

Transcript

Event: **ADDRESS BY ANZ CHIEF EXECUTIVE OFFICER JOHN MCFARLANE TO THE TRANS-TASMAN BUSINESS CIRCLE LUNCH, SYDNEY**

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JOHN MCFARLANE:

It's not without considerable personal risk that a chief executive stands up in front of such a distinguished audience and talks about governance. In doing so, I make no claims for ANZ to be good at this, nor do I make any claims for myself being on top of the agenda. I do recognise the incongruence about this potential poacher talking about gamekeeping and if you can see it in that context I would appreciate it.

I did notice the number of auditors in the audience today. I can assure you that you can relax in that whilst I spent a lot of time thinking about auditing about 10 years ago, it's not my main subject today.

But I wouldn't completely relax, if I was you, but my subject is elsewhere.

The last few months has been an incredibly difficult period for the world in terms of the large corporate collapses that we've seen and we've seen some evidence of that, of course, domestically in Australia.

That has led, around the world, to a considerable debate about corporate governance and, of course, regulation has then ensued with Sarbanes-Oxley in the United States extending to CLERP 9 here in Australia and I'm on the Business Regulation Advisory Group advising the Government on the introduction of CLERP 9.

The question that keeps being addressed and certainly the feeling of corporations around the world is the danger here is that there's going to be too much governance and too much emphasis on increasing regulation and that's understandable but what is also equally understandable is that what has happened has been a tragedy for the world's financial industry and it's perfectly appropriate that we see this force given what has transpired.

And therefore the force, which is a large force, to change governance in corporations is perfectly appropriate. When things go so badly off-track then you need a very large force at work bring it back on track.

Of course, governance is really a bit protection of others and in this case particularly the protection of shareholders

but also is the protection of other stakeholders such as debt-holders etcetera.

The question is, what is good governance? And good governance is about making sure essentially that stakeholders get what they could reasonably expect and bad governance is when they get something that they could not possibly have expected.

What it does not mean is that people should not be exposed to risk, nor does it mean that people should not be exposed to failure. These things must happen in the normal run of economic events. What it does mean though is that they are exposed to the level of risk that has been articulated as the potential risks in the situation that they are actually involved or investing in.

A high risk investment, therefore, still means that the possibility of loss or failure is high but a low risk investment means precisely that: low risk, unlikely to fail barring unusual circumstances that are normally beyond the control of the company.

And when you consider the examples of Enron and other major companies around the world that were investment grade, in other words, low risk, unlikely to fail, it wasn't circumstances beyond the control of the company that caused the problem and, therefore, there was a failure of governance.

What it means, therefore, is that reasonable controls need to be placed on the activities of a company, on the activities of its management, its directors and its auditors. It does mean, therefore, that companies should keep stakeholders fully informed through open and regular disclosure and in this context we're at least pleased at ANZ that for the corporate confidence index that we get every six months, that ANZ is well-regarded as a leader in disclosure, in disclosing exactly the level of risk that our stakeholders should expect of us.

And, as we find in each ensuing level of results, that the expectations of us continue to rise and areas of uncertainty continue to emerge and, therefore, we have to continue to increase our disclosure to those areas that actually emerge as uncertainties for the marketplace.

But also in this context, we've seen the Australian Stock Exchange issue proposals and proposals relating to increased disclosure. There has been some pushback on that, some concerns from corporate Australia as to whether this is appropriate but in this context ANZ feels that the proposed ASX proposals appear perfectly appropriate and perfectly normal for a market of this type.

Now, it also means that stakeholders can also expect proper diligence from auditors, regulators, rating agencies as well as by management and by directors. And so there's a hierarchy of defence levels here in governance that really need to operate effectively.

On the first hand, you've got management and essentially what we're looking for in management is balance, making sure that too much risk is not taken unless that's cleared in advance by shareholders.

You've got the responsibilities of directors who are there for oversight of the management team and their main responsibility is to be independent, objective and to form an independent and objective view as to what is going on inside the company.

We then have the auditors, in essence, the auditors need to avoid conflict of interest and also, in that context, there are maybe three things that I would point out about auditors.

Over the years it became perfectly normal for auditors to refer to the companies that they audit as the client. Now, when you think about the nature of the role that is performed by auditors, whilst there is a business relationship of auditing between themselves and the company that they audit, it is not the company that is the client. In this case it is the shareholders who are the client and not the company and therefore why do I mention this? It's that if there is a feeling inside the audit firm that the company is the client, then the attitude towards the audit will be to see the company as the client rather than the company that is being audited and it is therefore the shareholders that the auditors should look to as the client or the clients and not the company.

I believe this is a principle that really needs to be changed in the minds of the auditing profession.

You've seen more recently, of course, the separation of the consultancy activities from the auditors and I believe that is the absolutely appropriate thing to do, such that the auditors will begin to specialise in the areas of audit.

At the same time, it's very important that the auditors are independent of those companies that they audit. Now, a lot is said about criticisms of auditors but not much is said about other aspects of the audit. Much is claimed about the auditors missing certain things in company accounts and, in particular, being asked to find fraud should it exist inside companies.

And there's a general misconception that auditors' responsibilities are to find fraud. That is not correct. The auditor's responsibility is to give an opinion on the truthfulness and fairness of the accounts. It is not to find fraud. If the fraud is sufficiently material to warrant qualification of the accounts such that it affects the truthfulness and fairness of the accounts, then that falls within the scope of the audit. If, on the other hand, the level of fraud is below what would be regarded as material, that is not within the scope of a normal audit and therefore is not part of the price of the audit.

So if society wishes auditors and government wishes auditors to find fraud then the scope of the audit needs to be extended and the price of the audit needs to rise and the materiality threshold, which is quite large is very large companies such as ANZ, the materiality could be as much as \$50 million.

If you want that materiality and accounting issues and fraud at that lower materiality level to be looked at, then we need to extend the scope of the audit and we need to increase the cost of the audit to shareholders because that is not within the current scope of the audit and I think that requires review.

Another thing in favour of the auditors is that generally they are seen as the source of potential damages in the consequence of a client failing, the company failing. Now, in this particular respect, there is an issue in that relative to the size of the firms that are audited the audit firms are in general very small and whilst in a collapse the auditor may have one of the deepest pockets that are available for potential damages, these pockets are not very large and, therefore, urgently what is needed is an increase in availability of insurance premiums for auditors to meet the demands placed on them because that is not available to the extent it's required today.

And in tandem with that the auditors need to think about ensuring that they have limited rather than unlimited liability because the size of the firms that fail are far greater than the size of the auditing firms themselves and, therefore, the concept of limited liability is absolutely at the threshold of making some progress here.

Of course, if there's a failure of audit then there are other people who should be responsible. We do have standard-setters around the world, we have the listing authorities where you need to ensure that you meet the listing requirements of the Australian or London or the New York stock exchanges and, of course, we have the rating agencies. It goes without saying that most of the

companies that failed were investment grade rated by rating agencies.

And so there is another layer there that really needs to bite in order that we avoid these unpredictable collapses.

And then finally we have the statutory regulators. In a number of professions around the world, the concept of self-regulation has been the dominant theme and self-regulation has added value through time to the governance of society. I would remark though, that there tends to be more compromise in self-regulation than there is in statutory regulation and as a former regulator myself I am more in favour of statutory regulation than self-regulation as a strong force for governance.

Now, why do I say that? It's because most of the reform around the world tends to be placed on the oversight by directors and by auditors but I believe that that consideration needs to be extended to the other checks and balances that are in the system.

Now, in terms of reforming governance around the world, much of the reforms focus on tightening the rules. The Sarbanes-Oxley Act, for example, is extremely prescriptive in its application.

One of the problem about rules is that the rules describe the boundary of what is tolerable. For example, the 100 kilometre speed limit on the freeway is a rule. It says that you're OK to drive up to 100 but you shouldn't drive beyond.

A principle defines the central gravity of what is expected. In other words, we want safe drivers. What tends to happen with a rules-based society is that the rule becomes the mean. So, in other words, the 100 kilometres is the average speed on the freeway not what is intended which is, I'd say, around about 90 where the distribution fades off at about 100.

And so you cannot base a governance system on rules alone. You do need rules because there are going to be those situations and those people who need to be caught by the enforcers of rules but you do need principles as the central gravity also of any governance system because they describe what is intended. And the closer you are to the principle the less the distribution will fall outside the boundary.

And so we need well-thought principles to really guide us to good governance but we also need the rules so that they catch those that actually veer towards the boundaries.

In talking about directors' role in governance, the structure of boards varies around the world, with Australia having a relatively unique, and I would regard as an advantageous system, having really been involved in the other systems personally.

In the United States, the chairman has hitherto been the chief executive and most of the vice-chairmen were executive directors of the boards of American companies with extremely large boards.

In the United Kingdom, you have executive directors and non-executive directors and the governance authorities find a way round that by creating a two-tier responsibility between executives and non-executive directors.

In Australia you tend to find that there is either no executive on the board or there is one executive that tends to be the managing director.

Now, I would talk about this concept of executive director as being fundamentally flawed. I think it's very difficult to be an executive director. You can be a director and you can be an executive but you cannot wear both hats at the same time. And so, for that reason, when an executive is on the board of a company, they are not representing management at the board, they are a director of the company representing the shareholders. When they're an executive they are actually overseeing the management of the company.

One of the issues with the Australian paradigm is that managers manage and that directors direct. Now, anyone who's been involved in running a company knows that that obscures the interdependent nature of those roles in today's very complex companies. In order for boards to be informed they need to get involved in the companies.

Some years ago there was a press article that argued, "Who is running ANZ?" And the argument was that the board should not get involved in management but should only be involved in oversight. It is very difficult to define where management ends and governance begins and it's for that reason that there has to be a level of interdependence, certainly in the dialogue between management and directors and there are states of the world where management has failed that then the directors need to take on a more onerous role beyond that of governance, in managing the company temporarily until a new management team is formed.

And so I would argue that all these defence mechanisms are important but the first rule and the first line of

defence is actually that of the CEO and the management team and not just the governance.

Now, one of the issues about being a CEO of ANZ or of any other company, I will tell you that in my whole career I have never seen a set of cash flows that don't go up.

I have never seen a set of cash flows that don't repay a loan. Ever.

And yet, we have seen ultimate results where the cash flows not only not go up but actually go down quite fast and we've also seen hundreds and thousands of bad loans. And so it's very important, therefore, that the beginnings of governance start at the management team and that the directors and beyond that are really the next and following subsequent lines of defence.

The first effective line of defence, therefore, requires that management is capable, it is principled, it is trustworthy and it is well-controlled and those things do not reduce the need for oversight but they do reduce the risk of that oversight needing to bite.

And therefore management needs to institute inside the companies that they manage independent controls that are independent of the line executives whose cash flows always go up and you need activities such as risk management, financial control and internal audit. And each process should be focused and structured around the most important control areas and around the most important risks in the company as the first line of defence.

I've been giving some thought as to what is required to avoid a disaster in a company.

We've seen, over the years a number of disasters and they tend to be environmental but we've also seen them in terms of company collapses, you know, you have the Exxon Valdez tragedy and tankers in North America, we've seen plane crashes, etcetera. And the question, what can you do to avoid a disaster?

It is my view that the disaster is not a surprise to everyone either outside or inside the company when it happens.

On the aeroplane, somebody says, "I thought the runway was over there." If the captain of a ship is drunk he's not the only one who knows that. And inside the company, somebody inside the company has said, "Are you absolutely sure we should be doing this? Are you sure that that's right?"

And what tends to happen is that those voices are there and that one of two things happen, is the voices are quelled such that they cannot be spoken or that there's nobody listening.

And the secret of avoiding large-scale problems inside companies is a strong, open culture and a value system that actually encourages an inquiring mind and an inquiring set of voices. And therefore it's very important particularly in a bank that we have that.

Now, a commercial bank such as ANZ should have a low-risk profile. We hear arguments by shareholders that what they're interested in is in growth. I do not believe that shareholders want a high-growth bank. I'm absolutely certain that depositors don't want a high-growth bank.

With a high-growth bank you get high growth but it's only temporarily and then after the period of growth you get the impending disaster. You only have to look at ANZ in the early nineties to see the consequence of too much growth in the eighties and then the consequence of that in the early nineties period. And a commercial bank that has responsibility to shareholders but also has the responsibility to deposit-takers, to protect their money and keep their money safely, in the absence of an insurance system that exists here, a commercial bank can only have a low-risk profile.

And, of course, having a low-risk profile, as far as ANZ is concerned, and in my terms, is making sure you don't make big screw-ups. It's very important as a chief executive to manage the downside in every situation and to lower the probability of severe downside such that notwithstanding you may not get the upside, at least you can make sure that depositors' interests are protected.

Now, governance has been really focused around shareholders' interests and the financial equation for some time but I believe in the 21st century that will actually evolve and that good governance will need to cover all stakeholders and not just shareholders.

Traditionally the shareholder focus in the 19th and 20th centuries have been perfectly appropriate as governance actually started to become a key industry and requirement of companies but I think as we move into the 21st century it's not good enough just to produce results for shareholders and to be a safe organisation. Corporations today can be bigger than countries around the world and therefore it's very important that these companies contribute to society and are good corporate citizens beyond just being contributors to shareholders.

And therefore, it's likely, going forward, that governance will extend and the role of boards in this will extend to customers making sure that in producing shareholder returns that customers' interests are advanced; employees' interests, because if your employees are happy they're more likely to serve the customers, if the customers are well-served you're more likely to produce revenues and therefore you'll produce results for your shareholders; debt-holders, given the nature of the financial markets today and the level of financial gearing, and then finally the community as a whole. The community now expects companies not only to produce good results but also to be good citizens and I believe that the balanced nature of Australia has given us a very different paradigm here in that the sense of the community and for customers is far stronger on balance than exists in most other countries and therefore the force at work in favour of the community and good corporate citizenship of companies actually is on the up in Australia and I believe Australia can and has the opportunity to show the way for companies globally.

So let me summarise the key points I've made.

Firstly, the force to improve governance of corporations is perfectly appropriate in the light of the collapses that we've seen.

Secondly, stakeholders should expect from their companies a reasonable level of governance but a rules-based approach must be accompanied by core principles and by values and that governance is not the sole responsibility of the board alone, the hierarchy of governance of companies and that each level of defence, starting with the management, going up to the board, onwards through to the regulators needs to bite for the whole system to be robust.

And that Australia has an appropriate board structure but that the role of the CEO and management is the first line of defence in good governance by the board and by the authorities.

And that finally, in the 21st century, that good governance really needs to be extended to all stakeholders and not just shareholders and I believe that Australia stands at the forefront of that as an opportunity. Thank you.

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