‘(1) A director or other officer of the corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:

(a) were a director or officer of a corporation in the corporation’s circumstances; and

(b) occupied the office held by, and had the same responsibilities within the corporation as, the director or officer.’

1.2 The current provision is section 232(4):

‘In the exercise of his or her powers and the discharge of his or her duties, an officer of a corporation must exercise the degree of care and diligence that a reasonable person in a like position in a corporation would exercise in the corporation’s circumstances.’

1.3 The key concern with the current provision is uncertainty over the words ‘in a like position’. They were intended, according to the explanatory memorandum to the 1992 legislation which introduced this wording, to allow consideration of the special background, qualifications and management responsibilities of a particular officer in evaluating their compliance with the standard of care. However, the words suggest simply a consideration of the type of position held by the officer, and not the individual circumstances of the officer.

1.4 The proposed new wording will retain the need to consider the corporation’s circumstances, and will allow consideration of the nature of the office and responsibilities held by the officer. It appears still to be the case that the wording does not extend to the special background or qualifications of the officer.

1.5 A related amendment is that the definition of ‘officer’ will be replaced, removing the dichotomy between, on the one hand, the general definition of that term in sections 9 and 82A and, on the other hand, the special definition of that term in section 232(1). The proposed new definition will be substantially similar to the existing definition in section 232(1), with the exception that the existing reference to ‘executive officer’ will be replaced with a reference to, in summary, a person who makes or participates in making decisions that affect the whole, or a substantial part, of the business of the corporation; or who has the capacity to affect significantly the corporation’s financial standing; or in accordance with whose instructions or wishes the directors of the corporation are accustomed to act.

1.6 Given that the current definition of ‘executive officer’ refers to a person who is concerned in, or takes part in, the management of the body corporate, the class of officers subject to the duties may be somewhat smaller than under the current law.

1.7 It appears that the proposed changes will not introduce a statutory objective standard of skill. This will continue to be confined to the common law duty of skill applicable to financial statements and the financial affairs of the company.

1.8 It is helpful that breach of the duty of care and diligence will no longer be an offence under the law.
2. **Good Faith**

2.1 The proposed section 181, which requires directors and other officers to act in good faith in what they believe to be in the best interests of the corporation, and for a proper purpose, will replace existing section 232(2), which is in the following terms:

> 'An officer of a corporation shall at all times act honestly in the exercise of his or her powers and the discharge of the duties of his or her office.'

2.2 The new provision will be complemented by section 184(1), which creates a criminal offence where directors or officers intentionally or recklessly fail to exercise their powers and discharge their duties in good faith in the best interests of the corporation, or for a proper purpose, and they do so dishonestly.

2.3 As noted in the explanatory memorandum to the Bill, the use of the term ‘honestly’ in the current wording gives rise to a number of difficulties. In particular:

(a) there has been doubt over whether the provision applies to subjectively honest conduct which nevertheless contravenes the strict duty of loyalty. In *Marchesi v Barnes* [1970] VR 434, it was concluded that acting ‘honestly’ refers to acting bona fide in the interests of the company, and that a breach of this obligation involves consciousness that what is being done is not in the interests of the company, and deliberate conduct in disregard of that knowledge. The question which has arisen since that case is whether there is a breach of the section if a director fails to exercise a power for proper corporate purposes even though the decision gives no personal benefit and the director honestly believes that the conduct is in the best interests of the company; and

(b) the use of the term ‘honestly’ is difficult to relate to the use of the term ‘dishonestly’ as one of the fault elements in section 1317FA, which sets out the circumstances when a person is guilty of a criminal offence where there is a contravention of a civil penalty provision.

3. **Directors of Wholly Owned Subsidiaries**

3.1 Proposed section 187 provides that a director of a wholly-owned subsidiary is to be taken to act in good faith in the best interests of the subsidiary if the constitution of the subsidiary expressly authorises the director to act in the best interests of the holding company; the director acts in good faith in the best interests of the holding company; and the subsidiary is not insolvent at the time (or in consequence of) the director’s conduct.

3.2 The explanatory memorandum indicates that this provision is based on section 131(2) of the New Zealand *Companies Act 1993*. It would also appear to reflect High Court authority that a provision in the company’s constitution authorising a director to act in the interests of the holding company is relevant to the question of whether there has been conduct tainted by conflict of interest (*Whitehouse v Carlton Hotel* (1987) 162 CLR 285).

3.3 In the context of large corporate groups, it should be noted that the definition of ‘wholly-owned subsidiary’ in section 9 is effectively confined, on a literal reading, to two levels in the corporate structure.
4. Reliance on Information or Advice Provided by Others and Delegation of Responsibility

4.1 Before the Court of Appeal decision in the AWA litigation, the test of ‘permissible delegation’ referred to in the judgment of Romer J in Re City Equitable Fire Insurance Co Ltd [1925] Ch 407 had been accepted, namely that ‘in respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly’.

4.2 In the Court of Appeal decision in AWA, it was made clear that reliance is not permissible if the directors by the exercise of ordinary care should have known the facts which would make reliance unreasonable.

4.3 The Court refers to a number of US cases for propositions to the effect that a director may not rely on the judgment of others, especially where there is notice of mismanagement. For example, when an investment poses an obvious risk, a director cannot rely blindly on the judgment of others. Similarly:

‘If, upon the other hand, directors know, or by the exercise of ordinary care should have known, any facts which would awaken suspicion and put a prudent man on his guard, then a degree of care commensurate with the evil to be avoided is required, and a want of that care makes them responsible. Directors cannot... shut their eyes to what is going on around them’ (Rankin v Cooper (1907) 149F 1010 at 1013).

4.4 In summary, the Court required that directors must monitor and guide the affairs of the company. The extent of the practical obligations that this imposed on non-executive directors was left somewhat unclear.

4.5 Proposed section 189 provides that a director’s reliance on information or professional or expert advice is taken to be reasonable, unless the contrary is proved, in specified circumstances. In summary:

- the director must believe on reasonable grounds that the employee is reliable and competent or that the advice is given by an adviser or expert in relation to matters within that person’s professional or expert competence;

- where reliance is placed on another director or officer, it must be in relation to matters within the director’s or officer’s authority or, if a committee of directors is involved, reliance is placed on the committee in relation to matters within the committee’s authority;

- the reliance must be made in good faith and after making proper inquiry if the circumstances indicate the need for inquiry; and

- the reasonableness of reliance must arise in proceedings brought in relation to the director’s performance of a duty under Part 2D.1 or an equivalent general law duty.

4.6 As a practical matter, the proposed provisions will require directors to make sure they have ‘reasonable grounds’ to believe in the competence of employees and advisers.
Will the mere holding of a particular office or capacity be sufficient? Directors will need to be cautious in accepting advice from employees or advisers who do not have recognised seniority or who have tendered questionable advice in the past.

4.7 Proposed section 198D provides that unless the company's constitution provides otherwise, the directors may delegate any of their powers to a committee, a director, an employee or any other person. Proposed section 190 provides that where delegation takes place under section 198D, a director is responsible for the exercise of the power by the delegate as if the power had been exercised by the directors themselves unless:

- there were reasonable grounds to believe that the delegate would exercise the power in conformity with the duties imposed on directors and by the law and the constitution; and

- the director believed on reasonable grounds and in good faith and after making proper inquiry if the circumstances indicated the need for inquiry, that the delegate was reliable and competent in relation to the power delegated.

5. Indemnities and Insurance

5.1 Currently, section 241(1) prohibits a company or a related body corporate from indemnifying a person who is or has been an officer or auditor against a liability incurred in that capacity (or exempting such a person from such liability). In the case of an indemnity against a liability to a third party, the prohibition does not apply unless the liability arises out of conduct involving a lack of good faith. The prohibition also does not apply in the case of a liability for costs and expenses incurred in defending proceedings in which judgment is given in favour of the person or in which the person is acquitted, or in connection with an application in which the court grants relief to the person under the Corporations Law.

5.2 Proposed section 199A(2):

(a) broadens the prohibition to include indemnities given by agreement or the making of a payment and whether directly or through an interposed entity;

(b) specifies the kinds of liability against which a person may not be indemnified (namely a liability owed to the company or a related body corporate; a liability for a pecuniary penalty or compensation order under sections 1317G and 1317H; and a liability that is owed to a third party which did not arise out of conduct in good faith); and

(c) provides that the prohibition does not apply to a liability for legal costs.

5.3 Proposed section 199A(3) introduces special rules about legal costs. An indemnity may not be given in respect of legal costs incurred in defending an action for liability as an officer or auditor if:

- the person has a liability for which they could not be indemnified under section 199A(2);

- the person is found guilty in criminal proceedings;
the court agrees that grounds for seeking an order by the ASIC or a liquidator have been established; or

the person applies for relief under the Corporations Law but the court denies the relief.

5.4 These provisions should be read in the light of proposed section 212 which states a number of circumstances in which member approval is not needed for the giving of a financial benefit. Under that section, member approval will not be required for the giving of a financial benefit which is a payment (whether by way of advance, loan or otherwise) to an officer in respect of legal costs incurred in defending an action for a liability incurred in that capacity and, in the case where section 199A applies to the costs, the officer is obliged to repay the amount if the costs become costs for which the company must not give the officer an indemnity under that section.

5.5 The prohibition on providing an indemnity in respect of legal costs in defending or resisting proceedings brought by ASIC or a liquidator does not apply to costs incurred in responding to actions taken by ASIC or a liquidator as part of an investigation before commencing proceedings for the court order.

6. Right of Access to Company Books

Proposed section 198F is directed to reducing the difficulties experienced by many directors when proceedings are brought against them after they have ceased to hold office. Section 198F(1) provides that a director may inspect the books of the company (other than its financial records) at all reasonable times for the purposes of a legal proceeding to which the person is a party; that the person proposes in good faith to bring; or that the person has reason to believe will be brought against them. A similar right continues for seven years after the person has ceased to be a director.

7. Material Personal Interests

7.1 The obligation in current section 231 on a director of a proprietary company to disclose certain interests is to be expanded to include any material personal interest that the director may have in relation to the affairs of the company. Under proposed section 191, this disclosure obligation will no longer be confined to interests in contracts and proposed contracts and certain offices or property held by the director which might give rise to future conflicts of interest.

7.2 Proposed section 191 will require a director who has a material personal interest in a matter relating to the affairs of the company to give the other directors notice of the interest unless falling within one of a number of listed exceptions.

MINTER ELLISON
27 April 1999
MEMORANDUM ON
DIRECTORS’ DUTIES TO PREVENT INSOLVENT TRADING

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1. **DIRECTORS’ DUTIES**

1.1 Recent cases indicate that a director should have regard to the interests of the company’s creditors, particularly at times of insolvency, or near insolvency. A director owes a duty to the company’s present and future creditors to ensure that the assets of the company are not dissipated so as to defeat a creditor’s claim. This duty does not arise where the company is clearly solvent and the action proposed will not jeopardise that solvency.

1.2 **Under section 588G where:**

(a) a person is a director (see paragraph 1.7 below) of a company at the time when the company incurs a debt;

(b) the company is insolvent at that time, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt; and

(c) at that time, there are reasonable grounds for suspecting that the company is insolvent, as the case may be,

by failing to prevent the company from incurring the debt, the person contravenes section 588G if:

(i) the person is aware at that time that there are such grounds for so suspecting; or

(ii) a reasonable person in a like position in a company in the company’s circumstances would be so aware.

1.3 **Under section 95A** a person is solvent if, and only if, the person is able to pay all the person’s debts, as and when they become due and payable.

1.4 **Assistance in proving insolvency is given by rebuttable presumptions created by section 588E for the benefit of the Australian Securities and Investments Commission applying for a civil penalty order or a liquidator or creditor suing for compensation for a contravention of section 588G.** For example, if it is proved that the company has failed to keep accounting records as required by section 289, it is presumed to be insolvent during the period of the contravention.

1.5 Where a company is being wound up and it is proved (or presumed) that the company is insolvent at a particular time during the 12 months ending on the filing of the application for winding up, there is a rebuttable presumption that the company was insolvent throughout the period beginning at that time and ending on the filing day (section 588E(3)).

2. **PENALTIES**

A contravention of section 588G may attract both civil and criminal penalties. Liability to a civil penalty can be an order to pay a pecuniary penalty in an amount not exceeding $200,000 and the director may also be prohibited from managing a company (section 1317EA(3)). The court may also order the director to pay compensation to creditors.
and the corporation for loss suffered by reason of the contravention (sections 588K, 588N and 588R). If the contravention was dishonest, a criminal penalty may be imposed with a maximum penalty of $200,000 or 5 years imprisonment or both (section 1317FA(1)).

3. DEFENCES

Under section 588H, it is a defence to section 588G if it can be proved that:

(a) at the time when the debt was incurred, the person had reasonable grounds to expect, and did expect, that the company was solvent at that time and would remain solvent even if it incurred that debt and any other debts that it incurred at that time; or

(b) at the time the debt was incurred, the person:

(i) had reasonable grounds to believe, and did believe:

• that a competent and reliable person (‘the other person’) was responsible for providing to the first-mentioned person adequate information about whether the company was solvent; and

• that the other person was fulfilling that responsibility; and

(ii) expected, on the basis of information provided to the first-mentioned person by the other person, that the company was solvent at that time and would remain solvent even if it incurred that debt and any other debts that it incurred at that time; or

(c) if the person was a director of the company at the time when the debt was incurred because of illness or for some other good reason, the director did not take part at that time in the management of the company; or

(d) the person took all reasonable steps to prevent the company from incurring the debt.

MINTER ELLISON
27 April 1999
CASE NOTE ON DANIELS v AWA LTD (1995) 37 NSWLR 438

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1. FACTS OF THE CASE

1.1 Andrew Koval, AWA’s Foreign Exchange Manager, was permitted by AWA management to operate without effective control and supervision. There were no proper books and records and no systems of internal control segregating functions. There was, as a consequence, no ready means of ascertaining what the exposure of AWA was on open foreign exchange contracts at any given point in time. This allowed Koval to engage in extensive trading outside the limits contemplated by AWA’s Board.

1.2 During the period of Koval’s activities, Deloitte Haskins and Sells (‘Deloittes’) (through its partner in charge, ‘Daniels’) carried out two audits. The first was a statutory audit for the year ended 30 June 1986. The second was an examination of AWA’s financial position for the period ending 31 December 1986. Daniels had a long association with AWA, and was very friendly with senior executives of the company. On neither occasion did the auditors bring to light the full extent of Koval’s activities or the deficiencies in AWA’s accounting and internal control systems.

1.3 The auditors eventually made a report to AWA’s Chief Executive drawing attention to the inadequacy of internal controls, but the report was inadequate and failed to emphasise the immediacy of the problems.

1.4 AWA took proceedings against Deloittes alleging that they were negligent in the execution of the two audits. AWA claimed that Deloittes had a duty to AWA to carry out the audit in a proper manner and that Deloitte’s failure to discover the deficiencies in their internal financial control systems and to alert the Board to the deficiencies was negligent. Deloittes, in turn, claimed that the directors of AWA were negligent in not exercising better control over the activities of AWA.

2. DECISION

2.1 At first instance, Rogers (CJ in Comm Division) found that Deloittes had been negligent in failing to alert management to the irregularities that had been taking place in relation to the foreign exchange (‘FX’) transactions. However, he also found that the Board had delegated responsibility for the carrying out of FX transactions to management. In turn, management had been negligent in the manner in which it had carried out these functions. The acts and omissions of management were properly to be taken as acts of AWA itself and taken into account as acts of contributory negligence.

2.2 In relation to directors’ duties, his Honour concluded:

(a) the functions of the Board are to set goals for the corporation, to appoint the corporation’s chief executive, to oversee the management and to review the corporation’s progress towards obtaining its goals. The Board of a large public corporation cannot manage the corporation’s day to day business;

(b) the degree of skill required by an executive director is measured objectively. In contrast to the managing director, non-executive directors are not bound to give continuous attention to the affairs of the corporation. There is no objective standard for the reasonably competent company director to aspire to. The very diversity of companies and the variety of business endeavours do not apply to a uniform standard;
if directors appoint a person of good repute and competence to audit the accounts, absent real grounds for suspecting that the auditor is wrong, the directors will have discharged their duty to the corporation. The directors are not required to look at the entries in any of the corporation’s books of record, or verify the calculation of the corporation’s accountants in preparing the financial statements or of the auditor himself. Directors are entitled to rely on the judgment, information and advice of the auditor; and

reliance may properly be more complete where the auditor is acknowledged as being more knowledgeable, skilled and experienced in a particular matter than the directors or other auditors. In such circumstances, the auditor will be under a higher duty of care than the standard of care of an auditor without specialist knowledge, skill and experience. In the present case Daniels was a partner in a major international accounting firm. The directors were entitled to rely on the belief that he could draw on all the resources of such a firm.

3. **APPEAL**

3.1 Deloitte appealed on the finding of negligence by the trial judge and AWA cross-appealed on the finding of contributory negligence.

3.2 The Court of Appeal in part affirmed the decision of Rogers CJ in Comm Division. However, the Court took a stricter view of directors’ duties than had Rogers, particularly in respect of what is required of non-executive directors.

3.3 While Rogers had not been prepared to extend the duty of directors, particularly non-executive directors, beyond the accepted categories of equitable duties, the Court of Appeal found that the historical policy reasons against directors being under a common law duty of care to the company were ‘outdated’.

3.4 In relation to director’s duties, the Court of Appeal held:

(a) directors of a company owe a duty of care to the company to take reasonable care in the performance of their office, breach of which may render them liable to an action for damages at common law at the suit of the company;

(b) the common law duty of care is owed by non-executive directors as much as executive directors;

(c) the responsibilities of directors require that they take reasonable steps to place themselves in a position to guide and monitor management of the company;

(d) a person who accepts the office of director of a particular company undertakes the responsibility of ensuring that he or she understands the nature of the duty a director is called upon to perform. That duty will vary according to the size and business of a particular company and the experience or skills that the director held himself or herself out to have in support of appointment to that office;

(e) the duty is a common law duty to take reasonable care owed severally by persons who are fiduciary agents bound not to exercise the powers conferred upon them for private purposes or for any purpose foreign to the power that is
placed on those who are placed at the apex of the structure of direction and management. The duty includes that of acting collectively to manage the company.

3.5 The Court of Appeal found that the Board should meet as often as is necessary to carry out its functions properly, that is, to carry out its functions in accordance with the nature of its duty. The question that should be asked is what are the particular duties and responsibilities of the directors and what time is required of them as a Board to adequately carry out those duties and responsibilities. It is not a matter of tailoring the extent of the duty of function to prefixed intervals between Board meetings.

MINTER ELLISON
27 April 1999
Obligations - Success

- Establish mutual agreement about:
  - The model
  - The structure
  - The relationships
  - The relevant roles
  - The operating procedures
  - The delegations - responsibility/authority...

Ensure that the Governance is Effective
Models of Governance

The Model of Governance - Options

"The Continuum"

The discussion about options will be aided by identifying the alternatives in approximate or relative positions on this continuum.

1 2 3 4 5 6 7 8 9 10

Co-operative Society or "Hands on" Model  Chief Executive Model
Governance or Management?

Know the Difference!

- Policy or implementation?
- Broad Principles or operational details?...

Exercises 1 and 7

Structure

Would all members agree on the one description?

- A diagramatic representation often helps in developing a new structure or in gaining an understanding of the existing model.
- Does the theoretical model align with what really exists? (Relationships, communication lines etc.)
- The diagram should be reviewed regularly and adapted where necessary...
Characteristics - Model 1

The Cooperative Society Or

*Hands on Model*

- Governance and Management are combined
- The Principal (Head Teacher) is assisted or told how to implement policy in detail.
- There will be implementation committees responsible to the Board.
- Board meetings will be more frequent and long.
- There will be little real delegation.
- The chairman will probably only chair meetings...

---

The Cooperative Society Model

```
Parents ─── Community ─── Staff

The Board

Committees of the Board

Teachers and other staff

- Bursar or Hon. Treasurer
```
Characteristics - Model 5

The Mix and Match Model

- There will be some distinction between Governance and Management.
- The Board will have quite a number of committees, some of which will get involved in Management.
- The Head will have some delegated authority.
- Some Board members will want the Board to discuss matters raised with them by parents and teachers.
- The Chairman's role will be limited: mainly to the conduct of Board meetings.
Characteristics - Model 8

The Chief Executive

- There will be a clear division between Governance and Management
- The Board will have some Committees that report to it.
- There will be very significant delegation of authority to the Head
- The Head will be expected to develop some policies for Board endorsement.
- Support to the Head will be at a significant level.
- Board meetings will be less frequent and shorter...

Exercise 8

Chief Executive (Model 8)

The Board

Committees of the Board

The Head

Heads Committees

Bursar

Teaching and other staff
The Correct Model?

In whose opinion?

- There is no "correct model" only the "chosen model" for each school.

- The model can and should be reviewed regularly and where appropriate, amended.
  Any model chosen will work if:
  - It is absolutely understood by all
  - All participants want to make it work
  - Those who don’t agree with it or aren’t suited to it leave the school.

The Most Common Model?

It depends on the type of school

- Model Eight with variations.
  - There will be a variety of positions on the continuum for different issues and at different times.
  - There will be a need to formalise both the delegations and the withdrawals of delegation.
  - There will be a need to regularly check that the board members are aware of the delegations and the implications.
  - The Chairman will have a close working relationship with the Head.
  - The Chairman and the members of the Board will need to provide strong backing to the Head...
Management Styles

The Board/Head

Who makes the final decision?
Who is held responsible for the effects of the decisions?
What is the decision making process?

Relationships

Different Models will impose different requirements:

- The criteria for the selection of the:
  - Chairman
  - Board members
  - Head
  - Bursar
- The employment conditions of the Head and Bursar
- The decision making procedures;
- The position and duties of the Bursar;
- The Board’s relations with the school community...
Operating Procedures

- Advisers to the Board
- Contractors
- Debate
- Decision Making
  - Representatives?
  - Nominees?
  - Unanimity
  - Conflict of Interest
- United in support of Board decisions.
- Mutual Trust and Confidence...

Each Governor’s

Operational Responsibilities

- A Director’s responsibilities to the board:
  - Responsible participation in meetings
  - and in decisions
  - Confidentiality should be assumed
  - Support for decisions of the Board...
Governance

The major Responsibilities

- Financial Affairs
- Contracts
  - Employment
  - Goods and Services
- Duty of Care
  - Students (including child protection)
  - Staff
- Policies

Financial Affairs

- Financial Awareness of Directors
- Capacity of Directors to meet their responsibilities
  - Educational responsibilities
  - Appropriate presentation of information to enable responsible decision making.
Financial Affairs

Expectation of Directors

- A director is expected to be capable of understanding the company’s affairs to the extent of reaching a reasonably informed opinion of its financial capacity.

Financial Knowledge is Power

The Attitudes and Skills Continuum

- High skill level
- Justifies position
- Unhelpful

- Low skill level
- Avoids involvement
- No attempt to improve

There is an obligation to ensure that all Directors are able to participate responsibly in decisions that may have financial impact...
Financial Crisis!

Can it happen to my school?

- Watch the big ticket items!
  - Fees ➔ Enrolments
  - Grants ➔ Enrolments
  - Salaries ➔ Award increases
  - Debt servicing ➔ Interest rate rises
  - Staffing Levels ➔ Subject choice etc...

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Financial Affairs

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Financial affairs

Balance Sheet Ratios

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Case study

Governance Responsibilities

Contracts

- The board’s responsibility for contracts
- What sort of contracts?
  - What is a contract?
  - Who can enter into a contract?
- How can a contract be varied?
Employment Contracts

- Employment of the Principal
- Senior staff
- Teaching Staff
- Personnel and Industrial Relations Policy
  - Award/Agreement?
  - Open ended or for a set period?
  - Level of responsibility?
  - Letter of appointment or formal contract document?
  - Variations

Employment Contracts

Some examples

- Draft letters of appointment
  - Principal
  - Teacher
  - AIS professional staff