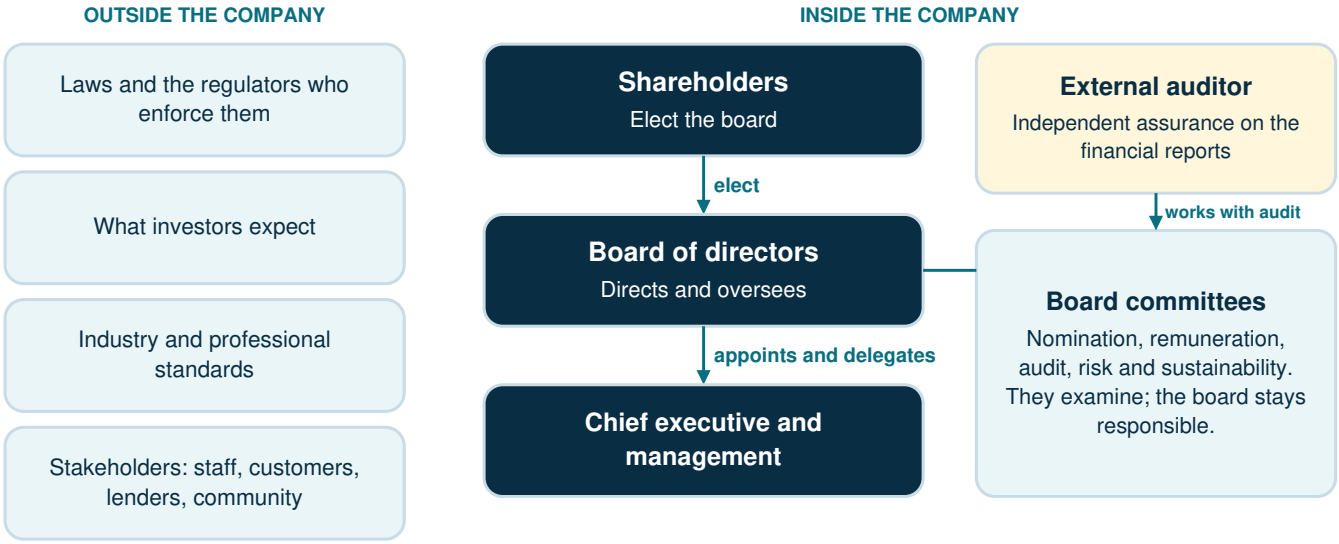
The governance framework

MODULE 3 | PART B.2 | STUDENT COMPANION

Outside influences shape every company. Inside, shareholders elect the board, the board appoints the chief executive and uses committees, and the external auditor gives independent assurance.



Two kinds of shareholder

	Individual shareholders	Institutional shareholders
Who	People who own shares directly, many of them retirees	Super funds, insurers, investment trusts, fund managers
What they want	Efficient, profitable, honestly run companies	Returns for their own members over the long term
How they influence	Votes, questions at meetings, media and online, shareholder associations	Large votes, in-house analysts, proxy advisers, stewardship codes, private engagement

Information asymmetry - one side knows much more than the other. **Moral hazard** - someone takes more risk, or less care, because they won't bear the full consequences and others can't easily see what they do. The first often opens the door to the second.

Committees and the audit committee

MODULE 3 | PART B.2 | COMMITTEES AT A GLANCE

Committee	Main job	Who should sit on it
Nomination	Succession, board evaluation, recommending director candidates	Mostly independent directors; executives can contribute
Remuneration	Pay for directors and senior executives	Independent directors; executives never set their own pay
Audit	Financial reporting, internal control, internal and external audit	Non-executives only, mostly independent, independent chair who is not the board chair, financial expertise
Risk	Risk framework and risk appetite, including strategic and climate risks	Mostly independent directors
Sustainability	Climate, emissions, modern slavery, cybersecurity, sustainability reporting	Works closely with the risk and audit committees

Audit committee health check

1. **All members non-executive?**
2. **Mostly independent, with an independent chair who is not the board chair?**
3. **Enough accounting and financial expertise, and industry knowledge?**
4. **A written charter giving clear authority and reporting lines?**
5. **Meets the auditors, including without management present?**

→

All yes
Independent, skilled and genuinely at work

Any no
A warning sign: fix it, or for recommendations, explain why not

Benefits when it works	Limitations to watch for
Stronger internal control and record keeping	May lack power to enforce its recommendations
Supports the external auditor's independence	Members lacking financial skills, or chosen for loyalty
Better-quality financial reports	Management's presence stifling open discussion
A forum for auditor-management disagreements; checks whistleblowing channels work	Unclear terms of reference, time and cost, or existing for appearances only

Practice questions

MODULE 3 | PART B.2 | TRY THESE BEFORE THE WORKED ANSWERS

Question 1 - Lakeside Medical Devices Ltd

Imagine **Lakeside Medical Devices Ltd**, a company in the S&P/ASX 300. Its audit committee has two members. It is chaired by the chief operating officer, an executive director. The other member, a non-executive, is the chief executive's brother-in-law. Neither has accounting or financial qualifications. The committee meets once a year, a week before the annual results, has no written charter, and the external auditor reports its findings to the chief executive rather than to the committee. Identify the weaknesses and suggest a fix for each.

Question 2 - Westward Logistics Ltd

Regional managers at **Westward Logistics Ltd** earn a bonus for on-time deliveries. The board sees only the on-time percentage. Managers know some drivers skip rest breaks to hit targets. Explain the problem using the terms information asymmetry and moral hazard, and suggest two fixes.

Lakeside Medical Devices and Westward Logistics are imagined examples. Study guide reference: Module 3, Part B, section 3.6.

Worked answers

MODULE 3 | PART B.2 | WORKED ANSWERS - ATTEMPT THE QUESTIONS FIRST

Question 1 - Lakeside's audit committee

Weakness	Why it matters	Fix
Only two members	Too small to give depth and independence	At least three members
Chaired by an executive director	Management would be overseeing its own reporting	Non-executives only, with an independent chair who is not the board chair
Member is the CEO's brother-in-law	Close family ties to management undermine independence	Replace with an independent director so most members are independent
No financial qualifications	Can't challenge judgements, estimates or audit findings	Appoint members with accounting and financial expertise
Meets once a year	Too late to influence reporting or audit planning	Meet regularly through the year, including half-year and year-end reviews
No written charter	Authority and duties are unclear	Adopt a written charter with clear reporting to the board
Auditor reports to the CEO	Defeats the committee's role as the link to the auditor	Auditor reports to, and meets, the committee, including without management

Because Lakeside is in the S&P/ASX 300, the listing rules also require it to follow the recommended audit committee structure, so these are not optional design choices.

Question 2 - Westward Logistics

Information asymmetry: the managers know drivers are skipping rest breaks, but the board sees only a strong on-time figure. **Moral hazard:** the managers gain the bonus while the safety risk, fines and harm fall on the drivers, the company and the public, and the board can't easily see what is happening.

- Give the board richer information, such as fatigue, safety incident and rest-break data.
- Balance the bonus with safety measures, or make safety a gateway the managers must pass before any bonus.
- Arrange independent checks, for example internal audit reviews of driver logbooks.