.

When using external fund managers, APRA will expect that the soft money issue will be considered and managed appropriately.

Votes and soft dollars are negotiable assets that belong to the fund members, and should be treated accordingly when trustees set up their investment management plans."

REGULATORS UNDER MICROSCOPE

It looks as though the Government is trying to lead by example with the announcement on 14 November that, Mr John Uhrig, a former chairman of Westpac, will conduct a review into the corporate governance of Commonwealth statutory authorities and office holders.

The objective of the proposed governance review is to improve the performance of statutory authorities and office holders and their accountability frameworks. The specific focus of the review will be on a select group of agencies with critical business relationships including the Australian Taxation Office, the Australian Competition and Consumer Commission, the Australian Financial Regulation Authority, the Reserve Bank of

Australia, the Australian Securities and Investments Commission, the Health Insurance Commission and Centrelink.

The review will also address the selection process for board members and office holders, the mix of experience and skills required by boards, their development requirements and their relationship to the Government. The review is expected to be completed within six months.

CORPORATE GOVERNANCE DEVELOPMENTS ABROAD

US

Corporate Governance Developments in the US – Address by Ralph Willis at AIST Seminar on 14 October 2002

From 24 April to 7 May 2002 Ralph Willis and Phil Spathis took part in the CMSF study tour to the US on "Good Investment Practice, Good Corporate Governance". Study participants are listed below:

- Mr Daryl Cochrane, Chair, LASB
- Mr Russ Collison, Trustee, First State Super State Secretary, AWU
- Ms Jean Elborn, Manager Superannuation, News Limited Director, JUST Super
- Mr Don Good, Deputy Chair, HESTA
- Mr Frank Pegan, Chief Executive Officer, Catholic Super Fund
- Ms Fiona Reynolds, Manager, CMSF; Executive Officer, AIST and Management Committee Member, WIS
- Ms Mavis Robertson, AM, Director, CMSF; National

Spokesperson for WIS, and Board Member, ACSI

- Mr Phil Spathis, ACSI and Solicitor for IFS Fairley
- Mr Bill Watton, Chair, VicSuper
- Mr Ralph Willis, Chair, Cbus
- Ms Kate Wood, Director of AGEST and Director of CARE Super

ACSI would like to warmly thank CMSF for the opportunity to take part in the 2002 study tour and the participants who made the tour both educational and enjoyable.

Attached you will find an address given by Ralph Willis to an AIST seminar on 14 October 2002 which provides a very informative overview of his findings in the US in relation to corporate governance. The paper covers –

- Examples of recent US corporate collapses, frauds and scandals,
- Findings from discussions with fund managers,
- Problems that need to be addressed in the US, and
- Action in the US to improve corporate governance.

Expensing of Stock Options

On the eve of the release of International Accounting Standards relating to the expensing of options the debate in the US continues on this issue. A handful of companies such as Coca Cola voluntarily expense share options. But there may be a further push in this area as a survey just completed for CalPERS by The Corporate Library found that 86.4% of the institutional investors surveyed want companies to treat stock options as an expense. Watch this space.

Europe

Highlights from the Winter Committee

On Monday 4 November the Winter Committee made up of a high level group of company law experts, chaired by Dutch attorney Jaap Winter, issued its final report. The Winter Committee have been examining the core impediments to improved investor rights in Europe. The final action plan is due out in January 2003, in the meantime the highlights include:

- **Voting Disclosure.** The committee urges each EU state to require funds to tell investors how they cast share votes at specific companies.
- **Executive Remuneration.** The committee wants boards across the EU to disclose individual pay for top executives and directors. To date, only Britain, France, Ireland and the Netherlands require similar disclosure.
- **Electronic Voting.** Winter recommends that Brussels require all companies to offer investors the option of casting proxy ballots electronically once secure means are developed.
- **Board committees.** Each listed company in Europe would have to ensure that executive compensation, audit oversight and director selection decisions are made only by non-executives, a majority of whom should be independent outsiders. In continental Europe independents at even the biggest firms now comprise no more than an average 20% of boards.
- **Databases.** Winter wants each EU state to create online information archives linked to each other.

The European Parliament's Committee on Legal Affairs and the Internal Market commence debate on the committee recommendations on November 27.

THE OECD LAUNCHES DRIVE TO STRENGTHEN GOVERNANCE

The Organization for Economic Cooperation and Development (OECD) recently consulted with a group of international experts on corporate governance to discuss the possibility of revising the 1999 OECD Principles of Corporate Governance. The OECD said it would launch a survey of its 29 member countries and consult with corporations, unions and non-government organisations to form a consensus on revising and strengthening the code. The revised code will likely include detailed recommendations on the role of lawyers, analyst, and ratings agencies; establish independent oversight bodies for auditors; enhanced protection for shareholders; greater role for institutional investors; greater transparency in corporate structures and, the definition of independence for boards and audit committees. The tougher code will be prepared by spring 2004.

LEADING CORPORATE GOVERNANCE INDICATORS 2002

Davis Global Investors has issued its seventh annual index of Leading Corporate Governance Indicators (LCGI). The index ranks the following countries corporate governance developments, Belgium, France, Germany, Japan, Netherlands, Portugal, United Kingdom and the United States.

Outlined below is a brief snapshot of the key findings. For a copy of the executive summary visit www.davisglobal.com

One of the most surprising findings in light of all the initiatives by legislative, regulators, stock exchanges and code writers following recent corporate collapses, is that there has been slow progress and striking weaknesses in the architecture of corporate governance.

The survey raises questions about risks associated with inadequate oversight of management. This has led to the suppression of scores of every country surveyed but France.

Two findings of particular interest are:

- In five of the eight countries surveyed, no top companies featured independent Chair's. In the UK, where watchdog powers are advanced, less than one quarter of FTSE 100 firms featured Chairs independent of management. In the US, the number of independent Chairs of the S&P 500 was trivial.
- Tracking of board committees show that all-independent panels remain a big stretch for most countries.

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This newsletter is correct to the best of our knowledge and belief at the time of going to press. It is, however, written as a general guide so it is recommended that specific professional advice is sought before any action is taken

ACSI 2002 ACTIVITY REPORT

Outlined below is a brief overview of ACSI's activities for 2002.

ACSI's overriding objective is to provide research and advice on corporate governance issues that is relevant to a superannuation trustee.

ACSI's research and information services are aimed to equip trustees to pursue their fund's corporate governance objectives.

As at November 2002, the membership of ACSI is comprised of the following organisations:

AIST, CARE, Cbus, CMSF, CSS/PSS, IFS, HESTA, MTAA, STA, TISS, UNISUPER, REST, Local Authorities Super (Vic), AGEST, ARF, Catholic Super Fund, FINSUPER, GSO, Local Super SA-NT, Print Super, Seafarers' Retirement Fund, TASPLAN, TWU, VicSuper.

ACSI's membership represents over \$40 billion in assets and over 4.5 million superannuation fund members.

1. **Research Undertakings For 2002**

The ACSI Committee of Management had endorsed the following research agenda for 2002. ACSI members received full electronic and hard copies of the research undertaken prior to the inaugural ACSI Corporate Governance Conference in June 2002.

(a) **Board Composition and Pay in the Top 100 Companies**

ACSI Commissioned Institutional Analysis to analyse key structural and remuneration issues arising in Australia's top 100 listed companies. The research included information on the following:

- Board size
- Proportion of non-executive and executive directors
- The independence of non-executive directors
- Incidence of audit, remuneration and nomination committees
- Composition of audit, remuneration and nomination committees
- Incidence of companies with an executive chairperson
- Age of directors
- Gender of directors;
- Multiple directorships;
 - Incidence of executive directors holding multiple directorships;
 - The prevalence of professional non-executive directors;
 - Remuneration of professional non-executive directors;

- Incidence of multiple directorships in the Top 600 companies
- CEO remuneration
 - Comparison of fixed and variable remuneration between 2000-2001;
 - Analysis of remuneration packages with and without cash bonus, share incentive and option schemes and other long-term incentive payments;
- Analysis of CEO pay and their negligible correlation with the following factors:
 - Industry classifications;
 - Non-CEO Remuneration Committee membership;
 - Percentage of non-executive directors on a board and who are also independent;
 - Board size;
 - CEO age, share ownership and tenure;
 - Growth in shareholder return;
 - Return on assets
 - (The study found that the only variable that influenced the level of remuneration of an executive was in fact company size as measured by market capitalisation and total assets);
- Executive Share Option Schemes in Australia's Largest Companies
 - Discussion on the features of executive share option schemes
 - Reasons why they have been criticised
 - Discussion about the disclosure benchmarks under Corporations Law
 - Overview on the number of companies were disclosing the value and number of share option schemes as is required under Corporations Law;
- Identification of which top 100 ASX Listed Companies disclose the value of share option arrangements for their top 5 paid senior executives and directors;

(b) **Research into the adequacy of Australian Auditing Regimes**

ACSI commissioned research into key audit independence issues:

- Identifying the fundamentals for auditor independence. i.e. how auditor independence may be compromised?
- Analysis and comparison of the US, UK and Australian audit regimes

(c) **Non-audit services performed by auditors in the Top 100 companies in 2001**

- Analysis of the audit and non-audit fees by each accounting firm for the top 100 ASX Listed companies.

(d) **Corporation Law Reform and Policy Developments in the United Kingdom;**

- A discussion of the Blair Government's response to the Myners Report on Corporate Governance.

2. **CONFERENCES AND SEMINARS**

In the course of the year ACSI representatives addressed the following conferences:

- Conference of Major Superannuation Funds- March 2002;
- ACTU Superannuation Forum-July 2002;
- Australian Government School of Management - University of New South Wales - Corporate Governance Roundtable - July 2002;
- Equities Conference - September 2002;
- University of NSW Corporate Governance - November 2002;
- AIST Seminars on Corporate Governance - Melbourne, Brisbane, Adelaide, Hobart - November 2002;
- Addressed number of Superannuation Fund board meetings across Australia, towards the development of a corporate governance policy - October/November 2002;
- Ethical Investor Conference - Governance and Sustainability - November 2002;
- CEDA Roundtable on Corporate Governance - December 2002.

3. **Media reports references**

- Articles about ACSI and research in 2002 in the following publications: The Age, Financial Review, Sydney Morning Herald, Investor Weekly, Courier Mail; Ethical Investor; Superannuation Review;
- ABC National - Board Disclosure - September 2002;
- ABC Business Sunday Program - November 2002;
- ABC AM Program - November 2002;
- House of Representatives - Hansard - September 2002 (re: disclosure under Corporations Law).

4. **ACSI Participation in the following forums**

CMSF study tour in the US on Corporate Governance –April/May 2002

5. **Participated on the following committees**

- Standards Australia - the development of Corporate Governance standards;
- Australian Stock Exchange Corporate Governance Council.

6. **ACSI CONFERENCES AND SEMINARS**

In June 2002, ACSI convened its first corporate governance conference.

(a) **Inaugural ACSI Conference on Corporate Governance-June 2002**

Sessions included:

- Introducing Corporate Governance Policy options for Trustees;
- Presentation of ACSI research from Dr. Geof Stapledon
- Presentation of how corporate governance policies work in practice from TISS, HESTA, PSS/CSS
- Perspectives on Corporate Governance from Henry Bosch (Directors and ex-regulators), Auditors, Fund Managers;
- Overview of recent corporate governance developments from Ralph Willis Cbus chair

(b) **Dinner Seminar on 16 September 2002**

‘Corporate Governance, Incentives and the Internationalization of Australian Business’ addressed by Professor David T. Merrett, Australian Centre for International Business & Department of Management The University of Melbourne

7. **LAUNCH OF ACSI INFORMATION AND EDUCATION SERVICE**

ACSI's service information and education service has been designed to provide superannuation funds with a cost effective way to monitor corporate governance issues that arise in S&P/ASX 100 companies and has been developed in conjunction with Institutional Analysis.

Our service comprises of a three tiered approach and will provide funds with:

- Timely notification of "contentious" corporate governance issues that arise in a data base of companies listed in the S&P/ASX 100
- Access to expert opinion in response to questions from superannuation fund subscribers on the corporate governance performance of identified S&P/ASX 100 companies;
- Educational and training seminars including a corporate governance "user manual" for subscribers on how to effectively utilise the service.

At the time of publication six superannuation funds have subscribed to the ACSI information and education service. They include, PSS/CSS, CARE Super, Cbus, STA, Local Authorities Super (Vic) and MTAA

8. FUTURE RESEARCH

The ACSI Committee of Management has endorsed the following research agenda for the 2002/2003 year.

(a) Research currently in progress

- Dual Listing arrangements and Shareholder Rights – A review of the impact dual listing proposals have on share holder rights and the potential to entrench board and managerial control particularly in light of the BHP-Biliton dual listing.
- Supporting a PHD study into the methodology utilised by company remuneration committees when developing remuneration policy for company executives and staff.

(b) Repeat research

- A comparison of results from annual reports and other company statements from the previous two years regarding the independence and composition of Company boards and committees. The study also reviews remuneration practises of the S&P/ASX 100 companies, particularly regarding executive share option arrangements.

(c) Proposed new research

- Identification of contentious corporate governance issues that are relevant to trustees (completed);
- Development of ACSI good Corporate Governance Principles and Guidelines (near completion);
- Study into promoting improved financial statement integrity and effectiveness, including ensuring that auditors perform effectively and independently;
- Other related considerations include:
 - Adequacy of financial information provided by the companies to properly reflect the position of the company;
 - Adequacy about the scope of Auditor activities in corporations;
 - Regulation of Auditing standards;
 - Conflicts of interest;
 - Rotation of partners/teams/firms;
 - Shareholder say in auditors/audit committees;
 - International Accounting Standards.
- A review of the regulatory environment that puts in place the corporate governance framework, including:
 - Corporations Law;
 - ASX - listing rules;

- Other relevant regulations;
- Industry self regulatory standards;
- Other mechanisms that provide shareholder redress;
- Role of ASIC, APRA, ASX in this framework.
- Investing in Cayman Island - due diligence, enforcement of investor rights, consideration of prosecution mechanisms for defalcations;
- Reform of the processes and timelines relevant to Trustee shareholders regarding provision of Company Notices of AGMs and EGMs and the requirements to lodge proxies;
- Development of options for Trustees who wish to become active in the corporate governance issues of overseas equity holdings, with particular focus on:
 - Pooled investment vehicles;
 - Discrete or direct investment portfolios;
 - Corporate credit arrangements.
- Options for communicating the importance of corporate governance considerations to Trustees, fund members and community;
- Overseas case studies/experiences of useful activities undertaken by pension funds/investors to bring about positive changes in corporate governance i.e. proxy voting, engagement, policy developments and initiatives;
- Connecting Corporate Governance issues to triple bottom line reporting and SRI considerations.

9. **ACSI staffing resources**

In September 2002, the ACSI Committee of Management endorsed that the Executive Officer's commitment to ACSI be increased to 3 days per week. In addition, a part time Research Officer has been appointed as of November 2002.

AIST SEMINAR – CORPORATE GOVERNANCE 14 OCTOBER 2002.

ADDRESS BY RALPH WILLIS

RE: CORPORATE GOVERNANCE DEVELOPMENTS IN THE UNITED STATES

1. Introduction

Late April to mid-May this year was a fortuitous time for the CMSF Study Group to be in the U.S. looking, inter alia, at Corporate Governance issues as this was soon after Enron and various other corporate governance frauds had come to light. Also a few days after we arrived the World Com corporate governance scandal began to be unveiled.

We were able to talk to fund managers, pension plan representatives, union officials (including the Secretary of the AFL/CIO), the U.S. counterpart to ACSI – the Council of Institutional Investors, and some lawyers engaged in this area.

We were also able to read and hear much about these issues in the media.

However, we weren't there just to learn about Corporate Governance. We were also looking at developments in the U.S. pension industry and the outlook for the U.S. economy and stock market.

2. Scene set for Corporate Governance Improvements

In the year or so before our arrival in the U.S. in late April there had been a number of corporate collapses, frauds and scandals - all of which pointed to the need for a considerable improvement in Corporate Governance.

Eg Sunbeam Corporation – In May 2001, its auditor, Arthur Anderson had paid \$110 million to shareholders to settle a lawsuit alleging fraud in its audit of the company. (This was \$US – all monetary amounts mentioned in this speech are in \$US).

In January this year, the Sunbeam CEO agreed to pay \$15 million to settle a lawsuit from shareholders and bond holders alleging he'd "cooked the books."

Global Crossing

- a telecom company which was accused of artificially boosting its declared revenue
- In January this year it went into Chapter 11 bankruptcy – but not before insiders had cashed in \$1.3 billion in stock!

Quest

- another telecom which inflated revenue improperly in its accounts.

CS First Boston

- paid \$100 million in fines to settle charges that it, as a broker, had allotted shares in an I.P.O. to certain investors in exchange for inflated commissions on other trades.

Enron, an electricity trading company

- collapsed in December 2001 with assets of \$63 billion – the biggest corporate collapse in history. It was subsequently revealed that it had inflated profits and impaired its balance sheet by various means – especially by putting much of its debt into Special Purpose Entities (SPE's) which conveniently took those debts off - balance sheet.

Arthur Anderson

- were the Enron Auditors, and in April 2002 one of its partners pleaded guilty to obstructing justice in the Enron case. Indeed, Arthur Anderson's whole future was in question as it had been auditor to Sunbeam, Global Crossing, Quest, Enron and finally, the biggest one of all, Worldcom.

A couple of days after we arrived in the U.S., the CEO of Worldcom – the 2nd biggest telecom in the U.S. – resigned his position and it was revealed he owed the company \$366 million in loans from the company – which was subsequently upgraded to \$408 million. His security for the loans was his shares in the company – which in the last 22 months had fallen from \$64.50 to \$2.35!

Another area of corporate governance that had caused increasing concern over the previous year or two was the issue of executive pay – especially against the background of a declining share market.

In 2001 – the average CEO of a large corporation in the U.S. earned 411 times the average factory workers pay.

In the last 10 years as workers pay rose only 36%, CEO pay had increased 340% !

In 2001 - 58% of CEO pay was in the form of options
 - 75% of all options had gone to the top 5 executives in large corporations.

At the end of year 2000 – options accounted for 16.4% of all shares on issue in the U.S.

Apart from the inequity aspects arising from such profligate issuance of options to corporate bosses a further issue was that they were mostly not expensed in the Companies' accounts – thus causing considerable overstatement of profits. UBS Warburg's research showed expensing options would have reduced corporate profits on average about 10% but for some companies - especially in the technology area - profits would have been reduced by 50% or more if options had been expensed like other components of senior executive pay.

3. Corporate Governance Discussions With Fund Managers

We started our trip in San Francisco where we had extensive discussions with Barclays Global Investors (BGI). The then CEO of BGI told us – in a sobering assessment of the stock market outlook – that up to 40% of reported profits in the previous few years could turn out to be nothing more than accounting tricks.

In New York we met with two important players in the Enron saga.

The first was J.P. Morgan who were subject to a lawsuit for their involvement as investment bankers to Enron. They were one of a number of investment bankers who had developed the special purpose entities which took Enron's debt off balance sheet.

Apart from defending such action as legal they were rather reluctant to discuss the matter.

The second Enron player we met was much more forthcoming. This was Alliance Capital, which we discovered was the biggest outside shareholder in Enron. Alliance had a director – a former senior

executive – who was also a director of Enron, and on its Finance Committee. Alliance had lost \$1 billion on Enron and maintained that despite their director being on the Enron Board they had no idea of its accounting fraud or financial vulnerability until everyone else knew.

Further developments

Subsequent to our return to Australia Worldcom announced it had wrongly allocated \$3.8 billion of expenditures as capital expenditures which it could amortise over time- rather than as current costs which would be brought to book in full in the year they'd been incurred. By this means they'd turned a loss for all of year 2001 and the 1st quarter of 2002 into a profit!

On 21 July – Worldcom went into Chapter 11 bankruptcy and in August its Chief Finance Officer was indicted for fraud.

It also came to light that Merrill Lynch had agreed to pay \$100 million to end an investigation into allegations that one of its investment analysts advice had been unduly favourable to companies who were Merrill's investment banking clients. Specifically in internal emails, the analyst, Henry Blodgett, had described some internet companies as 'crap' and "shit" whilst he was simultaneously issuing advice to buy the stock!!

4. Problems that need to be addressed.

(a) Laxity in accounting standards

The U.S. Accounting Standards have been developed under what is described as Generally Accepted Accounting Principles (GAAP) rather than the standard most other Western countries (including Australia) accept which is the standards set by the International Accounting Standards Board (IASB). The U.S. standards failed to clarify the treatment of the Special Purpose Entities – which allowed Enron to leave highly material information out of its accounts yet claim they were behaving within the rules.

(b) Incentives to fraudulent activity

Executives with major options packages have every incentive to keep the share price up and clearly some will resort to illegal means to do it. For example, the Chief Financial Officer of Worldcom had major stock options he was presumably trying to keep "in the money" by wrongly classifying major expenses. Clearly, an accounting requirement for such options to be expensed would reduce this incentive somewhat. The IASB is working on developing such a standard, now.

(c) Laxity in reporting standards

Companies are reporting profits on all sorts of differing bases.

Eg. Amazon.com in the last quarter of 2001

- Showed a Net Profit of \$5 million,
- A Pro forma operating profit of \$59 million,
- And a Pro forma net profit of \$35 million.

These pro forma profits had differing and obscure exclusions and adjustments. Knowing just what they mean is therefore difficult - and comparisons with other companies "pro forma profits" is almost impossible.

Its important that the reporting standards are clear and unambiguous – otherwise we are facilitating the situation described by the previous Reserve Bank Deputy Governor John Phillips recently – where:

- EBIT – Earnings Before interest and tax
Can become – Earnings before Interference and Tampering
- EBITDA – Earnings Before interest tax, depreciation and amortisation can become –
Earnings Before I Tricked the Dumb Auditor!!

(d) Auditor independence

This issue has been brought to the fore by recent events. For example, in Global Crossing – the Executive Vice President of Finance was the former leader of the Anderson audit team before joining Global Crossing. Also in Enron – a number of senior executives had previously been Arthur Andersen employees yet Arthur Anderson continued as the auditor.

These “gamekeepers turned poacher” arrangements are clearly a gross violation of auditor independence.

The perception of non-independence by the auditors in the Enron case was stated starkly by the Chairman of a Congressional committee investigating the matter.

In his opening remarks he said: “Enron robbed the bank and Arthur Anderson provided the get-away car”.

Another area of concern regarding auditor independence is the provision of non-audit services by the audit firm to its audit client. In many cases, such non-audit services are more valuable to the audit firm than the audit itself.

For example, in the case of Enron, Arthur Andersen earned more from non-audit services to Enron than from the audit - as well as providing substantial non-audit services to the very Special Purpose Entities which were a major means of Enron hiding its true condition from the investment community!

(e) Role of the Audit Committee

The Audit committee of the Board is supposed to appoint the auditor, review the auditor’s performance, understand the company’s accounts, be aware of any contentious issues relating to them and knowingly approve the accounts. In many cases the audit committee has been clearly negligent – or worse. In the case of Enron – the Audit Committee Chair was the wife of a Republican Senator who had received substantial donations from Enron – as had his wife’s favourite charity!

This also raises the more general issue of the responsibility of Board Directors to take their role very seriously, responsibly, and diligently and in particular, to hold management to account for it’s actions, to ensure that management is adhering to Board policy. The role of Board’s in a number of these companies shows that, if not complicit in managerial malpractice, they were at least asleep at the wheel. Such laxity (or worse) makes company directors objects of derision as summed up – this pithy riddle.

Q. What’s the difference between a company director and a shopping trolley?

A. A shopping trolley can’t hold as much liquor, but it does have a mind of its own!

5. Action to improve corporate governance

Following the Worldcom \$3.8 billion expense misallocation scandal, the White House – which had been seemingly loath to do too much – announced a modest package of reforms which:

- Require CEO's to vouch for the veracity of their financial statements
- Bar executives from profiting from fraudulent financial statements
- Require better disclosure by executives regarding buying and selling of company shares, and
- Require companies to guarantee investor confidence in the integrity and independence of external auditors

This legislation has already had an impact, with the CEO's and CFO's of 745 companies having to sign off in their companies accounts by August 14. All but a handful did so – the exceptions being the known casualties eg. Enron, Worldcom etc.

Other legislation has also been passed by Congress relating principally to the Auditor independence issue. Known as the Sarbanes Oxley Act – this Legislation:

- (i) Prohibits accounting firms from performing certain non-audit services for companies they **audit**,
- bookkeeping and related services
 - financial information system design and implementation
 - appraisal or valuation services
 - retrieval services
 - internal audit outsourcing services
 - broker or dealer services, investment advice or
 - investment banking services
 - legal services and expert services unrelated to the audit

However, tax services and some other non-audit services can be provided if pre-approved by the audit committee.

- (ii) Prevents accounting firms from providing audit services to companies whose senior executives have worked for that accounting firm at any time in the preceding two years.
- (iii) Establishes an accounting oversight Board to oversee auditors of public companies.
- (iv) Provides that audit partners (not firms) must rotate every five years. However, further consideration will be given to mandatory rotation of audit firms.

In addition, both the New York Stock Exchange (NYSE) and NASDAQ have recently revised their listing requirements regarding corporate governance.

The principal changes announced by the NYSE were:

- (i) Listed companies must have a majority of independent directors.

- (ii) **The definition of “independent director” was tightened so that:**
- No director qualifies as “independent” unless the Board affirmatively determines that the director has no material relationship with the company.
 - No director who is a former employee of the company can be independent until 5 years after that employment.
 - No director who has in the past 5 years been employed by an affiliated with the auditor of the company can be independent until 5 years later.
 - No director can be independent who in the past 5 years has been part of an interlocking directorate in which an executive officer of the company serves on the compensation committee of another company that concurrently employs the director.
 - Directors with family members in the above categories are likewise subject to the 5 year “cooling-off” provisions.
- (iii) Non-management directors must have regularly scheduled meetings without management.
- (iv) Listed companies must have a nominating/corporate governance committee composed entirely of independent directors.
- (v) Listed companies must have a compensation committee composed entirely of independent directors.
- (vi) Audit committee members, who were already required to be “independent”, are specifically prohibited from receiving compensation other than by directors’ fees, eg. No consultancy or advisory fees, paid either to the director or their firm.
- (vii) Increased authority and responsibility for Audit committees, including sole authority to hire and fire independent auditors, and to approve any significant non-audit relationship with the auditors.
- (viii) Shareholders to be given the opportunity to vote on most equity-compensation plans (eg. Options).
- (ix) Listed companies must adopt and disclose corporate governance guidelines.
- (x) Listed companies must disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waiver of the code for directors or officers.
- (xi) The CEO must certify to the NYSE each year that he/she is not aware of any violation by the company of NYSE corporate governance listing standards.

All this change to legislation and regulations clearly addresses some of the issues raised by recent events – but there is still great scope for shareholders to exercise some clout in this area.

6. **Role of pension funds in corporate governance.**

U.S. pension funds generally are well ahead of Australian Super Funds in relation to corporate governance activism. For the private sector funds this is very much a product of being required by law to vote their shares.

Regulators take the view that the right to vote shares owned by a pension plan is itself an asset of the fund and therefore the Trustees responsibility to manage the assets includes voting proxies on issues that may effect the value of those shares.

Many public sector pension funds have also chosen to comply with these provisions.

Eg. Calpers – Californian Public Employees U.S. Retirement System – one of the biggest funds in the country – had assets of \$150 billion, when we were there – more recently it's been reported as \$136 billion. (At the peak of the stock market in March 2000 Calpers assets were \$175 billion).

Calpers is very strong in corporate governance – and increasingly influential.

It is active in many ways:

(a) Proxy Voting

- Takes this very seriously. Unlike many other funds in U.S. it doesn't delegate this function to the fund managers – it does it all itself.
- It makes 10,000 votes a year – many are routine so they provide no problem.
- The Board doesn't make decisions on proxy voting issues - it delegates authority to the Corporate Governance Manager who operates subject to principles laid down by the Board.
- He gets help on some difficult issues from fund managers or from a proxy advisory service of which there are 2 major providers:
 - Institutional Shareholder services (ISS)
 - Investor Responsibility Research Centre (IRRC)

The proxy advisors track issues, analyse proposals for their impact on shareholder value and issue alerts and suggestions. They also assist with development of proxy voting guidelines and, if desired, execute the proxy voting program as an agent for the institution.

Calpers does most of all this for itself and only uses these proxy advisors on difficult issues.

Calpers also publishes a large number of their votes on their website.

(b) Education

Calpers gives good governance awards to companies that stand out. But perhaps symbolic of the times – its 3 years since they last did it!

They also publish a set of governance principles.

Post Enron - they issued a reform package calling for major improvements in corporate governance standards such as the standards required of Audit Committees, improvements to auditor independence (including mandatory rotation of auditor firms after 5-7years), and better accounting and reporting standards.

(c) They also produce a focus list – which focuses on poor performing companies

For each company they look at stock performance, economic value added and corporate governance.

They score up to 1000 companies - then reduce the list down to 50-60 that they research more thoroughly. They then select 15 for even closer analysis and talk to those companies before publishing their list of the worst 10!

However, after all this research to pick out the worst companies they do not disinvest from them. This is because all their domestic equity investment is index-based so if they disinvested from these companies they'd no longer be indexed. When asked why they had no active funds management they said it was too costly, which we all found curious until we learned later that, in the U.S., three quarters of active managers produce returns below the index! Presumably, this indicates the U.S. market is more efficient than ours so there is less scope to achieve alpha.

Calpers also engages in class action lawsuits in cases like Enron and also occasionally proposes shareholder resolutions - so it's not just reacting to proxy proposals but being proactive regarding them.

That is true of quite a few other funds – including the multi-employer private sector Taft-Hartley Funds and the New York City and State Pension Plans.

In New York it was pleasing to see that the city and state supported corporate governance action through their pension funds. The Controller of the City of New York Pension Policy Unit is the investment advisor to the New York City pension funds and is authorised by their Boards to vote the funds proxies.

He votes 2800 proxies and recommends proxy votes, identifies and researches issues appropriate for shareholder resolutions, develops a list of low and under performing companies and co-ordinates meetings with senior management of companies that perform badly.

The largest fund we met was the University Staff Fund – T.I.A.A.-C.R.E.F. (Teachers Insurance Annuity Account – College Retirement Equities Fund) which has \$280 billion in funds and 2,400,000 members.

It has a published policy statement on Corporate Governance. It tends not to be as aggressive as Calpers.

For example, on auditor rotation – it says companies should consider doing this. On non-audit services provided by an accounting firm to an audit client – they say merely such services should be limited.

The reason they gave for their cautious approach was that their Trustees are split on these issues.

Like Calpers, the fund staff vote the shares following the guidelines and principles laid down by the Trustees, except in matters like mergers or takeovers which do go to the Board for decision.

They frequently visit companies and tell them of their concerns. They have tried in particular to focus on improving the quality of Board Directors.

They are also very active in regard to proposals regarding executive remuneration and try to ensure that these matters, especially stock options, are brought before the shareholders at a general meeting.

T.I.A.A.-C.R.E.F. strongly support expensing of stock options and executives not being able to sell shares obtained from options for 5 years.

Overall, as we in Australia are finding our way into corporate governance activism, it was re-assuring to see that the large U.S. funds especially were able to deal with an enormous volume of proxy issues with relatively small resources. eg. Calpers had a staff of 7. Electronic notification and voting helped to manage this and proxy advisory services are a great resource.

But the first step – which many Australian funds are yet to take - is to develop a sound set of corporate governance principles on which to base action in this area. That is the main job of the Trustees – not to be meeting constantly to consider corporate governance issues, as that will prove totally impractical.

