CHAPTER 7

INTERNAL CONTROLS

The board of directors

7.1 The members in general meeting and the board of directors are the two main components in the structure of a company. The distribution of power between the two is governed by legislation and by the company's articles of association. Usually, the general meeting is given specific powers and the board of directors the residual ones.

7.2 The board is made up of the directors of the company. Under the Companies Code, a public company must have at least three directors and a proprietary company must have at least two.[1] A 1988 survey showed that the average size board among Australia's public listed companies was 9.3. The average board size for proprietary companies was 7.5 (see table 1, page 117).

7.3 Articles of association usually distribute power so that the board of directors rather than the general meeting controls the company. The articles usually confer wide management powers and the powers are conferred on the directors collectively, not individually. The general meeting has the power to appoint and dismiss the board, but in reality this power is limited (see paragraphs 7.38, 7.39). For the most part, the management of the company is firmly in the hands of the board and shareholders must be content to be passive owners.

What is a director?

7.4 The Macquarie Dictionary defines a director as

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1. *Companies Code, s219(1) (Corporations Act, s221(1))*.

one of a body of persons chosen to control or govern the affairs of a company or corporation.

7.5 'Director' is defined in section 5 of the Companies Code as including:

a) any person occupying or acting in the position of director of [a] corporation, by whatever name called and whether or not validly appointed or duly authorised to act in the position; and

b) any person in accordance with whose directions or instructions the directors of [a] corporation are accustomed to act.

7.6 In the Corporations Act 1989,

a reference to a director, in relation to a body corporate, includes a reference to:

(a) a person occupying or acting in the position of director of the body, by whatever name called and whether or not validly appointed to occupy, or duly authorised to act in, the position;

(b) a person in accordance with whose directions or instructions the directors of the body are accustomed to act;

(c) in the case of a body corporate incorporated outside Australia:

(i) a member of the body's board;

(ii) a person occupying or acting in the position of member of the body's board, by whatever name called and whether or not validly appointed to occupy, or duly authorised to act in, the position; and

(iii) a person in accordance with whose directions or instructions the members of the body's board are accustomed to act; and

(d) in the case of a close corporation - a member of the close corporation.[2]

7.7 Professional advisers are specifically excluded from the definition in the Corporations Act:

> A person shall not be regarded as a person in accordance with whose directions or instructions:
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> (a) a body corporate's directors; or
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> (b) the members of the board of a body corporate incorporated outside Australia;
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> are accustomed to act merely because the directors or members act on advice given by the person in the proper performance of the functions attaching to the person's professional capacity or to the person's business relationship with the directors or the members of the board, or with the body.[3]

7.8 Clearly, the definition is expansive. McMahon suggests that the purpose of such a wide definition is 'obvious':

> It is to include within the ambit of the responsibilities that a Director must bear all those persons who really are the heart and soul of the company, by whatever name they may be called.[4]

7.9 In its submission to the Committee, the NCSC suggested that

> [r]ecognition has been given in recent years to the considerable power which executive officers can exercise in the management of companies vis-a-vis that of directors.[5]

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2. *Corporations Act 1989, s60(1).*
3. *Ibid, s60(2).*
4. *McMahon, BJ, The Australian Company Director, 1972, Rydge Publications, Sydney, 1972, p 9.*
5. *Submission from NCSC, p 3 (Evidence, p 562).*

7.10 The NCSC suggested that the trend toward more powerful executive officers had increased in recent years

> as directors, particularly of large corporations, have become more concerned with broadbrush issues and executives are employed for their expertise in particular areas of management.[6]

7.11 The NCSC said that this situation raises the question whether the legal responsibilities of executive officers are (and, if not, whether they ought to be) commensurate with the fact that the real power to manage the company rests with them.[7] The NCSC referred to the Companies Code's imposition on secretaries and executive officers of the same duties of honesty, care and diligence as it imposes on directors. Similarly, secretaries and executive officers are subject to the same penalties as directors for making improper use of information. (See paragraph 3.16.)

7.12 The NCSC referred the Committee to section 556 of the Companies Code (Corporations Act, s592), which provides for civil and criminal penalties in relation to the incurring of debts or fraudulent conduct.[8] The section explicitly applies to directors and any persons 'who took part in the management of the company'.

7.13 The Institute of Directors was less impressed by the expansive nature of the Companies Code definition and the obligations imposed. It submitted to the Committee:

> While recognising the extraordinary difficulty posed in defining a director we believe that it has become totally inequitable to use the word director without some form of clearer differentiation of [the] position from an

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6. *Submission from NCSC, p 3 (Evidence, p 562).*
7. *Submission from NCSC, p 3 (Evidence, p 562).*
8. *Submission from NCSC, p 3 (Evidence, p 562).*

officer in a company.[9]

7.14 The Institute suggested that the current use of the word in the Companies Code was a drafting convenience

> as it relieves the draftsman of thinking about the objectives of the law being drafted.[10]

7.15 The Institute submitted that the enactment of the close corporations legislation would assist.[11] However, it was the Institute's view that

> further differentiation needs to be made depending upon the exact nature of the relationship between the directors and the shareholders/proprietor.[12]

7.16 As the NCSC pointed out (see paragraphs 7.9, 7.10), in recent years there has been a trend towards non-director officers becoming increasingly powerful within companies. This is understandable, given the preponderance of non-executive directors in Australia's boardrooms.[13] The expansive definition of 'director' in the companies legislation takes account of this trend and it is appropriate that it does so.

Representative directors

7.17 Directors might be appointed to a board to represent the interests of a particular group - for example, an institutional

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9. *Submission from Institute of Directors in Australia, p 2 (Evidence, p 120).*
10. *Submission from Institute of Directors in Australia, p 2 (Evidence, p 120).*
11. *Submission from Institute of Directors in Australia, p 2 (Evidence, p 120).*
12. *Submission from Institute of Directors in Australia, p 2 (Evidence, p 120).*
13. *Australia's board 'mix' - public companies: Korn Ferry, AGSM survey cited by Kohler, A, 'Chanticleer'* Australian Financial Review*, 5 May 1989, p 88.*

shareholder, a major creditor of the company, or the company's employees - or to act in accordance with some understanding or arrangement with a person or persons other than the company as a whole. Generally such directors are referred to as 'nominee' directors. The Companies Code recognises nominee directors.[14] Because of their commitment to other interests, there is a risk that nominee directors will be unable to fulfil the usual requirements of a director to act in the best interests of the company as a whole.[15]

Executive vs non-executive directors

7.18 Company directors fall into two basic categories. Executive directors are full-time employees of the company and have a contract of employment with it independent of their position as a director. Non-executive directors are 'outside' directors. They are generally appointed because they bring particular skills to the board and can approach decision making from an independent perspective. Mr Brian Loton, the Managing Director of BHP, suggested that one reason for the appointment of non-executive directors is

> to bring to bear a broader perspective, more background, a wider range of skills on a particular issue or indeed on the management of the company...[16]

7.19 Often the company secretary, accountant, solicitor, marketing or personnel manager will, because of his or her working knowledge of the company, be appointed as a director.

7.20 The Institute of Chartered Accountants suggested that

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14. *See s225(1) (Corporations Act, s227(2)).*
15. *See Companies and Securities Law Review Committee, Nominee Directors and Alternate Directors, Report No 8, 2 March 1989, for a full discussion of these issues.*
16. *Evidence, p 618.*

> a board in toto should ideally represent a balance of qualifications and experience. Maybe if you look at the board as a whole, you can see that one person is less qualified formally than another but would make up for that in experience or by some other contribution.[17]

7.21 Non-executive directors are quite common in public companies and relatively rare in small, family-centred, proprietary companies.[18] The absence of non-executive directors in proprietary companies is because those companies are generally based on small enterprises such as a family business. The directors are usually family members. There is little need or scope for the involvement of persons not directly involved in the business.

The composition of the board

7.22 In Australia, the average board has three executive and six non-executive directors (see table 1, page 117). Compared to the United Kingdom, where the ratio is five executive to three non-executive directors, and the United States, where the ratio is 4:10, the mix in Australia has been described as 'about right'.[19]

7.23 Mr John Richardson, of Peat Marwick Hungerfords, told the Committee that

> [i]n the public company context, I must admit that I would prefer there to be always a majority of non-executive directors at the board level because the board, to my mind, should be setting overall policy and philosophy, and should be questioning and considering what the entity has done, and

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17. *Evidence, p 55 (Mr Prosser).*
18. *Corkery, JF, Directors' Powers and Duties, Longman Cheshire Pty Ltd, Melbourne, 1987, p 3.*
19. *Kohler, A, 'Chanticleer', Australian Financial Review, 5 May 1989, p 88, quoting Mr Guy Pease, former chairman of Korn Ferry International.*

therefore being a sounding-board.[20]

7.24 The need for non-executive directors is increased with the introduction of audit committees. The Institute of Directors told the Committee:

> Most commentators who refer to audit committees insist that audit committees must be predominantly made up of non-executive directors ... those who promote audit committees should also be strongly promoting an increase in the use of non-executive directors in all companies because only in that way will you be able to have a sufficient body of directors to be able to conduct audit committees properly. A company which has all executive directors a priori cannot have an effective audit committee ...[21]

The Institute advocated the use of non-executive directors.[22]

7.25 Mayne Nickless Limited said that both the UK Institute of Directors and the London Stock Exchange had endorsed the need to appoint more non-executive directors to the boards of British companies.[23] The Committee notes that, in the United Kingdom, boards tend to be weighted 3:5 against non-executive directors.[24]

7.26 Neither the UK Institute of Directors nor the London Stock Exchange suggest that boards should have a majority of non-executive directors.[25]

7.27 It can be argued that executive directors are the best guarantee of commercial success because they are wholly committed, full-time managers with a significant personal stake

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20. *Evidence, pp 17-18.*
21. *Evidence, p 149 (Mr Bartels).*
22. *Evidence, p 149 (Mr Bartels).*
23. *Submission from Mayne Nickless Ltd, p 2 (Evidence, p 374).*
24. *Kohler, A, 'Chanticleer', Australian Financial Review, 5 May 1989, p 88 (citing a Korn Ferry, AGSM survey).*
25. *Submission from Mayne Nickless Ltd, p 2 (Evidence, p 374).*

in the success of the company. It can also be argued that the non-executive director, who brings an outside perspective to bear on the company's affairs and whose outlook is not overborne by current projects and problems, is the key to success.

7.28 The optimal number of independent, or non-executive, directors is a matter for each company. It would be incongruous to fix a specific mix of executive and non-executive directors for all boards. Various companies need various blends of talent, skill and personalities. The Committee considers that both executive and non-executive directors should be on the boards of public companies, in proportions best suited to each company.

Charitable and other non-profit companies

7.29 Section 66 of the Companies Code (Corporations Act, s383) provides for the registration of charitable and other non-profit organisations as companies, without the inclusion of 'limited' in their company name eg the National Safety Council of Australia (Victorian Branch). This means that the company is given all the benefits of limited liability without having to reflect this in the company name. It is entitled to certain prescribed exemptions from various lodgment and notification requirements which would otherwise be required pursuant to the Companies Code.[26] The directors of such companies are otherwise subject to the same duties and obligations as company directors generally.

Directors vs auditors

7.30 The Institute of Chartered Accountants contrasted the role of directors with the role of auditors. The Institute told the Committee that while a company's auditors, liquidators or receivers had to be qualified and registered, there were no such requirements for the people responsible for running the company

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26. *Companies Code, s66(5) (Corporations Act, s383(5)).*

in the first place.[27] They noted that in cases of corporate collapse there was an increasing tendency for the media to blame the companies' auditors rather than the directors.[28]

7.31 The media perception is partially attributable to what the Institute called the 'audit expectation gap':

> the perception of what an auditor does, versus the reality of what an auditor does...[29]

7.32 Mr Peter Middleton, the National President of the Institute of Chartered Accountants in Australia, told the Committee that the public assumed an auditor had checked every transaction when, in fact, the auditor has only used 'certain tests' and 'certain judgment'.[30] The auditor is not able to adjudge the business decisions taken by management.[31] He or she is simply required to certify that the balance sheet and accounts present a true and fair view of the company's financial activities.

7.33 The question of insurance was raised. Section 237 of the Companies Code (Corporations Act, s241) explicitly prohibits companies from insuring or indemnifying its 'officers' (including directors) or auditors against liability for negligence, default, breach of duty or breach of trust. Auditors independently carry professional indemnity insurance. However, the Institute told the Committee that auditors of companies were

> simply unable to obtain insurance cover to the level of their potential exposure.[32]

7.34 The Institute said the difference between the auditor's

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27. *Evidence, p 54 (Mr Middleton).*
28. *Evidence, pp 67-8 (Mr Middleton).*
29. *Evidence, p 69 (Mr Middleton).*
30. *Evidence, p 70 (Mr Middleton).*
31. *Evidence, p 69 (Mr Middleton).*
32. *Evidence, p 64 (Mr Middleton).*

insurance cover and the extent of potential liability was 'open-ended'.[33] Given a public perception that the auditor's insurance cover is able to meet any potential liability, the Institute conveyed to the Committee a fear of the 'deep pocket syndrome'. This involved aggrieved people deciding to 'go the auditors', on the basis that the auditors were assumed to be more than adequately covered by insurance. Quite apart from the gap between the actual and perceived levels of cover, this would have the effect of deflecting blame from the directors of a company to the auditors. The Institute found this 'extremely worrying'.[34]

7.35 The responsibility to see that a company is honestly, competently and profitably run is first and foremost that of its directors. That must be made clear to all. Auditors have a heavy responsibility to monitor the company's accounts properly. However, they should not be made scapegoats for the failure of directors to perform their tasks adequately. The law should reflect the community's growing expectation that directors be active, skilful and honest in their administration of the corporate sector. The Committee's recommendation that an objective duty of care be developed for company directors (see paragraph 3.28) will provide for this.

The division of power between directors and shareholders

7.36 Much of the attention given to the role of directors since the stock market collapse of October 1987 has focused on their treatment of investors. In theory, at least, directors administer a company on behalf of its shareholders. The dedication of some to that task has been questioned. The media have given extensive coverage to instances where investors' funds have been lost through ill-management in the corporate sector.

7.37 Shareholders depend on the board of directors for the

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33. *Evidence, p 64 (Mr Middleton).*
34. *Evidence, p 67 (Mr Middleton).*

success of their investment. Their ability to influence the board depends upon their relationship with it. This is based on the company's articles of association.[35]

7.38 Although it is possible for a company's articles of association to give expansive powers to the general meeting, for example, by giving it the right to declare dividends, to choose officers and to fix their salaries, and place strict limits on the powers of the board, this is rare. Commonly articles provide that the general meeting can periodically vote to determine the composition of the board but give it little power beyond that. Since the number of votes a person can cast depends on the number of shares the person has, those holding large numbers of shares decide who become directors. It is in those sitting as the board that the usual articles of association place the power to administer the company.[36] Shareholders may be in a position to refuse to re-elect directors of whose actions they disapprove,[37] but usually they will be able to do little. Shareholders as such are divorced from the company's management.

7.39 Legislation has sought to give shareholders a measure of control over their companies. Section 225 of the Companies Code (Corporations Act, s227) empowers a general meeting to remove a director of a public company during the period of his or her office. It is open to a private company to provide for a similar power in its articles.[38] Those who have substantial shareholdings benefit most from this kind of provision which has its own flaws:

> It is a double-edged sword which may facilitate the tyranny of the majority over

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35. *Section 76, Companies Code, provides that a company may alter or add to its articles by special resolution (Corporations Act, s176).*
36. *See, eg, Companies Code, Schedule 3, Table A, cl 66 (Corporations Act, Schedule 1, Table A, cl 66).*
37. *See John Shaw & Sons (Salford) Ltd v Shaw [1935] 2 KB 113 at 134 per Greer LJ.*
38. *See, for example, Companies Code, Schedule 3, Table A, cl 62(1) (Corporations Act, Schedule 1, Table A, cl 62(1)).*

minority and special interest groups.[39]

7.40 Even when there is a 'catch-all' provision such as reg 66 (see paragraph 7.38), there are some circumstances where the general meeting may be empowered to act in relation to matters generally within the control of the board. If there is a deadlock on the board or the board lacks a quorum, the general meeting may exercise management powers by ordinary resolution.[40] Similarly, the general meeting may be able to ratify directors' acts which are in abuse or excess of power (see paragraphs 11.48, 11.49), the shareholders may be able to bring an action (see chapter 11), and the 'informal corporate acts' doctrine gives shareholders a degree of control which is particularly relevant to small companies. This doctrine provides that a company is bound, in a matter that is within its power, by the unanimous agreement of its members, whether or not the agreement is given formally or informally.[41]

7.41 Efforts to give shareholders a greater say have had limited success. Following an inquiry into large quoted companies, one commentator painted a forlorn picture of shareholder inactivity. He found that

> a self-appointing oligarchy of directors has little difficulty in using the proxy voting device as a rubber stamp for its decisions. ... relatively few shareholders (generally less than 16 per cent) who have the right to vote make use of the proxy system, even when prepaid cards are supplied, and the proportion of voters opposing any resolution in normal circumstances is very small indeed. A mere quarter of one per cent, on average, of shareholders attended annual general meetings, which averaged less than half an hour in length; and at such meetings it was unusual

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39. *Afterman, Allen B, Company Directors and Controllers, Law Book Co Ltd, Sydney, 1970, p 20.*
40. *Eg Barrow v Potter [1914] 1 Ch 895; Foster v Foster [1916] 1 Ch 532.*
41. *Salomon v Salomon & Co Ltd [1897] AC 22 at 57 per Lord Davey.*

> for more than five questions to be asked and not uncommon for there to be no questions at all. The elaborate form of safeguard protection provided by statute - for example, the requisition of a meeting [Companies Code, s 241; Corporations Act, s246] - is also rarely used, and the chances of success for a dissentient shareholder who is prepared to incur the expense would appear to be remote.[42]

7.42 Midgley calls this the 'procedural facade of company control' rather than lack of responsibility in the shareholders. He says 'shareholders are realistic rather than irresponsible about formal company control procedures'.[43]

Shareholders and renounceable rights issues

7.43 Directors should administer companies in the interests of all shareholders. In reality, the present corporate culture militates against small shareholders. One illustration of how this might occur was given to the Committee by Mr Kingsley Allen in Melbourne. He spoke about shareholders and renounceable rights issues at prices that involve the rights selling for a significant value.[44]

7.44 Mr Allen described a situation where shareholders in a company are offered rights to take up a number of new shares in the company, calculated by reference to the number of shares already held by each shareholder. The right to take up the shares often has to be exercised within stringent time limits. The limits do not allow for 'mail delays, holidays, illnesses, deceased estates'.[45] The rights can be traded but this involves stockbroking charges which can be prohibitive in relation to

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42. *Midgley, Kenneth, 'To Whom Should the Board be Accountable ... and for What?' in Midgley, Kenneth (ed), Management Accountability and Corporate Governance, MacMillan, London, 1982, pp 61-77 at p 64.*
43. *Ibid.*
44. *Submissions and evidence (Evidence, pp 514-58).*
45. *Supplementary submission, p 3 (Evidence, p 524).*

small parcels of shares.[46] This system works against the small shareholder and in favour of the large one.

7.45 Mr Allen pointed out that not all companies acted in this way when making renounceable rights issues,[47] but when they did, small shareholders could lose the value of the rights because they would be unable to take them up or to trade them.[48] The main argument advanced by companies for acting in this way was that underwriting fees were reduced and the majority of shareholders thereby benefited.[49]

7.46 The Committee was told that Stock Exchange listing rules obliged companies to appoint a nominee to protect certain overseas shareholders.[50] Mr Allen said that 'the appointment of a trustee, nominee or even the underwriter itself' could protect Australian shareholders who fail to accept or sell their entitlements.[51] Otherwise a small minority of shareholders could be disadvantaged to enable savings in underwriting fees that should properly be borne by all shareholders.

7.47 The Committee drew the matter to the attention of the NCSC by letter. The NCSC replied to the Committee indicating that it had undertaken a preliminary study of the problems identified. In view of the complexity of the problem, the NCSC suggested that further consultation with companies and the participants in the securities industry was necessary before any firm proposal could be drawn up.[52]

7.48 The Committee recommends that **the NCSC and the ASC**

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46. *Supplementary submission from Mr Allen, p 3 (Evidence, p 524).*
47. *Evidence, p 551.*
48. *Supplementary submission, p 2 (Evidence, p 523).*
49. *Supplementary submission from Mr Allen, pp 5-6 (Evidence, p 527-8).*
50. *Evidence, p 550-1 (Mr Allen).*
51. *Evidence, p 557.*
52. *Supplementary submission from NCSC, p 2.*

proceed immediately to consult as necessary, in particular with shareholders' groups and others involved in the securities industry, in order to develop a proposal to eliminate the unfair practices relating to small shareholders in renounceable rights issues.

TABLE 1

AVERAGE SIZE AND COMPOSITION OF BOARDS, 1988

By type of company

Directors	Public Listed	Public Unlisted	Stat Auth	Private*	Overall
Executive	2.9	2.9	1.5	3.1	2.7
Non-Exec	6.4	6.0	6.6	4.4	5.9
Total	**9.3**	**8.9**	**8.1**	**7.5**	**8.6**

By size (turnover)

Directors	>$500m	$101-500m	$51-100m	<$50m
Executive	2.3	3.1	3.0	2.6
Non-Exec	7.3	5.9	4.6	3.8
Total	**9.6**	**9.0**	**7.6**	**6.4**

* In 1981 the ratio was 5-2 in favour of executive directors.

Supplied by Guy Pease of Pro-NED from Australian Board Study (formerly known as Korn Ferry Board Study).