AUSTRALIAN INSTITUTE of COMPANY DIRECTORS

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The Boardroom Report

Reforms still stuck at the starting line

> *"URGENT STEPS HAVE TO BE TAKEN BY ALL GOVERNMENTS TO ACHIEVE THESE CRUCIAL REFORMS"*

The Australian Institute of Company Directors supports new efforts by the Federal Government to amend director liability provisions in Australia, but has expressed extreme frustration at failure of the states and territories to move ahead with previously proposed reforms in this area.

Last week, Parliamentary Secretary to the Treasurer David Bradbury released for public comment amendments to director liability laws in an exposure draft of the Personal Liability for Corporate Fault Reform Bill 2012. These will form the first part of the Commonwealth's implementation of the Council of Australian Governments' (COAG) Director Liability reform project.

Bradbury noted: "The reform aims to harmonise the approach to imposing personal criminal liability for corporate fault – otherwise known as derivative liability – by requiring jurisdictions to audit their laws against COAG agreed principles and to amend legislative provisions to reflect a truly national approach to imposing personal criminal liability on corporate officers. In line with the COAG reform objectives, the Commonwealth has assessed its laws against the COAG principles and supplementary guidelines and the amendments proposed in this Bill reflect the proposed changes within Treasury portfolio legislation, excluding taxation legislation."

Company Directors CEO and managing director John H C Colvin said his organisation would be reviewing the draft legislation and looked forward to seeing the second tranche of proposed amendments relating to other Commonwealth legislation, which is expected to be released this quarter for public comment.

"Derivative liability laws currently imposed on directors hurt productivity because they encourage directors to make sub-optimal business decisions, take an overly cautious approach to decision-making and focus their minds excessively on risk avoidance rather than on ways to improve value, competitiveness and profitability," he said.

However, Colvin also slammed the failure by the states and territories to make any real progress in reforming the liability burden of Australia's 2.1 million directors.

The COAG Reform Council's annual progress report found that there had been "poor progress made" on these reforms and that they were at serious risk of not being achieved.

"We agree with the Reform Council that urgent steps have to be taken by all governments to achieve these crucial reforms that could have a far reaching benefit for the economy and jobs," said Colvin.

More than 90 per cent of Company Director members polled in a 2010 survey believed that personal liability had an effect on optimal business decision-making or outcomes and 65 per cent said this risk caused them or their boards to take an overly cautious approach to business decision-making, either frequently or occasionally.

There are currently around 700 state and territory laws, not including Federal legislation, which impose personal liability on company directors. But Colvin said: "After four years of so-called reform, of all the derivative personal criminal liability provisions across Australia, only 20 have been repealed – less than three per cent."

He said Company Directors had formulated its own set of principles that could be adopted to help address the inadequacy of the current framework. "Our principles have been developed in consultation with some of the nation's leading legal minds and include a model legislative provision, which allocates an appropriate burden of personal criminal liability while continuing to impose legal responsibility in cases of compelling public importance."

The draft Personal Liability for Corporate Fault Reform Bill 2012 can be found at www.treasury.gov.au and submissions close on 30 March 2012.

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The Boardroom Report

Super strong arguments for independent directors

The Australian Institute of Company Directors believes that the Australian Prudential Regulation Authority (APRA) should put more thought into how it could ensure independent directors and chairs are included on superannuation trustee boards.

In its *Discussion Paper: Prudential standards for superannuation*, ARPA does not propose that Registrable Superannuation Entity (RSE) licensees should have a minimum number of independent directors on their boards or that the chairman be independent.

However, in its response to this discussion paper, Company Directors points out that many organisations, including the Organisation for Economic Cooperation and Development, ASX Corporate Governance Council, Australian Council of Super Investors and Financial Services Council, have stressed the importance of having independent or non-executive directors on boards.

In addition, APRA's own standards require the boards of authorised deposit-taking institutions, general insurers and life companies to have a majority of independent directors at all times.

Company Directors notes that independent directors can:

- Exercise objective independent judgement in order to make decisions in the best interests of an entity;
- Bring external experience and specialist knowledge;
- Assist in areas where there is potential for conflict of interests;
- Help ensure legal and ethical behaviour;
- Bring an objective perspective in evaluating the performance of an entity and management;
- Bring an objective perspective in identifying and managing risk; and
- Assist in balancing competing demands on an entity.

Company Directors says independent directors can also add value to super funds subject to equal representation requirements or which for other reasons have boards made up of only employer and member representatives.

"Independent directors can represent and protect the interests of significant groups that are unrepresented under the equal representation model. The *Super System Review* found that employer and employee representatives are often nominated by third party organisations, such as employer associations and trade unions, which do not necessarily represent the interests of all employers or employees."

Company Directors adds that independent directors can provide a fresh perspective and bring different skills and knowledge, particularly where member and employer representatives have similar backgrounds, experiences or training. They can also bring specialist investment, finance, director or trustee experience, which employer and member representatives may lack. And, they may reduce the risk of industrial instability, which is inherent in the equal representation model.

Company Directors argues there should be enough independent directors to genuinely influence and affect the decisions of a superannuation board. But it does not believe that independent directors should be mandatory and warns against a "one-size-fits all" approach.

"RSE licensees should be free to adopt governance practices that are appropriate for the type of RSE and its situation, size, structure and industry associations. This flexibility is particularly important in view of the ongoing and rapid changes to the environment that RSEs operate in."

Among the other issues Company Directors believes APRA should consider further before introducing prudential standards for the superannuation industry are:

- Whether the proposed definition of "independent director" is sufficiently strict;
- Clarification of circumstances giving rise to potential conflicts and the disclosure of potential conflicts to APRA;
- Requirements regarding the qualifications, knowledge and skills of RSE licensee directors;
- The need to create a regulatory environment that fosters good governance while avoiding the imposition of unreasonable cost and time burdens on RSE licensees; and
- The education of RSE licensees and their directors in relation to the proposed regulatory changes and governance issues more broadly.

Company Directors also notes the strong and widespread support for the ASX *Corporate Governance Principles and Recommendations*, which establish a robust governance framework for listed entities. "To the extent possible, APRA should seek to ensure that the regulation of RSE licensees is consistent with these principles and recommendations, including the 'if not, why not' approach," it says.

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The Boardroom Report

One way to exit your business

Revenue royalty financing (RRF), which has been used in the US for decades, may help business owners exit their businesses in the current tough climate.

Yanese Chellapen, a director of Pennam Partners, observes that more Australian businesses are being put on the selling block as baby boomers near retirement age.

According to the latest 2011 BizExchange Index of Private Company Values, the number of businesses for sale skyrocketed in the September quarter from a previous record volume in the June quarter. And, values remain at an all time low.

Chellapen says lack of funding in this space is exacerbating business exits, causing owners to slash the value of their businesses in order to sell or to defer their retirements because they can't find a suitable buyer at the right price.

He says: "The current bank lending rule of thumb is 50 per cent gearing, with the incoming business owner expected to fund the remaining purchase consideration. While this may be conceivable at the micro-business level, it is a major impediment in the small and medium business space for a business owner to come up with this amount of cash."

He says there are numerous alternatives a buyer can contemplate, but many of these require the vendor to maintain some form of "skin in the game". "The feedback that we have been receiving from vendors is: 'Why should we finance the buyers for the next two to five years and get paid out of our own profits?' In short, vendors would generally want to cash out from day one and to fully exit their business or maintain their current ownership for the next couple of years and fully benefit from the returns before exiting."

Chellapen explains: "RRF investors will fund part of the acquisition proceeds and in return be entitled to 'royalty' payments computed on the (future) revenue of the business. This funding is akin to debt financing, with different permutations depending on circumstances, with the investor having a right to the revenue prior to the expenses of the business being funded."

The benefits of RRF are:

- There is little or no equity dilution and therefore the incoming business owner will maintain full control of the business;
- The incoming business owner does not have to plan for an exit strategy (or be rushed into one) since there is no third party equity investor. The investor is gradually exiting the business by getting paid back in revenue royalty payments;
- Little or no reliance is placed on the valuation of the business since no equity stake is being provided; and
- Generally, no director's guarantee is required.

Chellapen says: the RRF avenue could enable buyers to close the deal and may appeal to investors who are shying away from equity markets in the current economic environment. "It may be easier to attract investors since their returns will be revenue driven rather than net profit driven – the latter has more fluidity with management input."

He says the drawbacks of the RRF route, depending on the terms of the investment, could include:

- Banks may not be willing to lend concurrently to a business with an existing RRF in place.
- The financial modelling has to stack up or else the business may face liquidity issues. Remember that the P&L would have a net revenue starting point because the royalty payments would have effectively come out of the gross revenue.
- Without any ceiling cap, the investor will share the upside in revenue growth. RRF investors would share greater returns with high revenue growth companies translating into a higher cost of "debt" capital.
- This avenue may lead to a higher cost of "debt" capital if not properly managed and negotiated (for instance, by the use of a ceiling cap in relation to the revenue streams).

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The Boardroom Report

Five talent strategy questions

Boards of small and medium-sized enterprises (SMEs) encounter many challenges when planning their strategies. But without the right quantity and quality of talent now and in the future, the execution of those strategies will be constrained, warns Dianne Jacobs, founding principal of The Talent Advisors.

To ensure business and talent strategies are tightly fused, she advises directors to start with the outcome in mind.

Jacobs believes the questions directors may need to ask to build a defensible, diverse bench of talent ahead of less prepared competitors include:

- **Does it build revenue?** Considered efforts to attract, select, retain, engage and develop the right people should be directed at lead-business lines, critical market segments, service value, current key client groups, targeted new clients or new revenue streams.
- **Can we counter uncertainty?** Talent management has to work ahead of the curve. Directors should develop a range of scenarios to build a picture of how the external environment will affect the organisation, and how the business will respond from a talent perspective. What emerges is a true talent planning document and not just a head-count budgeting process.
- **Where are the risks?** The focus should be on critical roles – not only key people. On the list must be those positions that make a significant contribution to current or future core business activities as well as hard-to-fill roles or those that require specialised training. Do retirements alter plans? Consider unwanted vacancies: would you be able to replace or up-skill and how quickly could a new employee exceed break-even?
- **Do we need a new approach?** Looking outside the company helps form a view of community and demographic trends that affect supply sources for critical jobs. Closing any gaps may require alternative strategies such as investment in retraining, rethinking career paths or experience profiles, and redesigning position descriptions.
- **How do we measure outcomes?** A persistent issue is demonstrating a return on investment. Setting meaningful lead and lag human capital metrics is a start. What savings or costs are realised in filling skills gaps, resourcing and developing for future needs, rewarding high-performers and other strategic talent decisions?

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The Boardroom Report

Schools swelter as the reform temperature rises

Directors sitting on the boards of private school boards may be forgiven for feeling overwhelmed by the pace of regulatory reform.

As the deputy executive director of the Independent Schools Council of Australia (ISCA) Barry Wallett points out, there are currently a large number of reform activities that will affect the management of independent schools.

In addition to educational reforms, school boards have to keep up to speed with the Gonski review, early childhood reforms with a new regulator (Australian Children's Education and Care Quality Authority), a new vet regulator (Australian Skills Quality Authority), amendments to international student legislation (ESOS Act and Visa's) and now the Australian Charities and Not-for-profits Commission (ACNC).

Wallett says while ISCA supports the general thrust of the not-for-profit (NFP) reform agenda, it is potentially very complex in its application to schools as they are already highly regulated at Federal and state levels.

Schools are charities set up under a range of different formal structures in each jurisdiction. NFP changes affecting non-government schools include: the statutory definition of charity, better targeting of tax concessions, governance and imposed accounting standards, legislation and operational guidelines of the ACNC and a review of corporations limited by guarantee.

According to Wallett, schools are particularly worried about the pace of change and also concerned about the fact that none of the NFP changes will, for example, affect government schools.

"Schools should be seen as low risk NFPs and therefore be excluded from the initial regulatory environment and subject to a phased in approach under the ACNC's regulations."

Wallett notes that if schools are not able to maintain a charity status, including associated taxation benefits, there will be a major upward shift in their operational costs.

The Federal Government's consultation paper titled *A Definition of Charity*, released on 28 October 2011, suggests that NFPs may be required to demonstrate their "public benefit" when seeking approval as a charity.

But Wallett says: "Based on the independent school experience in the UK with its Charities Commission, the presumption of public benefit for non-government schools should be maintained to remove uncertainty in the sector."

He says any duplication of reporting that may result from reform initiatives is an issue as schools already have a sophisticated multi-level reporting system in place as well as My School as a public and very transparent information tool.

He adds: "Schools are already burdened with substantial compliance costs and any additional requirements would place further demands on the resources of school communities.

"Any new arrangements should at least be consistent with the current governance, duties and accountability arrangements required by the Australian Securities and Investments Commission, associated Corporations Law and the Department of Education, Employment and Workplace Relations under its current funding agreements."

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