Australian Studies of Boards

The purpose of this presentation is to provide an overview of the role and function of Boards and to suggest ways in which Board performance can be evaluated and enhanced.

AGENDA

Introduction

- Why is there a need to enhance Board Performance?

Boards in Action

- What does the "average" Board look like in terms of:
  - size
  - shape
  - background
  - what they spend their time on?
- What lessons can we learn from this?

Key Issues for Directors

- What are the key areas which impact on Directors?
- What do we need to know?

Where to From Here?

- How can Board performance be enhanced?
- How can Management Consultants help?

Introduction

In the past, the position of Director was well paid but required little work and few responsibilities. That was a long time ago. No longer is a Board appointment a licence for long lunches, membership of the "club" and an entry in "Who's Who". Since the beginning of the 1990's there has been a significant transformation in the role and responsibilities of Board Members. No longer can Directors afford to be little more than ornaments, rubber stamping the decisions of management.

THE INCREASED FOCUS ON CORPORATE GOVERNANCE

The Need to Address Board Performance

- ***Increased Expectations***
- Corporate excesses and collapses of the 80's
- Share market crash 1987
- Significant losses
- Greater scrutiny
  - shareholders
  - lenders
  - community
  - government
- Direct relationship with organisational performance

- ***Increased Accountability***
- Responsibility placed squarely on Directors
- Reflected in:
  - Corporations Law
  - Associations Incorporation Act
  - Occupational Health, Safety and Welfare
  - Trade Practices
  - Environmental Law

Membership of Boards - irrespective of whether they be in the Public or the Private Sector - is a serious profession and the risks must be acknowledged and accepted. The consequences of Organisational performance is aimed directly at Directors?

"IT CAN'T HAPPEN TO ME"

July 1994 - March 1996
Criminal charges by ASC
31 directors in gaol

Coles Myer

National Safety Council

State Bank

Garibaldi Smallgoods

LeFevre Hospital

Boards in Action

Before attempting to evaluate the performance of the Board, it is necessary to resolve a fundamental question . . .

THE KEY QUESTION

What Should the
Role of the Board be?

In exercising its Governance role, the prime activities of the Board fall into two categories:
*- Activities which involved **Conformance** to Standards, Statutory Obligations, Policies and Plans: and*
*- Activities which contribute to the **Performance** of the Organisation*
In practice, Boards can, and do, vary considerably in the emphasis they place on the various components of this Governance role. The key role of the Board is achieving an appropriate balance between Conformance and Performance.

THE ROLE OF THE BOARD - CONFORMANCE & PERFORMANCE

- Ensuring adequate relationships with stakeholders
- Customers (confirmation of service)
- Creditors (financial results)
- Employees (employment prospects)
- Regulators (Statutory Disclosure)
- Others

	Conformance Roles	Performance Roles
Outward Looking	**Providing Accountability**	**Strategy Formulation**
Inward Looking	**Monitoring & Supervising**	**Policy Making**
	Past & Present Oriented	***Future Oriented***

- More than just approval of the Annual Corporate Plan
- Process for appreciating the strategic context of the organisation
- Determining strategic advantage and competencies and how they will be protected and exploited

- Striking the right balance between over-involvement in managing the Organisation and passively accepting management proposals and decisions

- Shorter-term extension of Strategy formulation
- Translating the strategies into policies for management action
- Includes issues such as:
  - Finance
  - OHS
  - Quality
  - Environment Protection
  - Performance Measures
  - Customer Service
  - Employment and Labour Relations
  - Risk Management

The results of numerous surveys of Boards are available and provide an initial reference point for assessing performance.

Three studies in particular provide an insight into the role and function of Boards in practice.

BACK IN THE REAL WORLD

BOARD STUDIES

What do boards do?

What do they "look" like?

What do they spend their time on?

CULLEN EGAN DELL
Directors' Fees Survey
(1995/96)

- Over 120 Organisations
- Mostly top 1000 Companies
- Structured Questionnaire

KORN/FERRY INTERNATIONAL
Boards of Directors In Australia
14th Study 1995

- 200 Organisations
- Public & Private Companies & Government Enterprises
- Structured Questionnaire

MACK CONSULTING GROUP
Survey of Hospital Boards
(1995/96)

- Five South Australian Private Hospitals
- Face to Face Interviews
- Board Chairpersons, Board Members, CEO's

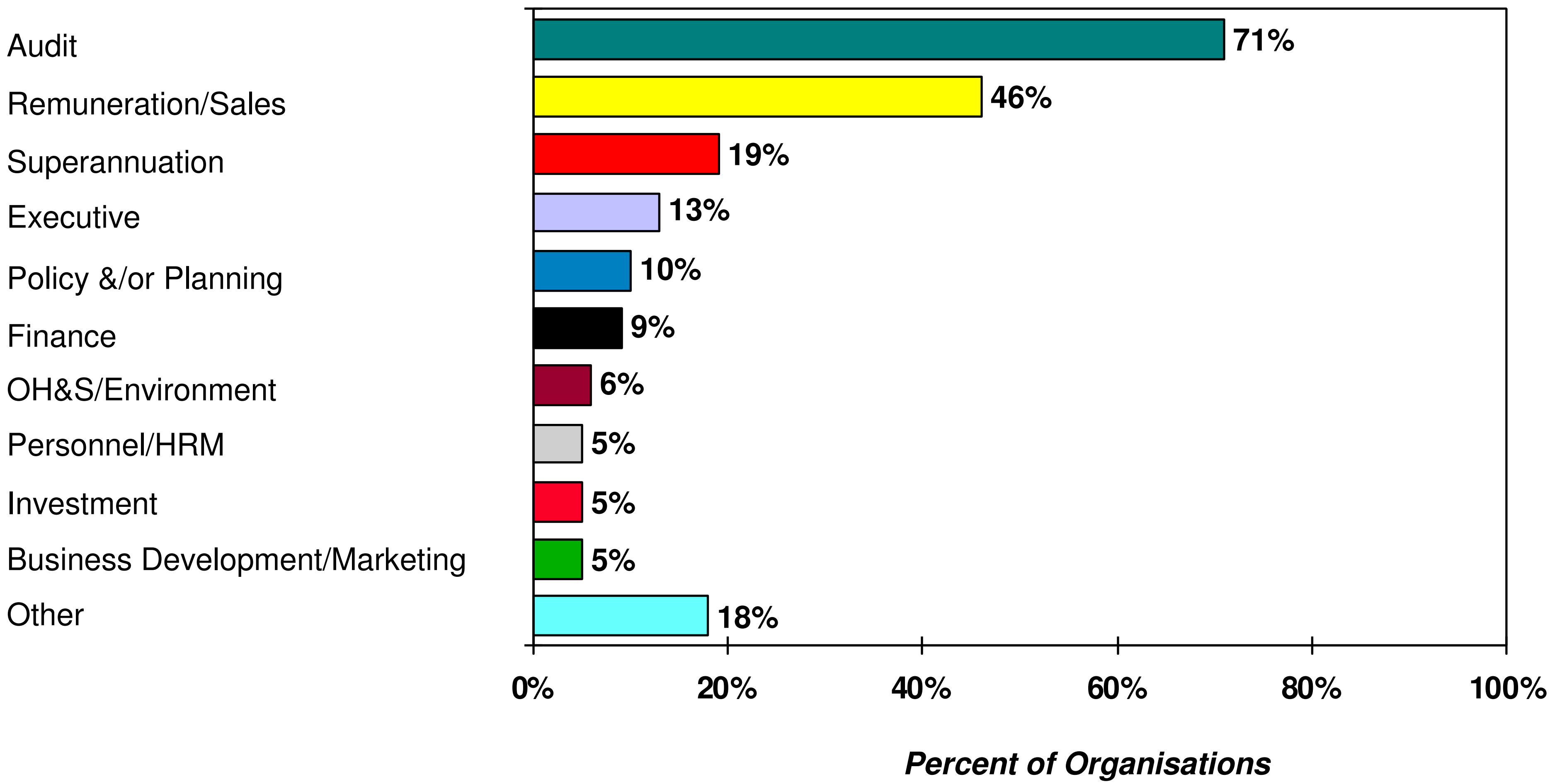
The Cullen Egan Dell, Directors' Fees Survey 1995/96 surveyed over 120 organisations mostly from the top 1000 companies. The survey method was a structured questionnaire.

DIRECTORS' FEE SURVEY

Characteristic	Key Findings
Board Size	• Average Board Size is eight • Range 2 to 13 (3 to 16 in 1994) • Confirms a trend towards smaller Boards
Number of Meetings	• Majority of responding Organisations hold meetings about once a month • Actual number of meetings held per year ranges from 2 to 20 • Little variation with respect to Company size (Employees, Value of Gross Assets or Sales Turnover)

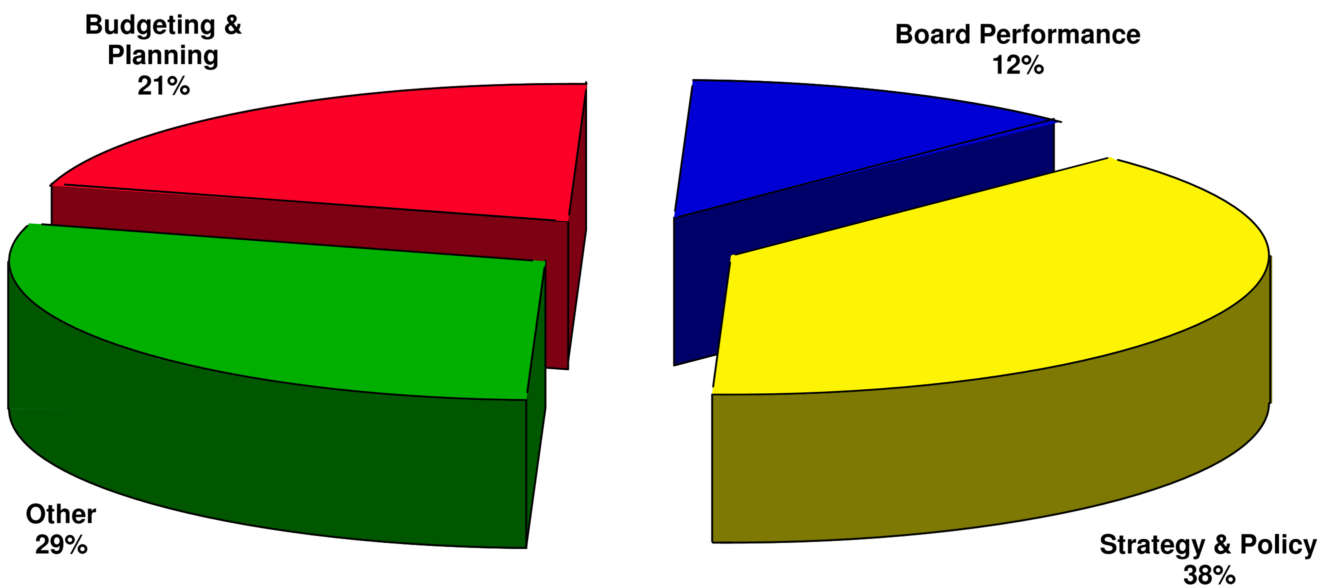
DIRECTORS' FEE SURVEY

Board Committees



DIRECTORS' FEE SURVEY

Time Spent on Various Board Activities



DIRECTORS’ FEE SURVEY

Characteristic	Key Findings
Duration of Meetings	• On average, Board Meetings run for four to five hours • Individual Board meeting times varying from one through to ten hours • Minimal variation according to organisational size
Criteria for Board Selection	• Comparison of 1995 with 1994 reveals that: - greater requirement for knowledge - increasing importance of industry experience - recognition of the value obtained from independence - higher performance orientation - alignment of an individual’s philosophy with that of the firm
Training for Directors	• 25% of firms provide some sort of training to incoming Directors • Range of training provided both formal and informal and includes: - internal briefings and induction - orientation of business operations - attendance of courses

The Fourteenth Study of Boards of Directors in Australia was undertaken by Korn/Ferry International and the Australian Institute of Company Directors. It analysed boardroom structure, practices and policies of up to 200 leading public and private companies and government enterprises using a structured questionnaire.

BOARDS OF DIRECTORS IN AUSTRALIA

Characteristic	Key Findings
Board Size	• Average Board size is eight (two Executive and six Non-Executive) • Most private companies ratio of one Executive Director to one Non-Executive Director
Selecting the Chief Executive	• Three main methods - Internal Appointment (48%) - Executive Search (29%) (18% in 1985) - Major Shareholder Nomination (14%)
Female Directors	• Virtually static over last few years and remains low • Women now constitute 4% of all Board Members - 1% of Executive Directors - 5% of Non-Executive Directors

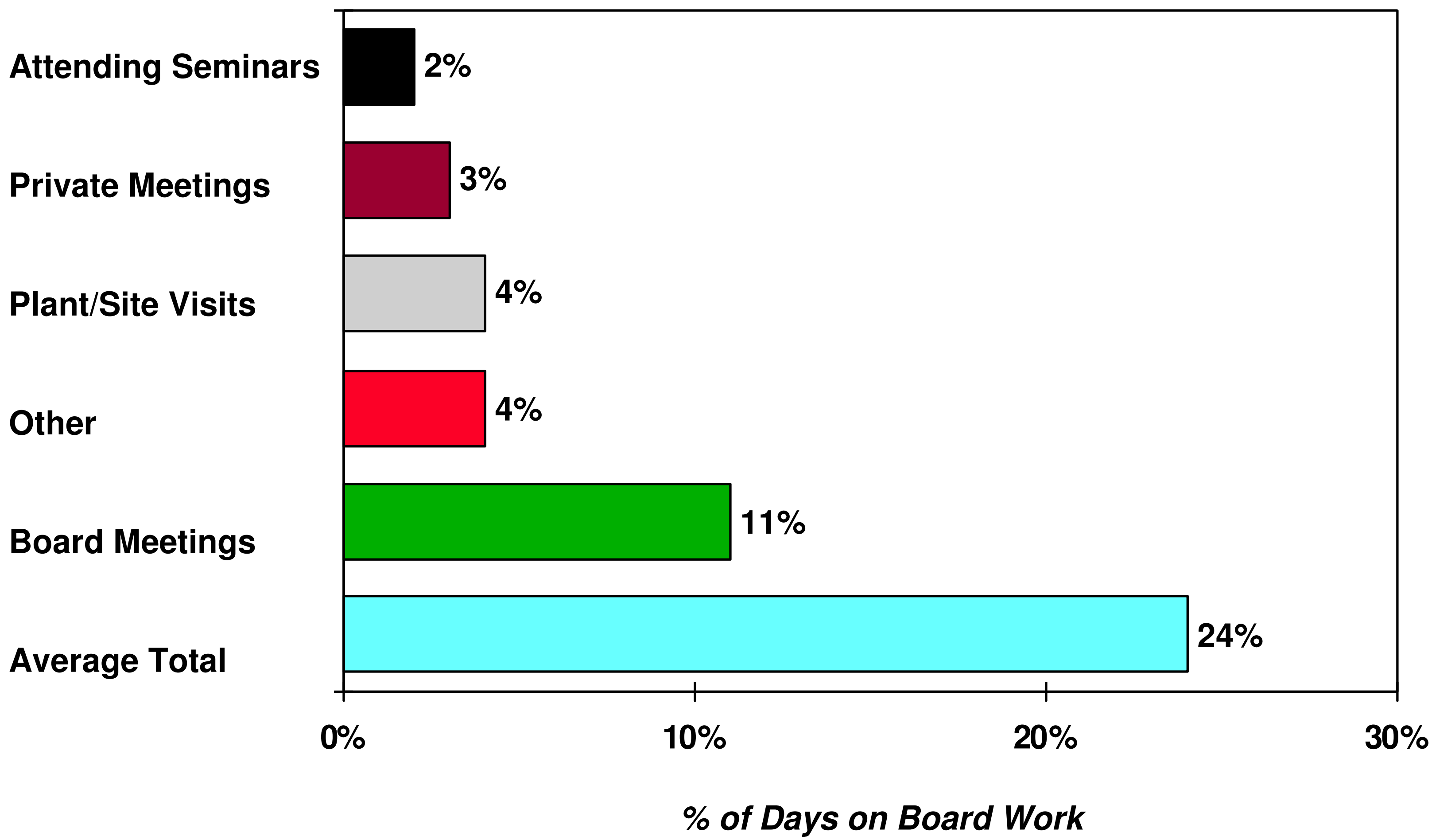
BOARDS OF DIRECTORS IN AUSTRALIA

Characteristic	Key Findings
Key Issues in the Boardroom	• Four main priorities: - financial results (76%) - customer focus (44%) - business ethics (41%) - shareholder relations (32%)
Keeping Up-to-Date	• 88% of organisations make internal information facilities available • 44% of organisations provide subscriptions to professional and other bodies • 70% of organisations had Directors who were members of the AICD
Non-Executive Chairpersons	• Average Non-Executive Chairperson received compensation of $71,000 for 50 days work pa (representing an increase of 6% from the previous year)

BOARDS OF DIRECTORS IN AUSTRALIA

Characteristic	Key Findings
Liability Insurance	• D&O insurance taken out by almost all Directors (92%) • 86% of Directors had their premiums paid by the Organisation
Non-Executive Directors	• Average total remuneration for NED's was $31,000 (up 15% from 1994) • Increase a reflection of the value placed on additional responsibilities, time and liabilities of NED's (???)
Retirement Benefits	• Retirement benefits provided to 52% of Directors • Up from 44% in the previous year • Of those organisations providing benefits, 50% have minimum qualifying period of Board Service (average being three years)

BOARDS OF DIRECTORS IN AUSTRALIA



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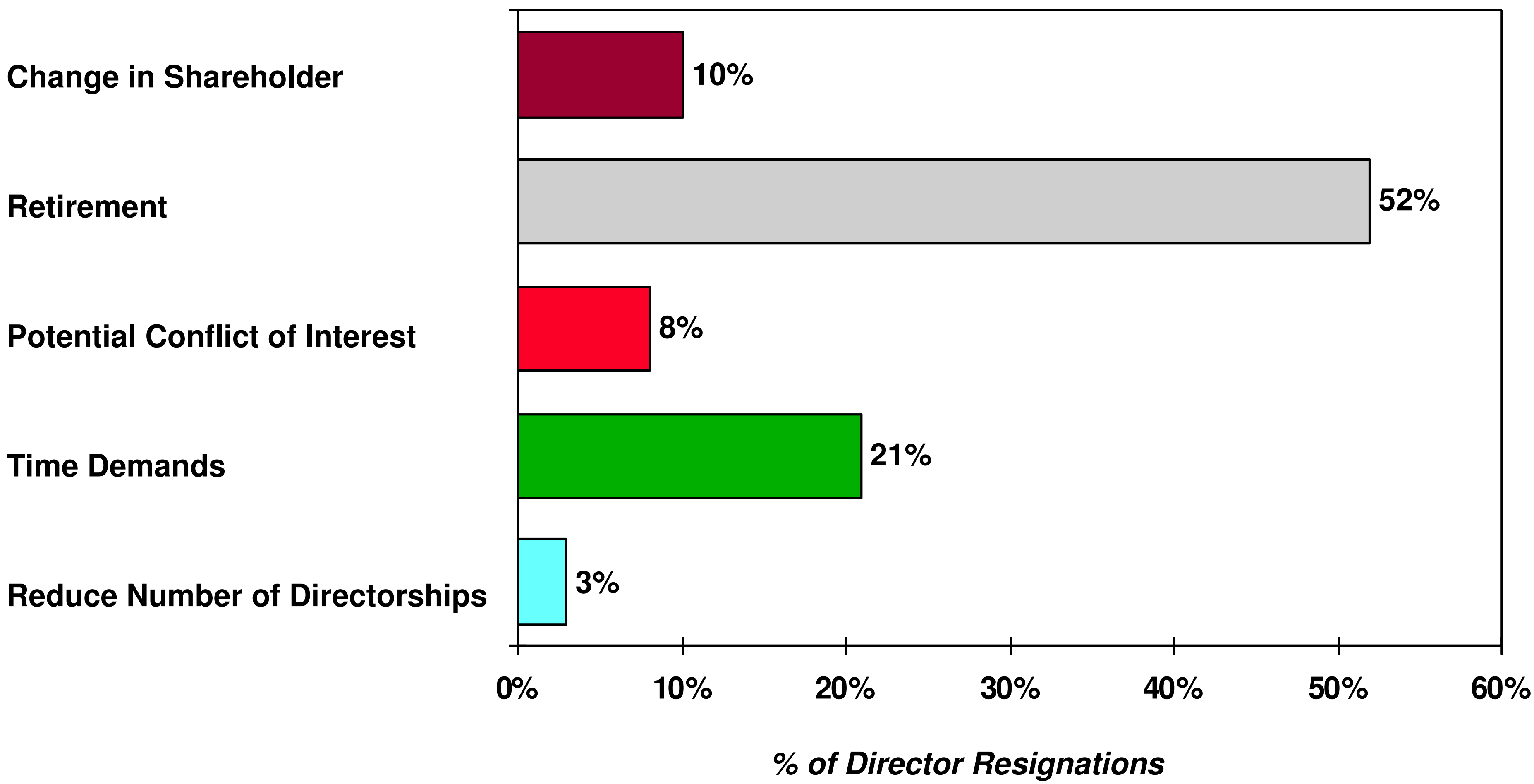

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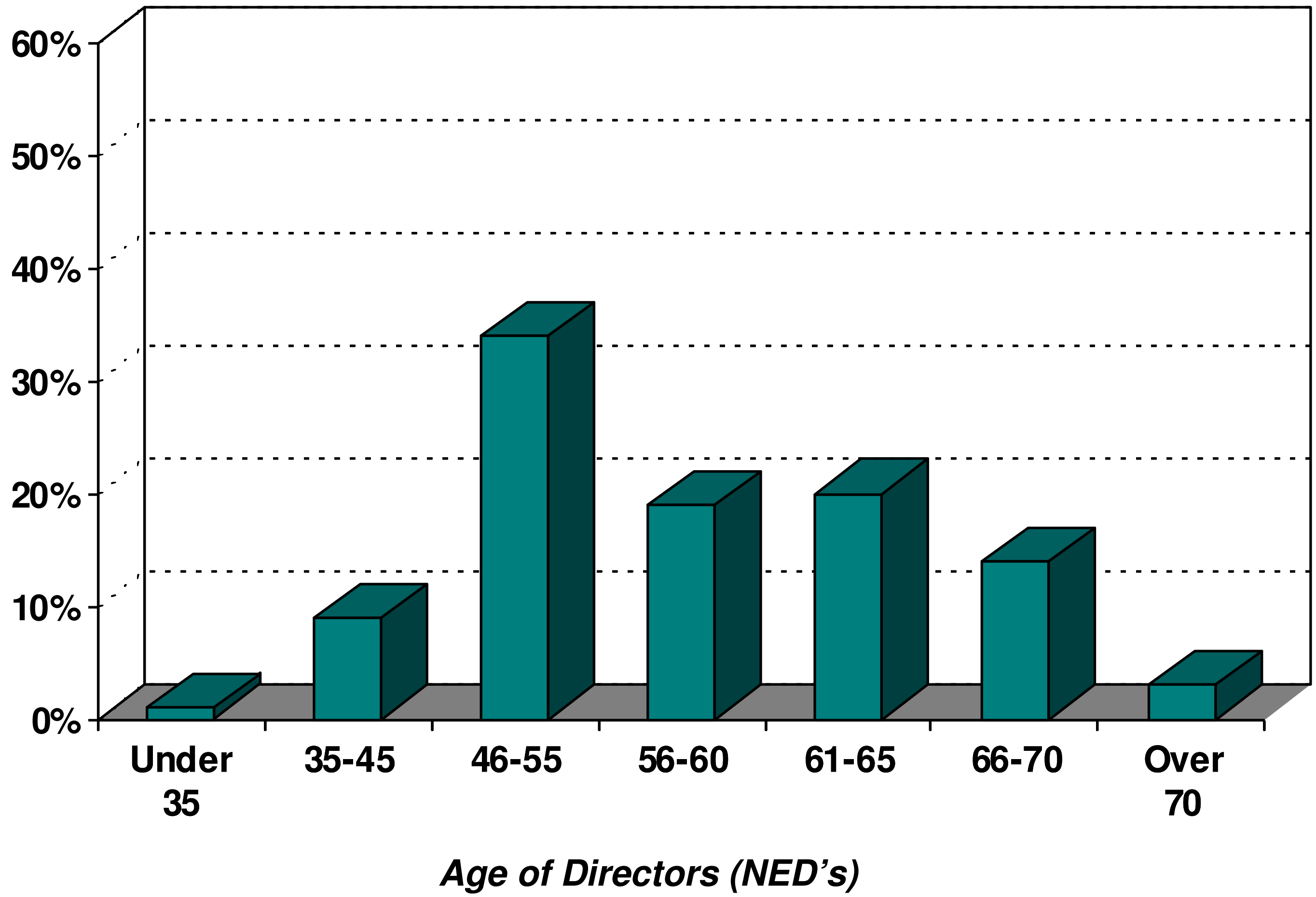
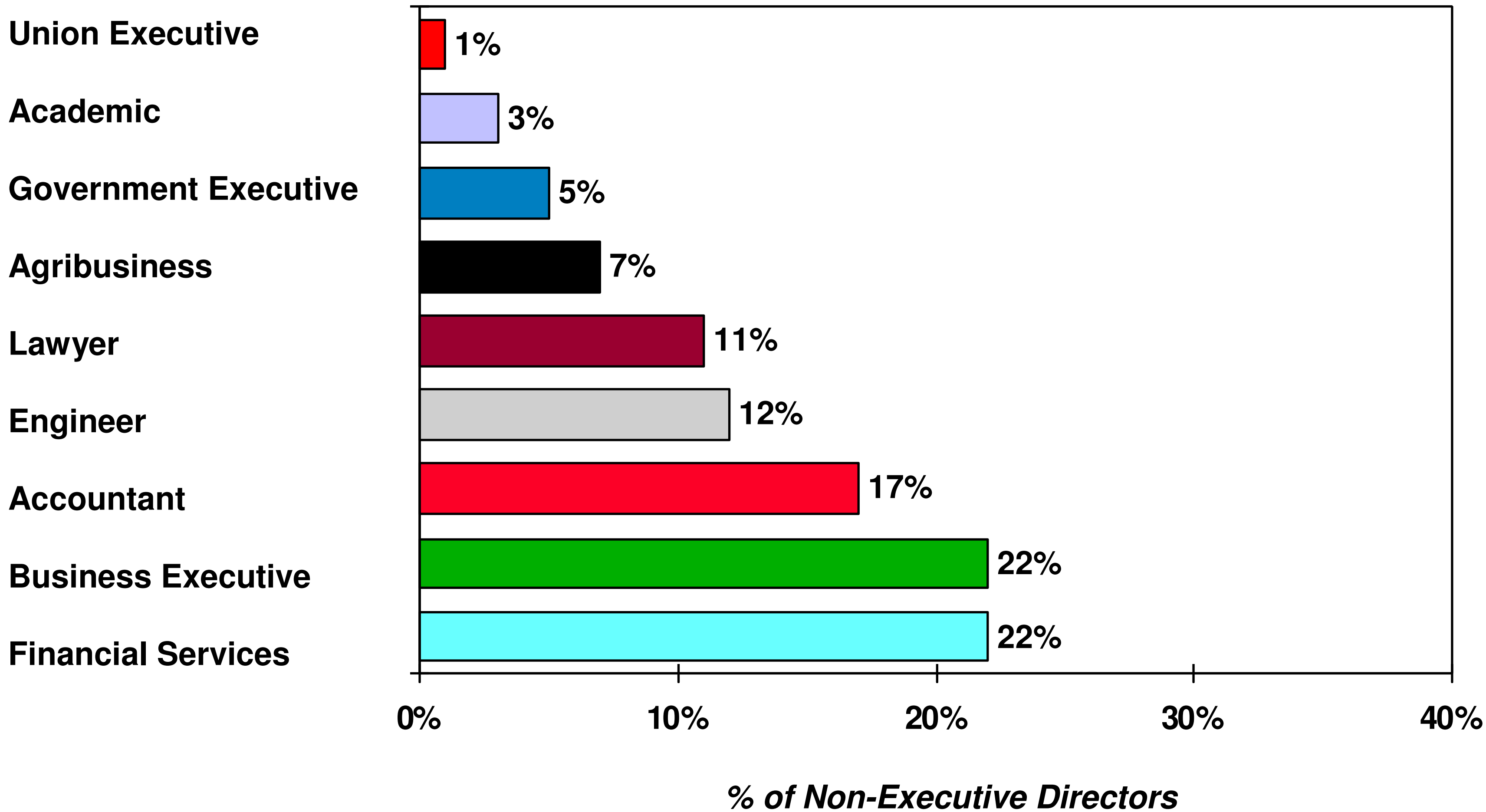


BOARDS OF DIRECTORS IN AUSTRALIA



Key Issues for Directors

The wide range of important issues at Board level and the rate of market and technological change require a comprehensive balance of skills, experience and operational knowledge. Enhancing the performance of the Board as a whole and improving the personal contribution of Directors requires an appreciation of a number of areas which impact on Board and Organisational performance.

Effective Corporate Governance

Strategic Direction	Assessing Organisational Performance	Duties & Responsibilities of Directors	Insurance	Risk Assessment & Environment Issues	Industrial Relations	Trade Practices	Intellectual Property
The Strategic Direction Process	*Financial Statement Analysis*	*Common Law & Statutory Duties*	*Directors & Officers Liability Insurance*	*Risk Management & Environmental Law*	*Contemporary Workplace Issues*	*Principles of Trade Practices Law*	*Forms of IP*

Surveys over the past three years have consistently identified Strategic Direction as the area of Board responsibility on which Directors most want to spend more time. This is not surprising given the level of turbulence that most Boards must now deal with and the important contribution which determining strategic direction can make to the Organisation's capacity to successfully navigate through this turbulence. Delivering these benefits involves having a process to adequately address on a timely, and rolling, basis five key issues.

STRATEGIC DIRECTION

(1) What Business do we want to be in?

(2) What are our ambitions?

(3) What must be done to achieve our ambitions?

(4) What Policy constraints apply?

(5) How do we sustain our course?

Determining Organisational Performance - in particular financial performance - is already a fundamental priority of the Board. Financial analysis of the organisation at the Board level has five primary objectives . . .

ASSESSING ORGANISATIONAL PERFORMANCE

(1)	**Understand Relationships**	- between revenues, expenses, assets, liabilities and equity
(2)	**Explain Performance**	- reasons for levels of revenue, margins, expenses, profits, assets, liabilities and equity
(3)	**Identify Trends**	- in profitability and key performance indicators over time
(4)	**Assess Comparative Position**	- identify the position of the organisation in an industry and gain insight into relative efficiency and profitability
(5)	**Assist in Planning**	- analyse past performance with the intention of using that information to plan for the future leading to the preparation of targets and budgets

The process of financial analysis is similar to a detective story. The reader of financial statements is presented with information (clues) from which he or she must unravel a chain of events to reach a conclusion. In analysing financial statements (Balance Sheet, Profit and Loss, Statement of Cash Flows), it is helpful to ask specific questions . . .

WHAT ARE WE LOOKING FOR?

- What does it represent?
- Has it been accurately calculated?
- How does it relate to the other financial statements?
- Is it commercially realistic for this Organisation?
- Is it commercially realistic relative to the Industry?
- Do we need to act on it and, if so, what specific actions are necessary?

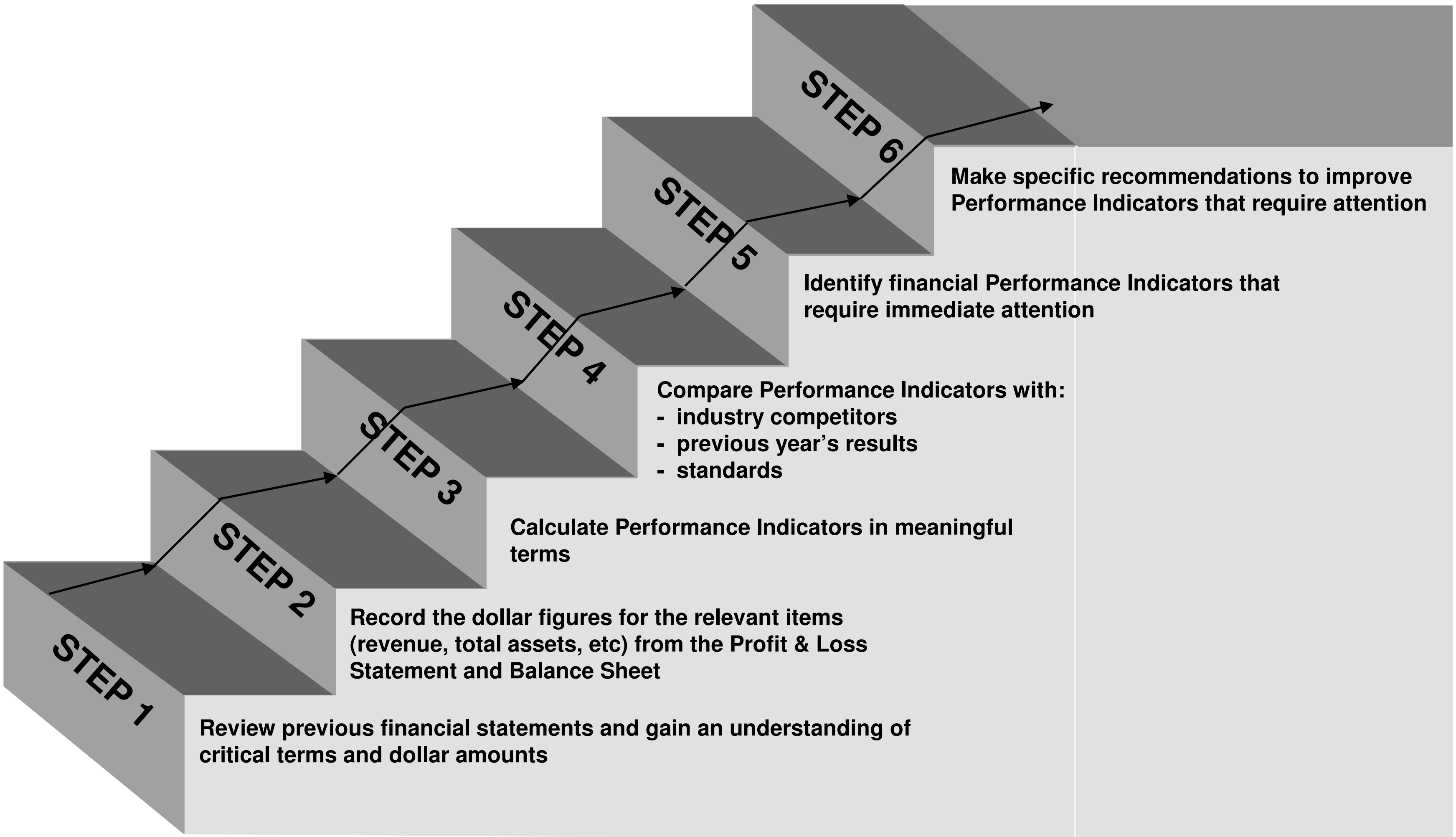
In assessing organisational performance there are a number of principles or rules of thumb which should be followed . . .

RULES OF THUMB

- Financial position can only be improved by increasing Equity or Net Worth over time
- If a profit or surplus is not made for the year, then Equity or Net Worth remains constant or declines
- Every year, earn a profit or surplus and invest it either by purchasing an asset or reducing a liability
- Most organisations make a net profit after tax of between 2% and 7% of total revenue
- An organisation should generate a positive cash flow from operating activities
- A cash deficit in the following areas requires immediate attention:
  - cash receipts is less than cash payments
  - net cash surplus from operating activities is less than net profit after tax

A process for the financial evaluation by Boards of their organisations comprises six steps. The purpose of the process is to generate questions rather than provide answers to the financial performance of the enterprise.

FINANCIAL ANALYSIS IN SIX EASY STEPS



The process for financial evaluation is based on the use of Financial Performance Indicators often called financial ratios. From the perspective of the Board, it is assumed that the effectiveness of generating a profit determines the ability of an organisation to survive financially and attract suppliers of funds. There are a number of key ratios that can assist in this evaluation.

FINANCIAL PERFORMANCE INDICATORS

COMPANY PERFORMANCE *(Return on Assets)*

Performance area	Indicator	Ratio
Profitability Performance	EBIT Margin	*EBIT / Sales*
	Gross Margin	*Gross Profit / Sales*
	Operating Expense Margin	*Operating Expense - Interest Paid / Sales*
Asset Performance	Asset Turnover	*Sales / Total Assets*
	Inventory Turnover	*COGS / Average Inventory*
	Debtors Turnover	*Account Sales / Debtors*
Debt Performance	Total Liabilities to Total Assets	*Total Liabilities / Total Assets*
	Gearing	*Interest Bearing Debt / Equity*
	Interest Cover	*EBIT / Interest Paid*
Liquidity Performance	Current Ratio	*Current Assets / Current Liabilities*
	Quick Ratio	*Current Assets -Stock / Current Liabilities*

Directors of both public and private firms are obliged to comply with various legal rules aimed at ensuring they properly carry out their duties and responsibilities. Some of these duties have their foundation in the Common Law, others are defined by statute in the Corporations Law. Directors and Officers are also bound by the Criminal Acts of the Commonwealth, States and Territories.

DUTIES AND RESPONSIBILITIES OF DIRECTORS

Directors Duties

Common Law

- Fiduciary duties

(duties to act in good faith and in the best interests of all shareholders)

- Duty of skill, care and diligence

Statutory

- Duty to act honestly
- Duty of care and diligence
- Duty not to make improper use of information
- Duty not to make improper use of position
- Duty of full disclosure
- Duty to avoid conflict of interest
- Duty not to take improper advantage of Corporate Opportunity

Insurance is a critical issue for all Directors - irrespective of the sector of the organisation or whether or not they are remunerated. There exist two principal forms of insurance cover which warrant consideration.

INSURANCE

TYPES OF COVER

	D&O	Co Reimbursement
What it is	• Indemnity against actions for negligence • Does not cover fraud/criminal activities	• Costs associated with successful defence of actions brought against D&O's
Who it covers	• Directors and officers	• The organisation
Who pays	• Prior to 1994 individuals • Currently, the organisation • Cost depends on extent of cover	• The organisation
Exclusions	• Notification of threatened action • Use insurance broker	• Depends upon actual policy

Organisations can no longer survive the impact of unrecognised and unmanaged risks in an environment where there exists a continual drive to improve returns and reduce operating costs. It is therefore important to manage business risks to make sure that an unmanaged risk does not adversely impact on organisational performance. Directors cannot and should not be responsible for day-to-day risk management of the Organisation, however they are responsible for shaping the overall risk profile of the Organisation by addressing three key questions . . .

RISK ASSESSMENT

- ☐ What is our appropriate role in managing organisation risk?
- ☐ How can we best balance risk and control?
- ☐ Which risk control style should we adopt?

A method that helps to determine the importance of decisions and the level of involvement of the Board in those decisions relating to risk is vital if risk management efforts are to be effective. A framework that places risk decisions according to chance of loss and relative impact on core business can avoid excessive time being spent by Boards on dealing with unanticipated losses and distracting them from strategic concerns.

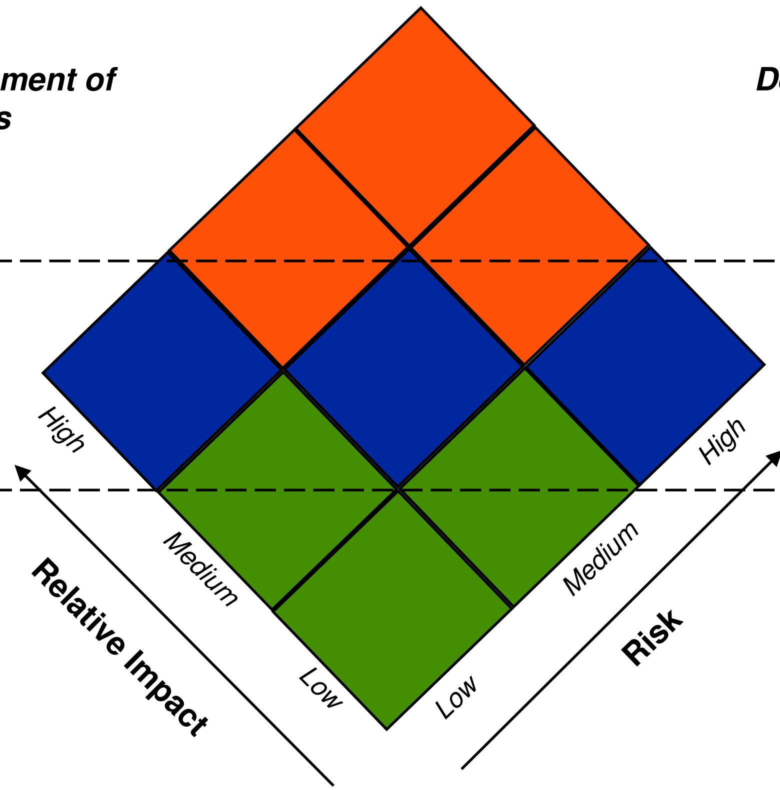
PRIORITISING RISK DECISIONS

Level of Involvement of Directors

A. Full

B. Interface with Staff

C. Limited

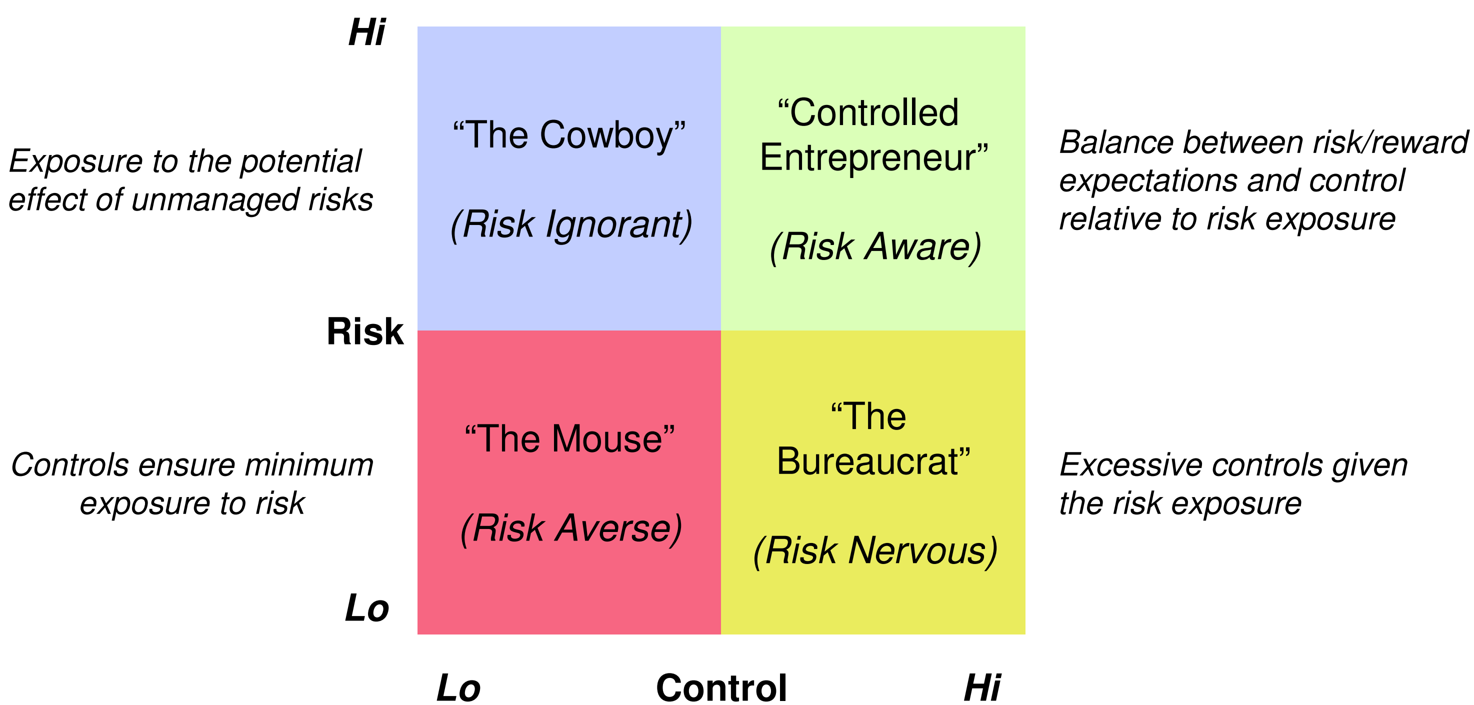


Decision Approach

1. Select among alternatives
2. Approve/disapprove specific staff recommendations
3. Provide explicit approval for decisions without review

Managing risk is fundamental to business success. Business risk management must recognise that risks ***do*** *occur and that operating decisions must reflect this. Risk management does* ***not*** *set out to encourage organisations to be risk-averse. The key element in risk management is correctly balancing risk and control.*

BALANCING RISK AND CONTROL



Source: AICD, Company Directors Course, Volume 2, Module 8A (1995), page 12

*Once an organisation has decided which Risk **Management** style it will adopt, it needs to consider which Risk **Control** style it will accept as part of its control strategy. Risk Control can be thought of as actions designed to reduce the frequency, severity or probability of a loss.*

WHICH RISK CONTROL STYLE?

RISK CONTROL STYLES

Acceptance	Risk reviewed Decision made on cost-effective controls	• Constant monitoring of the risk
Reduction	Risk reduced by instituting appropriate controls	• Loss Prevention (Reduction in probability) • Loss Reduction (Reduction in severity) • Segregation of Exposure (Duplicating facilities)
Transfer	Locking into a known position at a known cost	• Using - Insurance cover - Contracting-out - Outsourcing - Contractual transfer of ownership of an asset - Forward Exchange cover - Put options
Avoidance	Terminating the activity	• Feasibility Study • Evaluation/Assessment of Project

Although the issue of Enterprise Bargaining dominates the current Industrial Relations agenda, from a strategic perspective, the issue of Employment Contracts in many ways has greater and more far-reaching ramifications for Boards.

INDUSTRIAL RELATIONS

ESSENTIAL PRINCIPLES OF AN EMPLOYMENT CONTRACT

- *Offer and acceptance*
- *Consideration*
- *Agreement*
- *Intent*

TERMS AND CONDITIONS OF EMPLOYMENT CONTRACTS

- *the employee's position & duties*
- *non-salary entitlements*
- *review & performance assessment*
- *salary & wages*
- *notice provisions*
- *probation*
- *hours of work and overtime*
- *redundancy*
- *post-employment restraints*

TERMINATION OF EMPLOYMENT CONTRACTS

- *By Notice*
- *Payment-in-lieu*
- *Repudiation*
- *Frustration*

REMEDIES FOR BREACHES OF EMPLOYMENT CONTRACTS

- *Specific Performance*
- *Damages*

Trade Practices is a particularly important issue for Directors given the significant penalties and claims for damages that can arise from a breach of the law (the Trade Practices Act). The Trade Practices Act reflects the concerns that competition should not be unduly restricted and consumers should be treated fairly.

TRADE PRACTICES

MACRO-LEVEL **(Market Conduct Rules)**

- Anti-Competitive Agreements
- Price Fixing
- Exclusionary Provisions
- Abuse of Market Power
- Exclusive Dealing
- Resale Price Maintenance
- Price Discrimination

Civil and/or Criminal Liability

MICRO-LEVEL **(Consumer Protection Issues)**

- Misleading or Deceptive Conduct
- False Representations
- Unconscionable Conduct
- Defective Goods

Intellectual Property is becoming a more prevalent issue in the ever increasingly competitive environment of the 90's. It is vital to protect such organisational assets from misuse by others and equally important that your organisation does not infringe someone else's IP. In a very general sense, IP can be considered to be a "bundle of rights" which protect creative and innovative effort and an organisation's investment in that effort in six primary areas.

INTELLECTUAL PROPERTY

INTELLECTUAL PROPERTY RIGHTS

Copyright

Exclusive right to reproduce, publish or perform a literary, dramatic, musical or artist work and films, recordings and broadcasts in public

Information Technology

Methods by which information is used, stored, analysed and transmitted by all forms of modern electronic technology

Confidential Information

Information which the law protects from use or disclosure in certain circumstances

Trade Marks

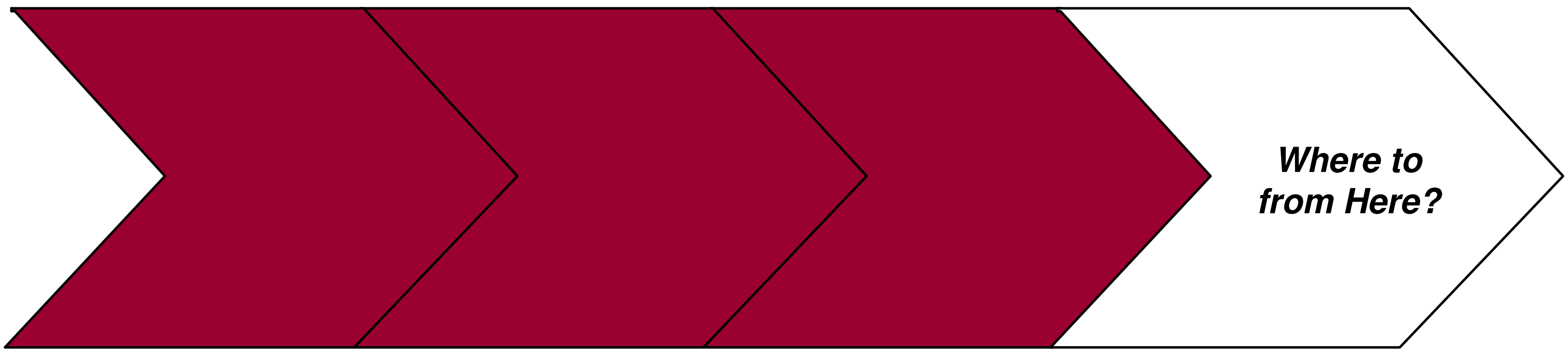
A sign used or intended to be used to distinguish goods or services dealt with or provided in the course of trade from those dealt with or provided by another organisation

Patents

A legal right or statutory monopoly under which a person entitled to an invention is given an exclusive right to exploit that invention for a certain period.

Designs

Features of shape, configuration, pattern or imitation application to an article that can be judged by the eye but does not include a method or principle of construction


Where to
from Here?

HOW EXTERNAL ASSISTANCE CAN HELP

Services to the Board

Board Review & Evaluation

- Do members understand and agree on the key functions of the Board - what they should be doing?
- Are those functions being properly performed and is sufficient time allocated to them?
- Have the most essential objectives been agreed and are they being achieved?
- Can the Boards administrative and operative arrangements be improved?

Director Training

- Do all Board members have a sufficient appreciation of the key areas impacting on their role as Directors?

ie.
- Legal Duties and Responsibilities
- Financial Evaluation
- Intellectual Property
- Trade Practices
- Industrial Relations
- Risk Management
- Strategic Direction