CORPORATE GOVERNANCE

Fad or Friend

Dr Ted Dahms

Queensland Audit Office

March 2002

CORPORATE GOVERNANCE

FAD OR FRIEND

Ted Dahms, Audit Principal, QAO

INTRODUCTION

In recent times the topic of corporate governance is appearing with great regularity. The concept has a long history, which can be traced in its present form to the early 19th century. It has risen to prominence due the excesses of the 80's which led to major corporate collapses not only in Australia but also overseas. Since that time the private sector governance concept has been adapted and applied to public sector organisations. During the late 1990's a number of Auditors-General in Australia have undertaken governance reviews of various public sector entities (*Further Reading* 1-5). The recent major collapses of HIH Insurance, Enron, Ansett and Onetel serve to keep the concept on the front pages of newspapers. The question arises, 'Is the concept just another management fad and a reactive response to these collapses or does it have practical value?' This paper takes the view that effective governance is the key to organisational performance and prudently implemented is a friend not a fad.The basic theme throughout this paper is that Corporate governance is a leadership concept with a focus on results, and I have long held the view that leadership is a mixture of two elements, common sense and common courtesy. In line with this theme the dialogue that follows is in two parts.

The initial discussion outlines governance systems in terms of principles that can be universally applied across all organisations, and frameworks that can and do vary from organisation to organisation.

This distinction between principles and frameworks is fundamental to an understanding of governance. The principles are essentially common management tools drawn together into a logical, inter-related system focussed on achieving results. Their application therefore can not be regarded as a new fad and is nothing more that common sense.

Governance frameworks are management structures within which the principles of corporate governance operate. Parts of the management structure are mandatory and set by legislation e.g. *Corporations Law*, the *Financial Administration and Audit Act 1977*, the *Financial Management Standard 1997*, *Government Owned Corporations Act 1993* and the various pieces of enabling legislation for statutory bodies. Others are discretionary and set by senior management to address the governance principles and vary from organisation to organisation even within the same mandatory management structure.

The final discussion provides a broad outline of the underlying value system necessary to develop a learning organisation focussed on results, i.e. a performance organisation rather than a conformance organisation. This value system is centred upon the implementation of a corporate culture which builds trust and develops relationships. It requires sound people skills, the foundation of which is common courtesy.

CORPORATE GOVERNANCE PRINCIPLES

The concept of corporate governance embodies a number of accepted management tools which have been around for some time. The value of corporate governance is that it draws these tools together into a logical, inter-related set of principles. To examine the inter-relationships it is necessary to review a definition of corporate governance.

> *Corporate governance is the way in which an organisation is governed and controlled in order to achieve its objectives. The control environment makes an organisation reliable in achieving these objectives within an acceptable degree of risk.*

- Inherent in this definition is the development of objectives and strategies through corporate planning and the establishment of controls to ensure that the objectives will be met.
- Operational plans are developed from the objectives and from these the organisational structure and the roles and responsibilities of members of the organisation are developed. Roles and responsibilities are clearly set out and communicated in position descriptions, performance plans, polices and procedures.
- Delegations are put in place to ensure that responsibilities are matched with the necessary authority.
- A code of conduct provides members of the organisation with the expected standard of behaviour and is directed at fraud prevention, client service and creating a culture which fosters trust and builds relationships.
- Monitoring and reporting processes are developed to ensure –
    - conformance with laws, policies, procedures, and the code of conduct;
    - performance against the corporate and operational plans.
- Internal and external reporting provides accountability.
- Information is the currency of good governance. Therefore the governing body and committees need to develop an information game plan to include the following –
    - All governing bodies/committees should receive quality information in a timely fashion. It is essential that such bodies/committees formally determine the type, format and timing of the information they require and that they convey this determination to the appropriate members of the organisation. Information of this nature is required for effective decision making.
    - All members of the organisation need to know how their role contributes to the achievement of the organisation's objectives. In this way members of the arrangement will become aware of any process which is not functioning effectively and will feel comfortable in suggesting improvements. This process of continuous improvement is an important principle of quality management.
    - All members of the organisation must be provided with information necessary for them to discharge their responsibilities and this information needs to be communicated in a timely manner. Included here are decisions made by the governing body/senior managers and the clear definition of roles, responsibilities and authorities through readily available policies, procedures and delegations.

- ➢ Decisions made by senior management must be readily transmitted to the appropriate members of the organisation. Systems to ensure adequate downward and lateral information flow should be developed.

A corporate and risk management culture needs to be developed and maintained within the organisation. Both of these are the responsibility of senior management and provide the underlying value system necessary for attaining effective governance. They are achieved by the implementation of the elements of corporate governance and the provision of training so that all members of the organisation have an understanding of –

- the concepts and the principles underlying these concepts; and
- how their individual roles contribute to the achievement of the organisation's objectives.

CORPORATE GOVERNANCE FRAMEWORKS

Governance frameworks are management structures within which the principles of corporate governance operate. Because organisations vary in size, complexity, structure, legislative background *etc* there is no one corporate governance framework that fits all. Organisations should develop frameworks to address the elements of corporate governance to suit their particular situation.

It is possible to recognise a number of governance framework models across the private and public sectors. Corporate governance had its origin in the private sector where shareholders delegate many of their responsibilities as owners to company directors who together as a board oversee the executive management of the business on their behalf.

In the public sector, corporate governance is the way in which Parliament, Government and public sector entities relate to one another in stewardship matters. Due to the diversity of operations in the Queensland public sector several governance frameworks exist as follows —

- Statutory Bodies (including Statutory Authorities, Universities);
- Government Owned Corporations;
- Local Authorities;
- Aboriginal and Island Councils; and
- Departments.

Statutory Bodies, Government Owned Corporations, Local Authorities and Aboriginal and Island Councils more closely resemble the private sector in having governing boards constituted under legislation, non-executive members of the board and a non-executive member as chairman.

Queensland departments provide a very different framework. They do not have management boards, but may have an executive group whose function is to provide support for the accountable officer in stewardship of the department. This arrangement has a number of differences from the private sector as follows —

- accountability resides with a single person in the chief executive – the accountable officer;
- members of the department's management group are also executive officers whereas company boards are mostly comprised of non-executive members;
- the Executive Group is an advisory body not a governing body; and
- the chairman of the departmental executive group is normally the accountable officer whereas in private sector companies the roles of chief executive and chairman of the board are most often separate.

Notwithstanding these differences, the corporate governance principles may be applied to the control and direction of departments. Executive groups like boards are served by committees and effective information flow, clarity in role definitions, the balance of responsibility and authority, an effective control environment, effective reporting lines and accountability are essential for their proper functioning.

CONTROL AND RISK MANAGEMENT

The concepts of internal control and risk management had very different origins, but they have become inseparable. To understand the relationships between these two concepts it is necessary to examine their origins and the subsequent shifts in perceptions.

Internal Control

Internal control had its origin with the accounting profession and understandably its focus was financial controls and legal compliance. The current expanded perception of internal control has been put forward in a variety of definitions.

The New South Wales Treasury[1] expanded the definition to cover the efficiency and effectiveness of all of an organisation's operations, and the associated processes and risks that impact on the achievement of its objectives.

In their view *internal control is a process effected by an organisation's Board of Directors, Chief Executive Officer, senior management and other members of the organisation, designed to provide reasonable assurance regarding the achievement of the organisation's objectives.*

The Canadian Institute of Chartered Accountants proposed that *control comprises those elements of an organisation (including resources, systems, processes, culture, structure and tasks) that, taken together, support people in the achievement of the organisation's objectives*[2].

One of the major developments in the new control frameworks and models was to recognise the essential contribution of what Leithhead[6] refers to as soft controls. Previously control was regarded as bureaucratic control, with second party authorisation and segregation of duties.

Soft controls are the human dimension of control and include leadership, teamwork, culture, values, communication, accountability, anticipation, flexibility and capability.

RISK

Risk management had its origin in the insurance industry and the main emphasis was on insurable risks for example –

- workplace health and safety;
- property loss or damage; and
- professional negligence.

More recently the principles of risk management have been applied to non-insurable risks and as with internal control has broadened its scope to embrace all business activities such that the concepts of internal control and risk management have converged. Further understanding of this convergence can be gained from examining the risk management procedures which involve the following steps –

- identification – you cannot manage what you don't know;
- analysis – examination of the combined effect of likelihood and consequences (risk rating);
- assessment of likely effect taken from the risk rating;
- treatment; and
- monitoring of risks.

Monitoring is necessary because risk has a dynamic context resulting from the constantly changing external and internal environments.

In my view, cost effective internal controls are equivalent to the treatment plans put in place to manage risks. Risk management is therefore the tool which assists in the development of the control environment and plays a key part in corporate governance.

To understand the relationship between risk management and corporate governance it is necessary to return to the definition —

> *Corporate governance is the way in which an organisation is controlled and governed in order to achieve its objectives. The control environment makes an organisation reliable in achieving these objectives within an acceptable degree of residual risk.*

The definition dwells heavily on control and oversight, but there is a paradox in that the organisation also needs to be flexible in order to respond to changes in its internal or external environments.

Risk management not only provides a strategy for treating risks which might impede an organisation in pursuit of its objectives, but also provides the flexibility for the organisation to respond to unexpected risks and take advantage of unexpected opportunities. Risk management therefore provides the resilience.

Corporate governance may be regarded as the glue which holds an organisation together in pursuit of its objectives. Risk management provides the resilience for an organisation to respond to unexpected risk and opportunities.

IMPLEMENTATION

There are two key considerations in this process. In the first instance implementation of an effective governance framework does not mean abandoning everything that is currently in place. Governance principles as outlined earlier are essentially common management practices that underpin the framework. Rather it entails refining and integrating current practices in line with the governance principles. This being so, governance cannot be regarded as a new fad. The QAO Self Assessment Program developed for testing governance and risk management practices in Queensland departments can be used as a guide for implementation. A schematic is provided at Attachment A.

The second consideration is that the establishment of a governance framework without an underlying value system encourages compliance rather than commitment. Elements of the underlying value system include systems thinking, developing key competencies, motivating trust and relationships, and developing a learning organisation.

Establishing an underlying value system is a leadership responsibility involving cultural change which takes time. Implementation of an effective governance system is therefore an evolutionary process rather than a revolutionary one and with a gradual change from a compliance-focussed or controlled organisation to a results-focussed or learning organisation. Constituted in this way an effective governance system is a friend and not a fad.

SYSTEMS THINKING

Organisations are complex systems. The traditional method of dealing with complexity is to break it down into component parts and examine each part in isolation. This process is followed in designing an organisational structure and assigning roles and responsibilities throughout the structure. The very act of assigning roles and responsibilities predisposes the organisation to fragmentary or silo behaviour where individual parts concentrate on their assigned tasks and function independently rather than as an integrated whole focussed on organisational goals. Where fragmentary behaviour develops, a compliance mentality follows and the worthy concepts of continuous improvement and innovation fall by the wayside. Performance is diminished and opportunities are lost.

Systems thinking takes an holistic view of an organisation based upon the observation that autonomy is never absolute and that we are all interdependent on each other. Decisions are never taken in isolation. An analogy would be an organisation as a still pool of water and the impact of one decision a rock thrown into the pool. The influence of that action can be seen in the ripples which radiate out from the impact to reach all parts of the pool. Now imagine a handful of stones thrown into the pool and you can appreciate the complexity of the interactions that occur – each action contributes to patterns of interrelated actions.

Organisations do not operate as closed isolated systems but in a world that is both dynamic and complex. The internal and external environments are constantly changing creating situations which lead to competition and collaboration both of which present opportunities and risks which must be managed. Organisations are therefore continuously adapting to change and are co-evolving with others.

In applying this to organisations the leadership skill is in promoting an understanding that all divisions of the organisation are part of an interconnected whole with the corporate goals as the unifying force.

LEARNING ORGANISATION

Peter Senge[5] in his book entitled The Fifth Discipline defines a learning organisation as:

> "*an organisation that is continually expanding its capacity to create its future. For such an organisation, it is not enough to merely survive. 'Survival learning' or what is more often termed 'adaptive learning' is important – indeed is necessary. But for a learning organisation, 'adaptive learning' must be joined by 'generative learning,' learning that enhances our ability to create*."

Here Senge means generative learning as the way of expanding an organisation's capacity to create rather than change by events of the moment (adaptive learning). The former is creative the latter reactive.

Those factors which facilitate the change from a controlling to a learning organisation include the development of a shared vision which in turn relies upon open communication in a climate of commitment and trust. New ideas are able to be shared allowing alignment of ideas to give a common direction and this gives rise to team learning. In this environment risk taking is encouraged, learning is shared and the focus of all members is on organisational performance.

TRUST & RELATIONSHIPS

Building trust and relationships is grounded in the ethical concept of respect for people and has two important outcomes.

Where interdependent agents wish to co-ordinate their behaviours they must invest in creating, building and maintaining trustful relationships. Earlier it was pointed out that trust together with open communication is essential to promote a learning organisation in which a shared vision can lead to team learning. Without trust both parties descend into non-communicative and defensive behaviour. Innovation and synergy do not flourish and the opportunity is lost for two to achieve more than they could by operating separately. This applies equally between organisations.

Taking another view, the more we can build relationships based upon trust in an organisation at all levels the less will we need to retain command/control structures founded on compliance. Where members of the organisation are willing to accept accountability and perceive that they are operating in an environment of trust and synergy the reliance on conformance is reduced. A greater focus of performance results. Complementing the aspect of trust is the development and maintaining a match of competencies with assigned responsibilities.

COMPETENCIES

It is a matter of common sense that an organisation must align the competencies of its employees with its goals if it is to be successful. This is facilitated by sound HR practices involving job design with matched position descriptions, recruitment and selection, professional development, performance planning, staff retention and succession planning. Because we are in a era of rapid change these practices must be continually reviewed to ensure the organisation maintains its core competencies and builds new competencies to take advantage of opportunities. Senior managers must view the organisation as a portfolio of competencies, of underlying strengths and not just a portfolio of business units[3]. In short strategic HR planning is a fundamental tool for success and should not be neglected.

SUMMARY

Governance has an underlying set of principles which are based upon management tools that have been around for some time. These principles can be universally applied and operate within governance frameworks which are in part set by legislation and in part designed to suit the organisation. Frameworks therefore can and do vary from one organisation to another.

Implementation of a governance system is an evolutionary process not a revolutionary one and involves cultural change as well as system changes. The building of a shared vision in an environment of commitment and trust are keys elements of a performance organisation where continuous improvement is a way of life and risk taking is encouraged.

It can be said that implementation of an effective governance system is more art than science. Broadly speaking, the science is in development of the mandatory management structure. The design of the discretionary elements of the governance framework and the creation of an underlying value system are the leadership elements of effective governance implementation and constitute the art. Both the are rooted in common sense and common courtesy.

NOTES

1. Risk Management and Internal Control. A Step by Step Approach to Managing Risk More Effectively. *New South Wales Treasury, September 1997: 4 volumes.*
2. **Control and Governance No. 1. Guidance on Control. *Canadian Institute of Chartered Accountants, Ontario, Canada, November 1995: 32pp.***
3. Prahalad, C K, 1998. Growth Strategies. *Executive Excellence*, January 1998: 6-7.
4. Hamel, G, 1998. Path Breaking. *Executive Excellence*, January 1998: 3-4.
5. Senge, P M, 1992. The Fifth Discipline, the Art & Practice of the Learning Organisation. *Random House, Australia, 1992: 424pp*.
6. Leithhead, B S, 1998. Control Self Assessment's Contribution to Corporate Governance. *In* Delivering Good Governance. *Institute of Internal Auditors Conference, Gold Coast, Queensland, 1998: 14pp.*

FURTHER READING

1. Corporate Governance, Beyond Compliance. *Audit Report No. 7 1998-99. Queensland Audit Office 1999: 65pp.* http://www.qao.qld.gov.au/
2. Corporate Governance and Risk Management Self Assessment Program. *Queensland Audit Office 2000.* http://www.qao.qld.gov.au/
3. Corporate Governance and Risk Management *Follow-up Review. Audit Report No. 1 of 2001-02. Queensland Audit Office, September 2001*. http://www.qao.qld.gov.au/
4. Applying Principles and Practice of Corporate Governance in Budget Funded Agencies. *Australian National Audit Office, Canberra, Australia, 1997: 14pp*. http://www.anao.gov.au/
5. Corporate Governance Performance Audit Report. *Audit Office of New South Wales, 1997 Vol 1: 102pp; Vol 2 : 86pp & Supplement to Vol 2: 32pp*.
6. **Guidance for Directors. Control and Governance Number - 2- Governance Processes for Control. Canadian Institute of Chartered Accountants, Ontario, Canada, 1995:18pp.**
7. **Guidance on Assessing Control. Control, Risk and Governance No.3. The Canadian Institute of Chartered Accountants, 1999: 44pp**.
8. Flood, R L, 1999. Rethinking the Fifth Dimension. *Routledge, New York, 1999: 213pp.*
9. Pound, J, 1995. The Promise of the Governed Corporation. *Harvard Business Review, Vol. 73: pp 89-98*.
10. **McNamee, D, 1998. Control frameworks and Self Assessment. Management Control Concepts, Alamo, CA, 1998: 135pp. *http://www.mc2consulting.com/***
11. Root, S J, 1998. Beyond COSO. Internal Control to Enhance Corporate Governance. *John Wiley & Sons, Inc, 1998: 340 pp*.
12. Welcome Aboard: a Guide for Members of Queensland Government Boards, Committees and Statutory Authorities. *State Affairs Branch, Department of the Premier and Cabinet, Brisbane, Queensland, January 2000*.

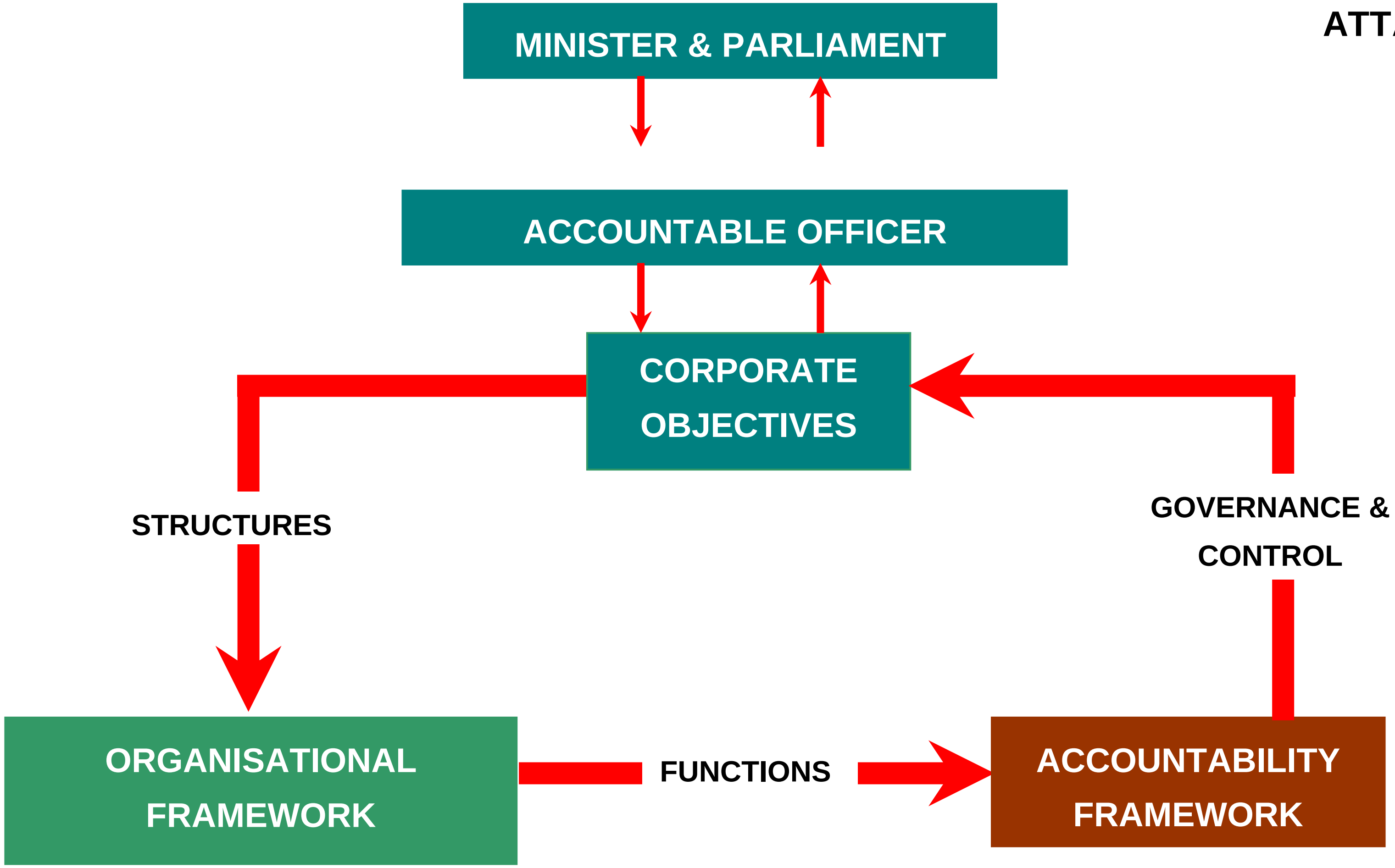
13. Business Continuity Management - Keeping the Wheels in Motion. A Guide to Effective Control*. Australian National Audit Office, Canberra, January 2000*. http://www.anao.gov.au/

14. Internal Control, guidance for Directors on the combined Code*. The Institute of Chartered Accountants in England and Wales*. http://www.icaew.co.uk/internalcontrol

15. Enhancing Shareholder Wealth by Better Managing Business Risk*. International Federation of Accountants (IFAC), 1999: 49pp.* http://www.pwcglobal.com/ch/eng/ins-sol/publ/risk/enhanced.html

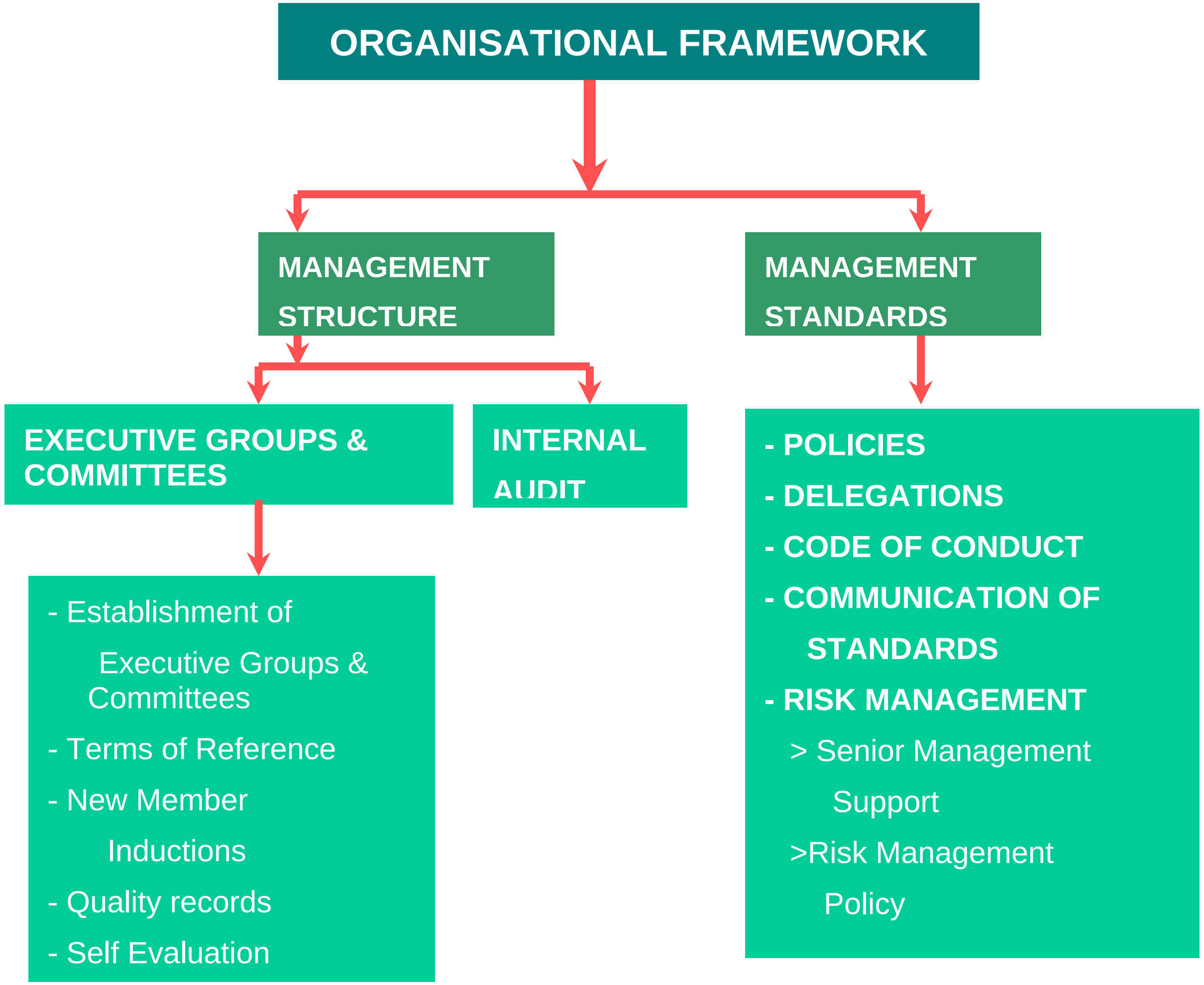
16. Supporting Innovation: Managing Risk in Government Departments*. Comptroller and Auditor-General, National Audit Office, London, 2000: 129pp*. http://www.nao.gov.uk/publications/nao_reports/9900864.htm

ATTACHMENT A

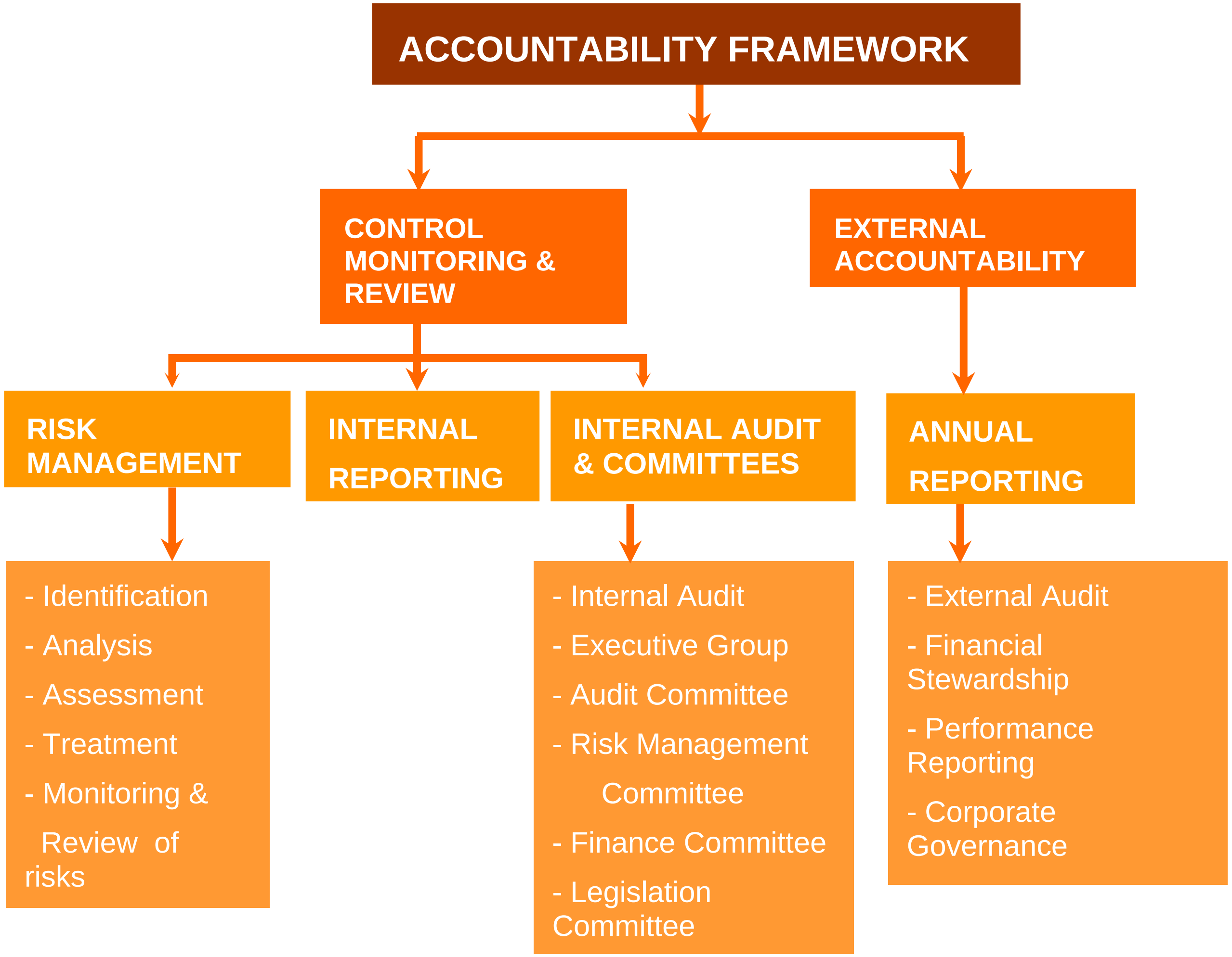


ATTACHMENT A

ATTACHMENT A



ATTACHMENT



ACCOUNTABILITY FRAMEWORK
CONTROL MONITORING & REVIEW
EXTERNAL ACCOUNTABILITY
RISK MANAGEMENT
INTERNAL REPORTING
INTERNAL AUDIT & COMMITTEES
ANNUAL REPORTING
- Identification
- Analysis
- Assessment
- Treatment
- Monitoring & Review of risks
- Internal Audit
- Executive Group
- Audit Committee
- Risk Management Committee
- Finance Committee
- Legislation Committee
- External Audit
- Financial Stewardship
- Performance Reporting
- Corporate Governance