# Providing your board with comfort on the accountability mechanisms operating in your company

CHARTERED SECRETARIES AUSTRALIA

*Leaders in governance*

# Accountability mechanisms — how to provide comfort to your board

Directors are expected to provide strategic guidance for the company and effective oversight of management. This goes beyond driving the bottom line and providing appropriate shareholder returns to encompass consideration of the economic, social and environmental ramifications of corporate activities as part of generating sustainable growth and opportunities for expansion as well as enhancing corporate reputation and market confidence.

Directors also have to balance the commercial expectations placed upon them with their broader responsibilities and legal obligations. This involves directors satisfying themselves that the company for which they are responsible is meeting all of its legal obligations; and meeting the specific legal obligations that are attached to the position of director.

There has been an influx of regulation over recent years, resulting in an increased regulatory burden, increased complexity and a perception of increased risk of personal liability for directors. At the same time, the standards expected of directors have increased amid heightened community expectations following corporate collapses.

It is essential that governance professionals ensure that the corporate instruments setting out the delegations of authority in a company clarify the accountability structure in the company, which in turn assists directors in meeting their legal obligations.

## Who is who in the company?

The focus on corporate governance has highlighted the importance of clarifying the roles and responsibilities of those with a stake in a company, that is, the shareholders, directors, executive management and employees.

- **Shareholders** (the members), as capital suppliers, share in the financial gains (and risks) of the enterprise without participating in its management.
- **Directors** are appointed by shareholders as their agents, with responsibility to oversee the company's management and to take decisions that govern the course of the enterprise.
- For the day-to-day despatch of business, directors delegate the management of the business to the **chief executive officer** (CEO), who is often also the managing director.
- The CEO in turn appoints members of **the executive management team** and delegates responsibility for particular aspects of decision-making to them. They in turn delegate operational responsibility to **employees** throughout the company.

Importantly, a central tenet of ensuring accountability in this structure is to ensure that shareholders can monitor directors' decisions, and that directors can monitor the decisions of the CEO and the executive team. Accountability mechanisms exist to constrain management power and strengthen shareholder controls, with key strategies being the clarification in law of legal duties imposed upon directors and senior management, the requirement of shareholder approval for a wider range of corporate transactions, and the disclosure of governance frameworks and processes in the annual report.

It is essential to the governance of a company to ensure that the corporate instruments put in place recognise and clarify the roles and responsibilities of those with a stake in the company.

## Why are roles differentiated?

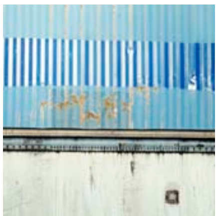
### History

The general meeting of members (shareholders) was historically the primary corporate organ — members assembled for a corporate purpose were the corporation which acted through the decision of the majority of those present. Yet an assembly of members was seen to be an unwieldy and ineffective body for decision-making. As a result, charters of trading corporations commonly provided for direction of group affairs by a council of governors or directors.

The first companies legislation[1] adopted this structure. The company (the term referred to the company in general meeting) was required to appoint directors for 'the conduct and superintendence of the affairs of the company'[2] and was precluded from participating in management 'otherwise than by means of directors'.[3] The next stage in companies legislation[4] constituted a board of directors and general meeting and left to replaceable rules and constitutional provisions the division of corporate powers between these organs. The acts of either organ, within authority, are acts of and not merely for the corporation.[5]

### Current law

Section 198A(1) (replaceable rule) of the *Corporations Act 2001* (Corporations Act) provides that the business of the company is to be managed by or under the direction of the directors; that is, the directors are to exercise all the powers of a company except any that the law or the company's constitution (if any) requires the company to exercise in general meeting.





In virtually all listed companies in Australia, this finds expression in a clause in the constitution similar to the following:

> The business of the company is to be managed by the directors, who may exercise all such powers of the company that are not, by the Corporations Act or by this constitution, required to be exercised by the company in general meeting.

The general meeting is not given express powers with respect to the conduct of the company's business. However, the members have the powers to:

- appoint directors
- determine the total remuneration cap to be paid to directors
- vote at shareholder meetings
- requisition a meeting
- question the directors and auditor at shareholders' meetings
- approve related party transactions
- vote on the remuneration report (non-binding)
- amend the constitution
- institute statutory derivative action
- access the minutes of a shareholders' meeting
- access the register of members (shareholders)
- request the circulation of a statement to all members.

That is, they are given qualified powers over the composition of the board of directors in whom management powers are vested.

Without the clause in the constitution that provides that the business of the company is to be managed by the directors, only the members in general meeting could manage the business of the company. As recognised by corporations law, and given the development of widely held corporations, this is not feasible.

## Delegation of authority

Listed companies in Australia have clauses in their constitutions that allow the directors broad ability to delegate their collective powers, but not their responsibility, to others. The constitution may specifically provide for the delegation of powers to board committees, the conferral of powers on a managing director; and for broad delegation to any other person. The Corporations Act recognises the appropriate delegation of powers.[6]
Directors may confer on a managing director any of their powers and revoke or vary the delegation of power to the managing director.[7] A managing director will be appointed under a contract of employment and, as an officer of the company, has the same duties under statute and common law as other directors, including the fiduciary duty of acting in the best interests of the company.

These constitutional provisions reflect modern corporate practice that non-executive directors of large public companies are unable to directly manage the affairs of a large company on a day-to-day basis. There is no general expectation at law that the non-executive directors will be directly involved in the day-to-day management of an extensive global enterprise or, indeed, any enterprise.

Courts have explicitly recognised that, although under a typical corporate constitution the business of the company is to be 'managed' by the directors, the reality for large companies is that management is delegated to executive officers and directors retain an oversight role.[8]

However, there can be a gap in expectations between the operation of the law and the belief in the community that directors are responsible for managing the business of the company on a day-to-day basis. The language used in the Corporations Act and constitutions can foster a belief in the community that directors have responsibility for operational management, without understanding that the delegation of authority is how directors effect their power to manage the affairs of the company. This is exacerbated by the inclusion of directors in the definition of Key Management Personnel in the Accounting Standards, which adds to the confusion that it is non-executive directors who manage the company on a day-to-day basis.

## Corporate instruments

It is therefore essential for a company to put in place various corporate instruments to clarify the operation of the delegation of authority. These can include:

- the constitution

- the board charter, including delegation of authority to CEO (or statement of matters reserved for the board)
- code of conduct
- board committee charters
- powers of attorney
- identification of risks and how they are being managed
- contract of employment with the executive team with the right to terminate.

### Accountability mechanisms resulting from a delegation of authority

The corporate instruments that set out the delegations of authority in a company clarify the accountability structure in the company.

1. Directors are accountable to shareholders (who appoint them and have the power to remove them).
2. The CEO (or managing director) is accountable to the board.
3. The executive management team is accountable to the CEO.
4. Employees are accountable to the management team.

## Aligning legal risk and community expectations

### Legal risk

There is a level of community expectation and ongoing media commentary that holds the view that directors manage their companies on a day-to-day basis and therefore should be held responsible if something allegedly goes wrong or is viewed as contentious in the media or by a shareholder. However, these expectations do not take into account the way companies operate through the delegations of authority as discussed above.

The legal risk that directors face is not aligned with the expectation of the community and media commentary. The decisions of the courts show that in matters of director liability they have given regard to the type of company involved, the size and nature of its businesses, the provisions of its constitution, the composition of the board and the distribution of work between the board and other officers.[9]

The question of whether a director has discharged their duty is not whether they have personally managed the company, but whether their conduct as director has satisfied the minimum standards of diligence and whether management powers have been delegated appropriately.

The minimum standards of diligence imposed upon a director include:

- being familiar with the fundamentals of the business and how it operates
- keeping informed of the company's activities
- generally monitoring the company's affairs
- ensuring that certain minimum standards of governance are in place and are working adequately
- ensuring that certain minimum standards of operating are in place and are functioning effectively, including providing that the entity has in place a budget which can be used to measure actual performance
- maintaining familiarity with the company's financial affairs, including reviewing financial statements and making appropriate further inquiries, and
- having a reasonably informed opinion of the company's financial capacity.[10]

The standard generally reflects what is objectively expected of a person appointed to the designated office.

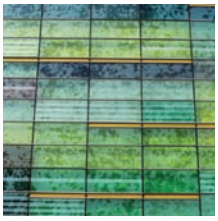
In terms of delegating management powers, a director is generally entitled to rely on the judgment, information and advice of management unless it would be unreasonable to do so.[11]

Factors that can be relevant in assessing the reasonableness of delegation or reliance include:

- the function that has been delegated is such that it may properly be left to such officers
- the extent to which the director is or should have been put on inquiry
- the relationship between the director and delegate must be such that the director honestly holds the belief that the delegate is trustworthy, competent and someone on whom reliance can be placed
- the risk involved in the transaction and the nature of the transaction, and
- the extent of steps taken by the director, for example, inquiries made or other circumstances engendering trust.[12]

### Community expectation

Governance professionals must ensure they have put in place those corporate instruments that clarify the roles and responsibilities of shareholders, directors, the CEO (or managing director) and the executive team.

For example, a constitution that altered the standard management clause (providing that the business of the company is to be managed by the directors) would change the accountability mechanisms. It has been suggested that the standard management clause could be changed to vest management powers in the CEO, which would clarify for the community that it is management, and not directors, who have responsibility for the day-to-day management of the company. However, if the clause was changed in this fashion, the power to manage the business of the company would be directly delegated to a person over whom the shareholders have no direct power. The CEO would be directly empowered by the constitution and management would no longer be a delegate of the board. (The board could retain an executive as the CEO even if they were no longer a managing director).[13]

Even if the constitution were further amended to provide for the board to 'call up' a matter from management, the line of accountability is broken. The central problem of direct delegation to a person over whom shareholders have no control remains. This would become apparent if the CEO and their executive management team was powerful and the board weak. It would be a poor governance outcome for the shareholders. Indeed, it is extremely unlikely that shareholders, proxy advisory firms or other governance advisers would approve a constitutional amendment that reduced the accountability of directors while delegating power to a person not directly accountable to the members.

However, governance professionals can assist shareholders to gain clarity as to those roles and responsibilities, and the important function that delegations of authority play in a governance structure.

## What can a governance professional do?

- Check that the management clause in the constitution aligns with s 198A of the Corporations Act, which states 'that the business of the company is to be managed by or under the direction of the directors'.
- Ensure there is a board charter that sets out clearly the scope of the role of the board.
- Ensure that there is a clear delineation of responsibility between the board and the CEO.
- Ensure there is a code of conduct applicable to all employees, including the CEO, the executive management team and all directors.
- Ensure that the board committee charters set out whether the board retains decision-making powers but receive and rely on advice and information provided by the committee.
- Ensure that there is an chart of the organisational structure in place; powers of attorney; and group delegations/discretion policies.
- Ensure that the CEO has in turn delegated authority to the executive management team.
- Ensure that the constitution and associated documents are regularly reviewed.

### Notes

1 *Joint Stock Companies Act 1844* (UK)
2 *Joint Stock Companies Act 1844* (UK), s 27 and Sch A
3 *Joint Stock Companies Act 1844* (UK), s 27 and Sch A
4 *Joint Stock Companies Act 1856* (UK)
5 Redmond P, 2000, *Companies and Securities Law*, 3rd edition, LBC Information Services
6 ss 190, 198D Corporations Act
7 s 198 Corporations Act
8 *ASIC v Rich* (2003) 44 ACSR 341(*ASIC v Rich* [2003]); *ASIC v Rich* [2009] NSWSC 1229 (*ASIC v Rich* [2009]); *AWA Ltd v Daniels Trading as Deloitte Haskins & Sells* (1992) 7 ACSR 759 (AWA); *Daniels v Anderson* (1995) 16 ACSR 607 *(AWA appeal)*
9 *ASIC v Rich* (2003), *ASIC v Rich* [2009]
10 *ASIC v Rich* [2009]
11 *AWA; AWA appeal*; *R v Williams* (2005) 216 ALR 113; *R v Adler (2005) 53 ACSR 471; ASIC v Adler [2002] NSWSC 17.* Section 190 provides that a director is not responsible for the exercise of power by the delegate if the director believes on reasonable grounds that the delegate would exercise the power in conformity with the duties imposed on directors under the Corporations Act and the company's constitution; and the director believes on reasonable grounds, in good faith and after making proper inquiry that the delegate was reliable and competent in relation to the power delegated
12 *R v Williams* (2005) 216 ALR 113
13 In many cases the CEO is also the managing director in which case the shareholders have power to remove them under s 203D. The managing director is not subject to rotation because that person is not subject to election every three years as are other directors.