DOING THE RIGHT THING

Good corporate governance is essential in business. Sarah Boyce explains why

The terms 'ethics' and 'corporate governance' are increasingly common in business circles, particularly in light of recent 'poor' behaviour by banks and other institutions. There are many possible definitions of these terms, but for our purposes, ethics refer to the principles that govern an individual's behaviour, whereas corporate governance is the system by which corporations are directed and controlled.

It is assumed that all treasury professionals adhere to the code of conduct set down by their own professional body (for example, the ACT Ethical Code can be found at www.treasurers.org/professionalguidance), as well as to their personal ethical code. Therefore, in order to understand why good corporate governance is important to treasury and to the organisation more widely, this article will focus on corporate governance.

Why is corporate governance desirable?

Most businesses start life as small enterprises, with the owners also being the people in charge of day-to-day decision making. As a business grows, shareholders become separated from management as it becomes necessary for the owners to rely on managers to make decisions on their behalf. The separation of ownership and control can lead to the problem that those acting as agents (managers) for the principals (shareholders) fail to do so in a way that maximises the wealth of shareholders. This conflict of interest between managers and shareholders is referred to as 'agency risk'.

Agency risk is: the risk that managers allow their own interests to interfere with their primary duty of acting in the best interests of the shareholders.

There are various ways of managing agency risk and encouraging managers to act in a more shareholder-oriented way. These may range from the *ad hoc* adjustment of remuneration policies, or the removal of managers who consistently fail to act in the interests of the shareholders, through to formal corporate governance codes of conduct.

Corporate governance can be defined as: a framework that ensures accountability, fairness and transparency in a company's relationship with all its stakeholders (financiers, customers, management, employees, government and the community).

How has corporate governance evolved?

Development of legislation and general codes of corporate governance have tended to 'follow the market' in that each time there is a corporate or financial scandal or crisis of some sort, an enquiry is held and lessons learned. These lessons are translated into either new legislation or new clauses in a code of practice, depending on the perceived severity of the incident. For example:

- Media tycoon Robert Maxwell was found to have raided his companies' pension funds before he died in mysterious circumstances in 1991. The resulting enquiry resulted in the UK Pensions Act of 1995.
- In the early 2000s, the high-profile corporate bankruptcies of Enron and WorldCom in the US sparked a regulatory backlash. Together, they prompted the Sarbanes-Oxley Act, which was US legislation, but resulted in a change in behaviour and standards in many other countries that adopted similar governance principles to mitigate risk in their own jurisdiction.
- The 2008 financial crisis led to further regulation (for example, Dodd-Frank in the US) and amendments to codes of conduct, which are aimed at improving the transparency with which risk is identified, managed and reported.

Corporate governance codes of practice are designed to encourage responsible management by stipulating certain standards of behaviour (for example, by requiring the presence of non-executive directors on any board of directors) and by requiring companies to explain why they choose not to adopt such standards.

Many codes of practice are given greater weight by being incorporated into the reporting requirements of listing authorities, such as the London or New York Stock Exchanges.

In addition, a more formalised approach to corporate governance has resulted in the introduction of legislation with the objective of aligning as closely as possible the interests of individuals, corporations and society. The aim is to make it impossible for companies to act against the best interests of the shareholders and other stakeholders.

What does corporate governance mean for you?

Good corporate governance is a combination of appropriate cultural behaviour in an organisation, which is reinforced by adherence to regulation, legislation and codes of practice. Corporate treasurers should understand the corporate-governance regulations that apply in the jurisdictions where they operate. Both the organisation itself and the daily activities of treasury need to be in compliance with these regulations.

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