Lessons from Enron:

A Corporate Governance Framework for New Zealand

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Introduction

With the collapse of Enron, many people have been asking for a basic overall guide to understanding Enron and some of its implications for New Zealand companies. What lessons are to be learned from the collapse of Enron and how can these lessons lead to more effective corporate governance rules and an improved regulatory framework in New Zealand?

Throughout the 1990s, Enron had grown rapidly from a small traditional natural gas pipeline company to a huge and innovative presence in national and international markets for energy. In business circles, Enron made a name for itself. Yet despite its size and (by the measures of the time) incredible success, Enron was not a household name. The company, however found a way to change that. In April 2000 the Houston Astros played their first game in their new stadium. Enron had agreed to pay more than $100 million for the right to name that stadium "Enron Field". Every fan of major league baseball learned the name "Enron".

Now we know that Enron need not have gone to such lengths and expense to raise its visibility. Such is its infamy now, in accounting, commercial and ethical terms, "pre-Enron" and "post-Enron" are part of the language.

Only months before Enron's bankruptcy filing in December 2001, it was a very complex company involved in energy trading and distribution. It was the seventh largest corporation in the United States and the 16th largest in the world. In a matter of 12 months, the Enron stock had gone from $US80 a share to 61 cents per share. The chronology of the giant energy company's demise is a shocking story of corporate and political corruption and mismanagement.

The paper will describe generally the events that led to the overnight implosion of Enron. The paper will then broaden the discussion from the financial scandal to examine the lessons to be learned here in New Zealand. The paper will look at recent changes in the regulatory environment in New Zealand that are a direct response to the Enron collapse, including the recent announcements by the Securities Commission. It will look at the new post-Enron corporate governance regime that has been developed for listed companies by the New Zealand Stock Exchange. The paper will also discuss the effectiveness of the rules and principles that aim to regulate, monitor, detect and punish corporate irresponsibility

The Enron saga

The name Enron has become synonymous with high level, deliberate, deceitful corporate governance failure. As far as bankruptcy stories go, this is the largest and perhaps most scandalous bankruptcy case in the history of the United States.

Enron had strong political links to the Bush administration. These "friends in high places" contributed to the rise of Enron as one of the most powerful and successful energy companies in the United States but those links could not prevent the eventual fall of the company.

The Rise of Enron

Enron was formed in 1985 when Houston Natural Gas merged with InterNorth, a natural gas company based in Omaha, Nebraska. It started as an interstate and intrastate natural gas pipeline company with 60,000 kilometres of pipe. By 1989 Enron was trading natural gas commodities and had become the largest natural gas supplier in North America and the United Kingdom.

By the early 1990s Enron branched off into trading energy futures and derivatives. Enron set up nearly 3000 offshore companies, many of which were treated as partnerships. Instead of allowing the free market to decide energy future prices, Enron manipulated energy prices and, at the same time hid its own debts.

Enron would show the contracts it had signed with its "partnerships" offshore when negotiating and, faced with supposedly legitimate contracts, Enron's customers had no choice but to pay Enron's high prices. By transferring its obligations to some of these shell companies they were able to show Wall Street profits when actually the company was being defrauded by its top executives.

In December 2000 Enron announced that president and chief operating officer Jeffery Skilling would take over as chief executive in February 2001 and that Kenneth Lay would remain as chairman of the Board. On 28 December 2000, Enron shares hit a 52 week high of almost $US85.

The Fall of Enron

In August 2001, Skilling resigned after just six months of being in charge of the company and Lay was renamed CEO. After Lay touting the company's stock and assuring employees that the company's growth "has never been more certain", the first sign was a memo on 15 August 2001 from a vice president of corporate development warning that the company "will implode in a wave of accounting scandal". Little did the author know just how accurate their words would turn out to be. On 28 November 2001, Enron shares fell below $US1 (in fact as low as 61 cents per share) and on 2 December 2001, Enron filed for bankruptcy protection in the biggest bankruptcy petition in US history.

It was only when an uncontrollable meltdown of Enron's scheme began in December 2001 that the world learned that Enron's apparent success had been little more than a complex illusion. Within days of Enron's bankruptcy California's energy prices returned to normal levels – convincing proof that Enron had successfully distorted national energy market prices. It now appears that other energy companies, such as El Paso Natural Gas, may have participated in the scheme by actually withholding energy from the market.

But, before Enron collapsed, insiders taking advantage of their knowledge of the looming downfall, sold over 16 million Enron shares pocketing over $US1 billion in profits. Allegations of share sales include that 29 key executives sold 17 million Enron shares for $US1.1 billion in the three years prior to Enron's collapse. Another alleges that Chairman Kenneth Lay sold 1.8 million shares for $US101 million and that the former CEO, Jeffery Skilling sold 1.1 million shares for $US67 million.

Current Events

Enron is now "in the pinks". For most public companies, being "in the pinks" has been a stigma to be avoided at all costs. Savvy investors view these stocks as a "pink flag" signifying that the company is in trouble. The pink sheets are inhabited primarily by over-hyped and often worthless penny stocks. Others are troubled companies that are just passing through on their way to oblivion. Enron is now, no doubt, going to remain in the pinks for a long time.

In other recent news, federal prosecutors are likely to seek a criminal indictment against Jeffery Skilling. The exact charges have not been formulated yet but will relate to events that took place from 1996 to 2001 when Skilling was the chief operating officer and president of Enron. The former chief financial officer, Andrew Fastow agreed last month to plead guilty to multiple felonies and provide evidence against other key executives. That evidence has led to the indictment of Richard Causey, the former chief accounting officer and is also thought to be playing a role in the potential indictment of Skilling. The prosecutors have built a strong case, with virtually every high level executive who worked for Skilling either under indictment or cooperating with the government.

It will be a long process but the investigation appears to have been thorough and the evidence damming. Those responsible for the Enron collapse will eventually be held accountable.

The Lessons for New Zealand – Could it happen here?

Corporate governance failure on a significant scale has not, fortunately occurred in New Zealand. There is not one major failure that can be likened to the fraud, excessive greed and dishonesty that has marked Enron, WorldCom, One.Tel and other corporate collapses overseas. But… how long can the ethical, integrity driven practices in New Zealand companies last with the temptation of gains of millions of dollars?

Lessons from Enron

It is inevitable that a corporate scandal as large as Enron will create waves of panic and knee-jerk reform around the world. In New Zealand, businesses are particularly wary of ensuring that their senior management and directors understand the basic implications of every key business transaction and the underlying purposes. The following list illustrates some of the key lessons that can be extracted from the demise of the energy giant Enron:

- The importance of senior management and directors communicating with each other with regard to major transactions and the ongoing management of the company;
- The development of internal controls for the company's objectives in relation to operation, finance, reporting and compliance;
- Ensuring processes are in place for the identification of risks to the company;
- Auditor independence and communications and reporting between the audit team and the board;
- Keeping auditing and consulting separate to avoid inherent conflicts of interest;
- The importance of accounting firms rotating their audit partner in charge and the team that is working with them to ensure an independent outcome is maintained;
- Keeping financial reporting transparent and simple;
- Separating the role of the Chairman of the Board from the Chief Executive Officer;
- Ensuring the fair and transparent remuneration of directors; and
- The importance of information disclosure, especially to shareholders and the New Zealand Stock Exchange.

These issues have been addressed in the consultation and recent announcements of the New Zealand Securities Commission and the New Zealand Stock Exchange's rule changes (discussed below).

Lessons from WorldCom

When Enron collapsed in 2001, shocked investors were assured by the US Government that Enron was just a case of one "rotten apple" in an otherwise healthy corporate system. Since then WorldCom, one of the biggest telecommunications companies in the US, has been exposed as having falsified their accounts to show inflated profits to keep the share price artificially high.

Bernard Ebbers, the ex CEO of WorldCom started investing in Long-Distance Discount Service (LDDS), a small telecom company in 1983. Two years later he took over as CEO and after a series of acquisitions LDDS had become the fourth-largest long-distance telecom network in the US. In 1995, LDDS acquired its now disgraced name, WorldCom. More acquisitions were undertaken and in 1998 WorldCom merged with MCI, in a deal valued at $US 40 billion, the highest priced acquisition in history at that time. WorldCom's stock reached a peak of over $US60 in June 1999 before collapsing to around 25 cents by June 2002. The company filed for bankruptcy on 21 July 2002.

During the acquisition binge, the company built up nearly $US30 billion in debt which was set off against over $US 50 billion of goodwill. The artificially high goodwill was used to cover the difference between the price paid and the actual value of the assets. Another one of the many ways the company inflated its earnings was to record routine expenses as capital expenditures. This worked because the cost of capital expenditures is not subtracted from the company's earnings straight away, it was merely recorded as a transfer from cash to assets. The total amount of goods and services the company purchased and declared as capital is around $US3.8 billion.

This was simple deceit which could have been easily detected had proper corporate governance checks been in place. Not surprisingly, WorldCom's auditor, Arthur Andersen, and the "independent" board of directors did not take prudent steps to detect the accounting tricks. They were all benefiting too much. WorldCom's downfall was not caused by an extravagant, complicated, structural web of companies that Enron was – merely a series of false entries in the books. The WorldCom saga illustrates to New Zealand companies the importance of independent auditors and boards, along with the need for appropriate monitoring and reporting.

Lessons from HIH Insurance

HIH suddenly went into liquidation on March 15, 2001. In what has become Australia's largest corporate failure, HIH left in its wake more than $A5 billion of losses, two million worthless insurance policies and about 1,000 former employees. The total damage bill is still not determined, but estimates range from $A2 to $A10 billion.

The demise of HIH really began with the increasing globalisation of financial markets in the 1980s. The entry to the California workers compensation market had, by 1992, cost the company $A350 million. In 1994 the company entered the high risk reinsurance market and this under-writing of other insurance companies' policies eventually cost about $A150 million. The share price began to fall in 1998 after investments in Hollywood movies and marine insurance failed, causing an under-reserve of $A1 billion. This under-reserve was added to when HIH purchased FAI Insurances for $A300 million without conducting the standard due diligence or the pre-purchase inspection of the books. Despite writing off $A400 million of FAI bad debts within a year, HIH continued to claim $A438 million worth of FAI goodwill as an "asset" on its books.

Hundreds of thousands of dollars were shifted around the world into HIH and personal accounts in the UK, Guernsey and the Isle of Man of CEO Ray Williams (who resigned just four months before the company went into liquidation). Williams and Adler allegedly used HIH company funds to buy $A10 million worth of its own shares. Other executives received $A16 million from HIH in its final six months, including a $A2 million fee to two executives the day before the company went into liquidation. There were some astonishing extravagances such as spending $A740,000 on the 1999 Christmas Party.

Randolph Wein, who was appointed CEO in December 2000, gave evidence that Ernst & Young had expressed concerns as early as 1995 that the reserves were insufficient and the accounts were not adequate. Three weeks after he testified, Wein died in a hit-and-run accident in Hong Kong where he was working as a consultant. Some reports suggest that his death was not an accident.

The response of the Australian government was to launch a Royal Commission of Inquiry into HIH Insurance. The key findings of the Inquiry were:

- The primary cause of HIH's failure was insufficient funds set aside to pay claims.
- Secondary causes were massive losses in the UK and US, the acquisition of FAI and the board's subservience to Chief Executive Ray Williams.
- HIH was mismanaged and out of control rather than brought down by fraud and illegal transactions.
- The Australian Prudential Regulation Authority was misled and failed to adequately supervise HIH.

The extensive mismanagement, dishonesty and the complete dominance of CEO Williams, who controlled the agenda for the board meetings and vetted the information provided certainly illustrates a lesson for companies operating in New Zealand – the independence of the board is *crucial* to good corporate governance.

Lessons from *AISC v Rich*[1]

A discussion of corporate governance is not complete without reference to a recent Australian court decision on the responsibilities of the Chairman of the board.

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[1] [2003] NSWSC 85, 341.

This case was against the former chairman of One.Tel, Mr Greaves, and three executive directors. The Australian Securities and Investments Commission ("ASIC") was suing these directors for breach of statutory duty of care. Mr Greaves sought to have the claim struck out on the grounds that he was a non-executive director and essentially in the same position as the other non-executive directors whom AISC had not commenced legal proceedings against.

Austin J rejected the argument that the chair's responsibilities are confined to ceremonial or procedural matters, or specific functions delegated to that director, and hence rejected Mr Greaves application to have the claim struck out. Austin J found it reasonably arguable that the responsibilities of the chair depended on the role of that chair in the company including:

- Any specific tasks or additional responsibilities undertaken by the chair.
- Any qualifications and experience relevant to the chair's directorship.
- Any remuneration paid for the chair's services.

Applying the above to Mr Greaves, Austin J found that Mr Greaves was not only the chairman but also:

- A founding director.
- Chair of the finance and audit committee.
- A qualified accountant with significant commercial and financial experience.
- Paid $A50,000 per annum for his services.

The Court found that in addition to his procedural responsibilities, Mr Greaves had a responsibility to:

- Take reasonable steps to ensure that he and other members of the Board monitored the management of One.Tel, properly assessed One.Tel's financial position and performance, and properly and promptly detected and assessed any material adverse development affecting its financial performance or position.
- Take reasonable steps to ensure that he and other members of the Board were informed of all material information concerning One.Tel, including information about cash reserves, actual business segment performance and key transactions.
- Establish and maintain systems for information flow to the Board.
- Employ a finance director with the appropriate skills and qualifications.
- Take reasonable steps to ensure that public statements made on behalf of the company did not mislead the Australian Stock Exchange (ASX) or the public.
- Make recommendations to the Board as to the prudent management of the company, including recommendations about its funding requirements, cessation of its business and/or appointment of an administrator.

The Court recognised that this finding may appear harsh for past behaviour in 2001 given that this degree of responsibility had never been set out in a statute or by judicial decision before. However Austin J noted that the Court's role in determining the liability of a defendant "is to apply a standard of care that reflects contemporary community expectations" and that the standard of care expected of company directors has been raised in recent years.

The Court found support in the case of *AWA v Daniels*[2] where Roger J said that the chairman is responsible to a greater extent than any other director for the performance of the board.

The Corporations Act 2001 (Australia)

Relevant to the case of *AISC v Rich* is s 180(1) of the Corporations Act 2001:

> "*A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:*
>
> *(a) were a director or officer of a corporation in the corporation's circumstances; and*
>
> *(b) occupied the office held by, and had the same responsibilities within the corporation as, the director or officer.*"

The opening paragraph to this section conveys an objective test by the use of the words "reasonable person". However in interpreting (b) Austin J used a subjective approach taking it to include Mr Greaves' experience and skills: "The director's responsibilities would include arrangements flowing from the experience and skills that the director brought to the office."

Therefore a director's duties are not only things specifically delegated to them but also things which flow from their experience or skills. The result of this interpretation is that s 180(1) has an objective minimum standard of care coupled with a subjective standard of care which may be used to increase the standard of care and potential liability of a director.

The Companies Act 1993 (New Zealand)

The corresponding New Zealand provision is s 137 of the Companies Act 1993:

> "*A director of a company, when exercising powers or performing duties as a director, must exercise the care, diligence, and skill that a reasonable director would exercise in the same circumstances taking into account, but without limitation,-*

[2] (1992) 7 ACSR 759.

(a) *The nature of the company; and*

(b) *The nature of the decision; and*

(c) *The position of the director and the nature of the responsibilities undertaken by him or her.*"

In addition to case law increasing the standard of care, s 137 removes the previous low common law standard and replaces it with the standard of a the reasonable competent director.

Under s 180(1)(b), Austin J considered the duty owed by a reasonable person who "occupied the office held by, and had the same responsibilities within the corporation as, the director or officer." Section 137(c) requires the care, diligence and skill of a reasonable director in the same circumstances, taking into account the "position of the director and the nature of the responsibilities undertaken by him or her."

Non Executive/Executive Directors and the Chairperson

The Act does not directly impose a higher standard of duty of care on executive directors but the Court may use s 137(a) – the director's position – to distinguish the responsibilities undertaken by the director.

AWA Ltd v Daniels tells us that non-executive directors are not bound to give continuous attention to the affairs of the company. However in *Dairy Containers Ltd v NZI Bank Ltd*[3] Thomas J was of the view that responsibility to manage the company still remains firmly with the directors – executive and non-executive alike.

In New Zealand, all directors, executive and non-executive, will be held to the objective standard set out in s 137. A chairperson may be interpreted as assuming a higher standard of care merely by virtue of taking that office. While qualifications or experience should only be relevant in relation to responsibilities undertaken *in fact*, there is a danger the courts could also follow Austin J's approach of imposing responsibilities not specifically assumed. The fact that s 137 requires responsibilities to be "undertaken", however, could provide some room to argue that the New Zealand situation is distinguishable from that in Australia under s180 of the Corporations Act 2001.

Recent Changes in the Regulatory Environment

History

Following the collapse of companies such as Enron, WorldCom, One.Tel and HIH Insurance over the last few years, the general reaction has been to tighten reporting and monitoring requirements for publicly listed companies. The United States rushed through the US Public Company Accounting Reform and Investor Protection Act (known as the Sarbanes-Oxley Act) 2002 which introduces a range of compliance rules in relation to auditing and other board practices, along with criminal penalties for a range of offences. The New York Stock Exchange also revised its corporate governance rules. The strict new rules create binding obligations on companies and they are subject to fines and other remedies if a breach is discovered. In Australia, the Australian Stock Exchange ("ASX") Corporate Governance Council issued principles and recommendations with which companies must comply or explain in the annual report in detail their non-compliance and reasons for it. A Corporate Law Economic Reform Program has also been launched by the Australian Federal Treasurer which is currently under consultation. In the United Kingdom the Combined Code of Corporate Governance, which addresses the concerns that have arisen, has been incorporated into the listing rules for publicly listed entities.

In New Zealand, the Securities Commission ("the Commission") has taken a much more consultative approach and recently published nine non-binding principles of good governance. The NZX has updated its listing rules (binding on Issuers) and best practice principles (not binding but any departure must be disclosed in the annual report). This section outlines the new principles published by the Commission and the key listing rules and best practice principles for listed companies.

The New Zealand Securities Commission – Corporate Governance Principles

On 18 February 2004, the New Zealand Securities Commission, after much consultation, announced nine principles as a guide to good corporate governance. These principles are in response to the concerns outlined in this paper and take into account the measures adopted overseas in response to Enron and other failures.

The Principles

The principles are intended to contribute to high standards of corporate governance in New Zealand entities. For the purposes of the principles, an entity is defined as:

> *Any entity operating under a governing board that is accountable to investors and/or stakeholders. It includes companies registered under the Companies Act 1993, all Issuers of securities, unit trusts and other collective investment schemes, and state-owned enterprises as well as many statutory bodies in the public sector.*

This definition excludes entities such as small, closely held companies where it is not possible or practical to comply with all the principles (such as the use of committees or the independence of directors).

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[3] [1995] 2 NZLR 30, 79-81.

The principles are listed below. More information, explanation and guidance to adopting the principles can be found in the Commission publication "Corporate Governance in New Zealand – Principles and Guidelines" published on the Commission website.[4]

1. Directors should observe and foster high ethical standards.
2. There should be a balance of independence, skills, knowledge, experience, and perspectives among directors so that the board works effectively.
3. The board should use committees where this would enhance its effectiveness in key areas while retaining board responsibility.
4. The board should demand integrity both in financial reporting and in the timeliness and balance of disclosures on entity affairs.
5. The remuneration of directors and executives should be transparent, fair, and reasonable.
6. The board should regularly verify that the entity has appropriate processes that identify and manage potential and relevant risks.
7. The board should ensure the quality and independence of the external audit process.
8. The board should foster constructive relationships with shareholders that encourage them to engage with the entity.
9. The board should respect the interests of stakeholders within the context of the entity's ownership type and its fundamental purpose.

The Effectiveness of the Principles

The major difference between the New Zealand and United States response is that the New Zealand principles do not impose new regulations on companies. They are not legally binding and there is no enforcement mechanism or penalties for non-compliance. Nevertheless, there has been an indication from Commission chairman Jane Diplock that companies failing to show they are considering the principles, or a good reason why they are not, will be publicly cited – "named and shamed".

Concern that the "soft touch" of the Commission may not be enough to ensure that companies are complying with the principles is evident. Many investors would have been happier with more prescriptive measures. The questions are how diligent is the Securities Commission going to be in monitoring these standards, and what action will actually be taken for breaches? Because the principles are not legally binding and there are no financial sanctions for breach, they do not seem to have any teeth. The success of the principles will depend on the monitoring by the Commission and the impact of publicly citing companies who fail to adhere to or adopt practices consistent with the principles.

Without any enforcement powers or penalties for non-compliance, the principles are no more than a reminder for directors that they should 'be good' and should 'be ethical'. The New Zealand regulators have obviously and correctly not wanted to go down the prescriptive, cumbersome path the United States has taken but in doing so have settled on guidelines that are little more than a gentle prod in the direction of good corporate governance.

The New Zealand Exchange Limited ("NZX") Listing Rules

The NZX listing rules ("the Rules") are binding on all listed companies and are authorised by the Minister of Commerce. There are three different sets of proposed rule changes that are being considered currently (the Discipline Rules, the Participant Rules and changes to the Listing Rules) but they do not contain the main implications for corporate governance. The major changes impacting on corporate governance came into force on 29 October 2003.

The foreword to the Rules states in relation to corporate governance:

> *NZX recognises the value that strong corporate governance brings to capital markets and their participants. The corporate governance rules set minimum standards which NZX believes will enhance confidence in the processes adopted by Issuers, and reduce the level of uncertainty for Issuers in this area. In addition to the Rules, NZX considers there are further corporate governance principles that may be desirable and which an Issuer should consider and determine whether or not to adopt them. These principles are contained in the Corporate Governance Best Practice Code.*

The Corporate Governance Best Practice Code

Rule 10.5.3 concerns the disclosures that are to be contained in the annual report of the company. At subpart (i), the annual report of an Issuer, among other things, must contain:

> *A statement on whether and, if so, how the corporate governance principles adopted or followed by the Issuer materially differ from the Corporate Governance Best Practice Code or a clear reference to where such statement may be found on the Issuer's public website.*

The rule provides the obligation on listed companies to adhere to the principles in the Corporate Governance Best Practice Code ("the Code") which is found at Appendix 16 of the Rules. The Code sets out principles to enhance investor confidence through corporate governance and accountability. The Code is composed of flexible principles which recognize differences in corporate size and culture.[5]

The key provisions of the code are:

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[4] www.sec-com.govt.nz

[5] From the Corporate Governance Best Practice Code, Foreword, paragraph B.

Section 1: Code of Ethics

This section specifies that each Issuer should formulate a Code to address ethical issues, establish compliance standards and procedures, provide mechanisms to report unethical behaviour and ensure that disciplinary measures are in place for any violations.

Section 2: Directors

- *Separation of Chief Executive and Chairman*: A director should not be the Chief Executive and chairman of the Board simultaneously.
- *Appointments to board*: Issuers should have nomination committees, unless constrained by size, and have formal and transparent methods for nominating and appointing directors.
- *Training*: Directors are to undertake appropriate training to remain up to date on how to best perform their duties.
- *Remuneration*: Issuers should have a remuneration committee unless constrained by size, and have formal and transparent methods to recommend director remuneration packages to shareholders. Directors are encouraged to take some remuneration under performance based equity securities (not to vest for 2 years) and to invest some of their fees in the Issuer's securities.
- *Information for the Board*: Management is to provide the Board with information of sufficient content, quality and timeliness as the Board considers necessary to carry out it's duties.
- *Board performance*: The Board should establish a formal procedure to regularly assess individual and collective Board performance.

Section 3: Committees

- *Audit Committee*: All members must be non-executive directors. There should be a written charter outlining the committees' authority, duties, responsibilities and relationship with the Board. Non-member directors and employees should only attend meetings of the Committee on invitation. The Board must regularly review the committee's performance against the charter. Members of the committee must be identified in the annual report.
- *Remuneration committee*: There should be a remuneration committee that recommends remuneration packages for directors to shareholders. Members must be identified in the annual report and there should be a written charter outlining the committees' authority, duties, responsibilities and relationship with the Board. The Board must regularly review committee performance against the charter.
- *Nomination committee*: This committee must be established to recommend director appointments to the Board, members must be named in the annual report and the majority must be independent. This committee must also have written charter and be regularly reviewed against that charter by the Board.

Section 4: Relationship with individual auditor

The audit committee must address the issues of auditor independence. This requires that the Board:

a. Establish a formal and transparent procedure for sustaining communication with the Issuer's independent and internal auditors;
b. Ensure the ability and independence of the auditors to carry out their work is not impaired;
c. Address what services (if any) other than the statutory audit role that the auditors may provide to the company; and
d. Provide for the monitoring and approval by the audit committee of any such additional services by the auditor to the company.

Other NZX Listing Rules relevant to Corporate Governance

Separate from the Code, there are numerous other Rules that companies must comply with. Below is a summary of the key ones that have an impact on corporate governance.

- *Board composition*: A Board must have a minimum of two independent directors or if there are eight or more directors, three (or one third rounded down to the nearest whole number of directors, whichever is the greater).
- *Identify independent directors*: The Board must identify which directors it regards as independent:
  a. no later than 10 working days after its annual meeting, and the Issuer must release to the market the names of those directors determined by the Board to be independent;
  b. immediately in respect of any director appointed by the Board and the Issuer must release to the market whether it regards the appointee as independent; and
  c. prior to the publication of its annual report.
- *Interpretation - Independence*: A director is independent if they are not an executive of the Issuer and do not have a disqualifying relationship. A disqualifying relationship exists if the director has a direct or indirect interest or relationship that could reasonably influence in a material way the director's decisions in relation to the Issuer. All circumstances including history of relationship or future plans are relevant to determining a disqualifying relationship.
- *Audit committee membership*: An Issuer must have an audit committee comprising only of at least three directors and the majority must be independent. At least one must have an accounting/financial background. Such background exists if such person:
  a. Is a member of the Institute of Chartered Accountants of NZ; or
  b. Has held a CFO position at an Issuer for more than 24 months; or
  c. Has successfully completed a course approved by the NZX for Audit Committee membership; or

d. Has experience/qualifications deemed satisfactory by the Board.

This last option is a concession by the NZX and will be judged in light of the above objective criteria.

- *Audit committee responsibilities*: These include:
  a. ensuring processes are in place and monitoring those processes so that the Board is properly and regularly informed and updated on corporate financial matters;
  b. recommending the appointment and removal of the independent auditor;
  c. meeting regularly to monitor and review the independent and internal auditing practices;
  d. having direct communications with, and unrestricted access to, the independent auditor and any internal auditors or accountants;
  e. reviewing the financial reports and advising all directors whether they comply with the appropriate laws and regulations; and
  f. ensuring that the external auditor or lead audit partner is changed every five years. This requirement may be waived if the Issuer is a "public entity" under s4 of the Public Audit Act 2001.

Effectiveness of NZX Listing Rules

The Rules contain the terms of a contract under which Issuers wishing to have their securities traded through NZX undertake to abide by rules imposed to facilitate the efficient operation of the market in the interests of securities Issuers, buyers, sellers and brokers.[6] A breach of the Rules is therefore a breach of contract and the NZX can take action against an Issuer by pursing and exercising its remedies against Issuers who fail to comply with the Rules.

Some of the sanctions that are available for breach of the Rules by the Issuer, a director or management include:[7]

- private reprimand (if confidentiality is important);
- a public statement by the NZX (with or without further action);
- public statement of unfitness to serve as a director;
- suspension or cancellation of listing;
- public censure;
- an order that remedial requirements are undertaken;
- financial penalties against the Issuer, director(s) or management;
- denial of market access for a specified period; or
- de-listing of the Issuer.

The factors relevant to the penalty imposed include the circumstance of the breach, the severity of the breach, the benefit obtained or the detriment suffered as a consequence, past conduct and repeat offences.

Compared with the Commission principles, listed companies face not only a strict reporting and monitoring process but a wide range of sanctions if they breach the Rules (including the requirements of good corporate governance). This regime provides incentives for directors of listed companies to ensure they are abiding by the Rules and also operating in line with the principles of good corporate governance.

The changes to the NZX Rules and Code along with the Principles recently announced by the Commission will be much less intrusive into Boards' corporate governance practices than the approaches adopted in the United States or Australia. The non-binding nature of the principles and the disclosure of whether the Board's practice "materially differs" from the principles in the Code will enable individual directors to be aware of their roles and responsibilities without burdening directors or boards with strict regulatory and reporting requirements.

Accounting Standards

Accounting standards and international norms are a key way of regulating the way the financial information of companies is recorded and reported. Post Enron, the International Accounting Standards Board published two revised standards that have been welcomed by the Commission and the Institute of Charted Accountants' Financial Reporting Standards Board. They relate to disclosure and presentation of information and also the recognition and measurement of financial assets.

IAS 32 contains requirements for the presentation of financial instruments and identifies the information that should be disclosed about them, This includes matters such as how to determine whether a financial instrument is a financial liability of an equity instrument. The disclosure requirements are intended to assist readers in assessing the risks an entity faces and the policies an entity has in place for controlling those risks. This standard is important given the amount of corporate failure that arises from the directors not fully understanding the financial aspects of the company and the real risks it faces.

IAS 39 establishes principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items, The standard specifies when and how financial assets and liabilities should be reported on or off the balance sheet. It also requires all derivatives and certain other financial assets and liabilities to be accounted for at fair value, and restricts the use of hedge accounting techniques to defer the recognition of gains and losses.

[6] From the NZX Rules, Foreword, paragraph 1.

[7] Extracted from the publication "Improving Regulatory Structure and Performance – Redefining the NZSE Regulatory Framework", May 2003.

Officials have taken a light handed regulatory approach, opting to allow companies space to manage and monitor their own governance performance before the regulators will step in. This approach puts trust and responsibility on all directors to ensure they undertake their role with integrity and the utmost good faith.

Conclusions

The collapse of Enron and other large companies has focused the minds of regulators, directors, shareholders and employees to the reality of corporate governance failure. There are many practical steps that individuals and boards can take to minimise the risk of a cover-up or scandal of this nature, some of which have been outlined in this paper. The importance of reliable corporate risk management has been emphasised by the recent, high profile failures and now is the time for companies to start addressing these issues.

The principles, guidelines and rules for corporate governance in New Zealand have been established. Post-Enron we can expect the New Zealand Stock Exchange and the New Zealand Securities Commission to take a robust, principled approach to corporate governance into the future.

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