

Protection,

Can good governance save bad companies or is it just a feel-good fad that New Zealand has borrowed from overseas?
Graeme Hunt reports.

Palliative or Placebo

Ask competitors why Provincial Finance, a second-tier finance company with a solid ABA ranking, failed this year and they put it down to a collapse in the car market. Two other finance companies, National Finance 2000 and Western Bay Finance, failed around the same time under similar circumstances.

But management “experts”, most of whom have never worked in finance, have been quick to cite these failures and other corporate shortcomings as evidence of deficient governance.

But is poor governance really responsible for so many debenture holders being left high and dry, or do companies fail anyway when market conditions work against them?

New Zealand Business Roundtable executive director Roger Kerr believes the latter. He says people tend to blame governance when businesses fail rather than accepting failure as part of the swings and roundabouts of the corporate cycle.

Kerr says efficient, “best-practice” boards are important but the way they are run often bears little relation to the marketplace.

“Most of what happens in a particular industry is outside the control of management and directors,” he says.

“Capitalism is a system of profits and losses and that will always be the case. There is nothing dishonourable about bankruptcy if a company has not committed anything dishonest.”

Kerr says he is tired of New Zealand directors and managers being portrayed as inferior.

“How was it that New Zealand became one of the highest-income countries if our companies were run by poor managers and poor boards? A lot of nonsense has been talked about old boys’ clubs and interlocking directorships but the calibre of management and governance in New Zealand is high.”

The real danger, he says, is when managers and directors become so focused with governance that they become risk averse. He claims the Government’s and regulators’ obsession with governance, far from protecting the interests of stakehold-

ers, actually imposes unacceptably high costs on companies.

“Business innovators take a risk and make mistakes – that is part of the price of an open economy. I don’t know any serious director or board that has not made a bad decision. To jump on anybody who has made a bad call is just ridiculous.”

Kerr says the growth of the private equity market, and the decisions of businessmen like Stephen Tindall (The Warehouse) and Graeme Hart (Burns Philp & Co) to take their companies private, reflect the folly of over-regulating listed companies.

He cautions the Government not to overreact to the recent finance company failures by imposing even more regulations.

“I don’t see anything special about finance companies. They are just like any other businesses. They are just part of the market.”

He says the real challenge for New Zealand is to create an environment that encourages risk-taking and capital-raising.

“In the United States the No 1 hero is the entrepreneur who succeeded and the No 2 hero is the entrepreneur who failed.”

Kerr accepts that good governance can result in better company decisions and even better outcomes, but it cannot make insolvent companies solvent.

This view runs counter to the politically correct line in official circles that good governance is the be-all, end-all of corporate best practice and a vital protection against things going wrong.

But talk of governance means little to the 70-year-old couple who might get only \$0.60 in the dollar back on their debenture investment in a failed finance company. Critics like Kerr say good governance might feel good and even look good but will not necessarily pay the bills when business turns sour.

What can be said is that the debate over whether good governance results in good outcomes for investors and other stakeholders is anything but clear cut.

NZSX adopted a corporate governance code in 2003 with an updated legal and regulatory framework to “minimise uncertainty and risk for all market participants”.

The changes were well intentioned, providing for differences in corporate size, culture and performance goals. They resulted in new listing rules providing for:

- a minimum two independent directors on a board or one-third of the board;
- a ban on a director simultaneously being chief executive and chairman;
- a requirement that directors complete an appropriate director certification course;
- a requirement that listed companies establish an audit committee with a minimum of three directors, a majority of independent directors, and at least one with an accounting or financial background; and
- a change of the external auditor or lead partner every five years.

Chief executive Mark Weldon said then that corporate governance was widely recognised as an important tool for improving accountability, transparency and certainty.

“If we are to be successful in attracting foreign investment back into the New Zealand market, we must be seen to uphold the appropriate standards,” he said in a statement.

But there has been scant evidence since that the changes have encouraged greater foreign participation in the New Zealand sharemarket, increased capital-raising or stopped directors from making mistakes.

Shareholders’ advocate Bruce Sheppard argued recently that governance failures had led to bad decisions by directors, pointing to carpetmaker Feltex as a prime example.

He said the board should have disclosed its increase in borrowings to meet the concerns of nervous suppliers.

“[The increase in debt] represents a fundamental change, it affects how much shareholders will get,” he told the *New Zealand Herald* on September 6, barely two weeks before the ANZ Bank called in the receivers to Feltex.

Sheppard, president of the New Zealand Shareholders’ Association, campaigned for the dismissal of four Feltex directors, though not former Deloitte chairman John Hagen. But his move was overtaken by the swiftness of the receivership and Feltex’s virtual fire sale to Australian carpetmaker Godfrey Hirst.

The association hopes to have more success in persuading the company to sue Credit Suisse First Boston Asian Merchant Partners, which sold Feltex in the float in 2004. But Feltex shareholders, who were the big losers from the corporate failure, should not hold their breath.

The Securities Commission’s secret investigation into Feltex revealed no wrongdoing though *New Zealand Herald*

columnist Brian Gaynor, a former sharebroker, expressed concern at the company’s failure to distinguish clearly between projected and forecast earnings.

“The Securities Commission would be lucky to score one out of 10 for its investigation of the Feltex prospectus. Its low rating is mainly due to the process, rather than the outcome, of the review,” he wrote in the *Herald* on September 2 this year.

“In an environment where public issuers have demanding disclosure and transparency requirements, the commission remains incredibly secretive and uncommunicative. It didn’t reveal it was undertaking an investigation nor did it give frustrated shareholders an opportunity to present their point of view.”

This might be so but Gaynor was unable to draw the long bow between Feltex’s apparent break down in governance and the ultimate fate of the company. Prospectuses are one

“Do not spend hours at board meetings on excessive conformance.”

thing: getting prospective shareholders to read them, and to distinguish between the finer points of forecast and projected earnings, is quite another.

The Securities Commission’s statement on Feltex was a terse one-pager, rejecting any breach of prospectus disclosure obligations or banking covenants requiring disclosure in the prospectus. But the commission noted that it had not considered Feltex’s compliance with the 1993 Companies Act or directors’ duties more generally “as these matters [were] beyond the commission’s jurisdiction”. The commission did continue to investigate continuous disclosure and financial reporting issues after Feltex’s earnings downgrade announcement on April 1 last year but took no action against the company.

Brian Gaynor was not pleased and told *Herald* readers as much: “Feltex was one of the biggest IPOs in the past 15 years yet the commission hasn’t made any substantive comments on the group’s failure to achieve its prospective financial information, to fully disclose directors’ interests or its dismal share-price performance.

“Surely these issues warranted a review and substantive comment? Surely the commission needs to go farther than a one-page press release stating ‘no further action will be taken in regard to this matter’. Why hasn’t it used the Feltex disaster to promote public understanding of the law and practice of securities?”

Commission chairman Jane Diplock would not comment on Feltex but she sees a strong link between good governance and good performance.

“There are a number of studies that suggest that good corporate governance brings about better financial results,” she says.

“One of the lens we look through is that in almost every case that comes before us we see poor corporate governance. One of the arguments is that good corporate governance brings better results to the shareholders. The other argument is that poor corporate governance brings bad results to the shareholders.”

Diplock admits that good corporate governance is no guarantee against business failure.

“In the business cycle, some businesses will succeed and some will fail and the reasons for those failures will be endogenous and exogenous ... It might not necessarily be poor governance; they [the directors or managers] might just have got it wrong.”

Diplock believes the commission’s principles-based approach to governance issues is what New Zealanders want.

“We see a greater focus on corporate governance as a very good thing and that is why we need to see principles developed. Shareholders are looking more closely at directors and their behaviour.”

The Shareholders’ Association, not surprisingly, cites good governance as a feature of a successful company. Its corporate liaison director Des Hunt says good companies need more than just experienced directors and management teams who openly seek to increase shareholder wealth.

“It is not just experience per se but the breath and depth of relevant experience that I consider fundamental to long-term business success,” he wrote in the October 2006 issue of the Institute of Directors’ *Boardroom* magazine.

“Few boards in New Zealand could be accused of lacking accounting and legal expertise but just as few jump out as having a healthy mix of operational, technical and marketing experience.”

Hunt says boards which communicate openly and constructively are more likely to engender investor, management and employee confidence than those which do not.

(For more of Des Hunt’s views, see “Successful companies” on page 22 of this month’s issue of *Management* magazine.)

The Institute of Directors has long placed governance on a corporate pedestal. Its director accreditation system, introduced in 2005, was, according to its publicity blurb, “one of the most significant steps the institute has taken in recent years”.

“The purpose of accreditation,” the institute says, “is to enhance corporate governance standards in New Zealand by providing a register of directors who can show evidence of their professional status in terms of their knowledge and experience. It allows accredited members to demonstrate a commitment to professional standards and provide shareholders and stakeholders with reassurance that boards are knowledgeable, experienced and committed to their profession.”

But president Rick Bettle says the institute warns members not to spend hours at board meetings on “excessive conformance”.

“We have to take risks but we do minimise them in case we have to go to court.”

Bettle concedes that the compliance duties for listed companies and their directors can be onerous and not always conducive to risk-taking – a situation that has encouraged growth in the private equity market. But he adds that corporate governance is not all about directors’ behaviour. In small to medium-sized enterprises it can be about creating an exit plan for proprietors and identifying and training competent replacements.

In one of his presentations Bettle quotes McKinsey & Co research which suggests a well-governed company should have a majority of outside directors, undertake formal evaluation of directors and be responsive to requests from investors for information on governance issues.

The research also suggests that 80 percent of investors will pay a share-price premium for such companies.



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Bad governance or bad luck?

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| TELECOM CORPORATION OF NEW ZEALAND (telecommunications company) | Natural monopoly on local loop removed because of perceived poor uptake in internet broadband |
| FELTEX CARPETS (carpetmaker) | Company fails despite glowing prospectus two years earlier but is cleared of making misleading statements |
| VECTOR (electricity lines company) | Agrees to administrative settlement with Commerce Commission after being found guilty of overcharging customers |
| DORCHESTER PACIFIC (financial services company) | Two shareholders (including a director) ordered to sell some shares after breaching Takeovers Code |
| OYSTER BAY MARLBOROUGH VINEYARDS (winemaker) | Failed to provide market valuations of its vineyards when subject to a takeover offer |
| PLUS SMS HOLDINGS (text message marketer) | Chairman and founder resign after the company is found to have issued incorrect statements |
| NGAI TAHU HOLDINGS CORPORATION (fishing, tourism & resources company) | Chief executive quits with \$1 million-plus golden handshake after \$22.8 million loss in seafood division |
| PROVINCIAL FINANCE (second-tier finance company) | Failed through downturn in car market despite ABA finance company ranking |

This is American research and, arguably, the New Zealand business psyche is different. But the trouble for opponents to corporate governance rules is that governance is not just an American obsession; it has developed a worldwide following.

The Institute of Directors, for instance, is part of the Global Director Development Circle and affiliated to the Commonwealth Association of Corporate Governance, formed in 1998 to promote best international standards through education, consultation and information as a means to “achieve global standards of business efficiency, commercial probity and effective economic and social development”.

In the many underdeveloped countries in the Commonwealth corporate governance is viewed more as a weapon against corruption and maladministration than a tool for business best practice.

Countries like New Zealand, with a history of virtually corruption-free business and public services, are important mentors for those seeking to improve the quality of public administration in Africa and Asia.

In New Zealand, the fastest-growing area of corporate governance is probably the public sector – from state-owned enterprises to district health boards. This has not happened overnight.

Back in 2002, the New Zealand Post chairman, former National prime minister Jim Bolger, told a conference in Sri Lanka that good governance played a “critical role in ensuring successful and sustained business performance, and accountabilities and responsibilities can be effectively delivered if proper governance arrangements are in place in accordance with the needs of the people”.

He said New Zealand’s governance and management structures were set up mainly to ensure that the buying and selling activities of state-owned institutions were better managed and delivered better results to the customers and taxpayers.

Few people would argue that the delivery of public services improved after the Douglas reforms of the late 1980s but what role governance, good or otherwise, played is open to question. The reinstatement of district health boards by the Labour Government in 2001, far from improving public perceptions about state-funded health, has not led to dramatic falls in hospital waiting lists or significant increases in funding. If anything, DHBs have become the focus of public and medical discontent over the health service. So much for the “people’s voice” that DHBs were set up to allegedly provide.

The same can be said of local government reform in 1989. Larger local authorities, especially in Auckland, did not bring about economies of scale, lower rates or better infrastructure – quite the reverse. Community boards, another example of “people’s voice” governance, also failed to fire.

The message seems to be that where services have deteriorated (such as crime detection and prevention), governance structures have got a bad name. Where services have improved, the promoters of good corporate governance have claimed the credit.

In the private sector, the outcome is much the same. Directors of companies which perform well are more likely to be held in higher regard than those of companies which do not.

Investors’ angst over the Australian acquisition of Waste Management earlier this year arose because yet another iconic company had fallen into Australian hands. It had little to do with Waste Management’s Takeovers Code-skirting amalgama-

tion scheme or the behaviour of the directors. Indeed, the hurt many investors felt was at the departure of the directors and the great company they had created rather than anything to do with corporate governance.


A glance at companies that have suffered corporate governance blues in the past year (see box story “Bad governance or bad luck?”) reveals no discernible trend. Telecom Corporation’s directors arguably misjudged government and public feeling over the poor uptake of internet broadband because of its “local loop” monopoly. The Government’s unbundling of the local loop, contrary to the advice of the telecommunications commissioner, cost Telecom shareholders dearly.

But this has nothing in common with the woes that beset Feltex, Oyster Bay Marlborough Vineyards, Dorchester Pacific, Plus SMS Holdings, Ngai Tahu Holdings Corporation or Provincial Finance. The only company facing a similar challenge to Telecom was lines company Vector. It and Telecom were subject to state intervention – the former by the Government, the latter by a government agency, the Commerce Commission. Both issues related to the abuse of a natural monopoly.

Unfortunately, the prevailing political view in Wellington is that the private sector cannot be trusted to look after its own and more laws are necessary to bring it into line on the basis that companies sometimes make mistakes.

Rick Bettle opposes this approach. “We have just got to live with the fact that we are people and we get things wrong.”

But he says good companies are run on good principles and he urges prospective directors to join the institute to take advantage of its best-practice statements for directors – 43 sets of guidelines, regularly updated, to help board members survive in a litigious age.

But let the buyer beware: good governance is not a comprehensive insurance policy against failure – something many politicians fail to grasp – but it can help, even if it reminds the country’s current crop of directors to do things their fathers and grandfathers would have done intuitively. 

By Graeme Hunt, an Auckland-based journalist and author.



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