INFORMATION NEEDS AND RIGHTS OF SHAREHOLDERS

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"Knowledge is power and access to information is analogous to access to power"

B. Jones, *Sleepers, Wake! Technology and the Future of Work* (Oxford University Press, Melbourne, 2nd ed 1990) at 178.

"The examination of information released by a company is a principal means by which shareholders determine the performance of directors and hence ascertain if the directors are acting in the best interests of the Company. The availability of accurate and timely information on the financial position of companies is fundamental to informed judgement by shareholders about their investments"

Lavarch Committee, *Corporate Practices & The Rights of Shareholders* (Australian Government Printing Service, Canberra, 1991) at paragraph 4.1.2.

This work contains no material which has been accepted for the award of any other degree or diploma in any university or other tertiary institution and, to the best of my knowledge and belief, contains no material previously published or written by any other person, except where due reference has been made in the text.

I give consent to this copy of my thesis, when deposited in the University Library, being available for loan and photocopying.

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ABSTRACT

This thesis is about the information needs and rights of shareholders. The thesis commences by grappling with the fundamental issues of knowledge, information and communication. I develop fundamental definitions of each of these. In particular I define communication as the endeavour of passing knowledge by information from one person to another. This definition is purposive and therefore requires a focus on the nature of the relationship between speaker and audience and in particular the information needs of the audience. Translated to the corporate context the respective roles of directors and shareholders are deconstructed in order to determine shareholders' information needs. At this stage shareholders should be regarded as monitors and investors.

I also view shareholders as a class of citizen by drawing an analogy between political democracies and corporations (which are modelled as mini democracies). The lack of an active opposition to, or an effective media antagonistic to the views of, the incumbent directors has serious implications concerning the credibility of information provided to shareholders. Also from the political context citizens enjoy two information rights, namely under freedom of information regimes and under the principle that administrators are required to give reasons for their decisions. I adapt these two information rights for the benefit of shareholders.

My thesis is that an unduly narrow view of the appropriate role of shareholders has been utilised which leads to an atrophied view of their legitimate information needs. This conclusion is the core of my thesis. The model of shareholders as monitors, investors and citizens is used to justify and evaluate the adequacy of existing disclosures and to consider if additional disclosures or methods of disclosures are warranted.

At the outset I also develop a model in order to assess the quality of corporate information. The model I develop is to consider the quality of information measured against the criteria of accuracy, credibility, relevance, comparability, understandability, accessibility and timeliness compared with its cost and confidentiality concerns. These quality criteria measure how useful current corporate disclosures are to shareholders as monitors, investors and citizens.

Subsequent chapters consider different topics of information shareholders receive or should receive using these models. The chapters cover financial information, management information, corporate information and social information. The last substantive chapter covers other methods of disclosure, namely the continuous disclosure regime, right to court ordered inspection of documents and information presented at shareholder meetings. Under these disclosure regimes/rights disclosure of any type of information may occur depending on the underlying circumstance that trigger their operation.

CHAPTER 1

INTRODUCTION

Omniscience. (Infinite knowledge).[1] If humans were omniscient then a thesis on information would end after the next full stop; the following pages would be blank (if they were there at all).

1 *The Macquarie Dictionary* (The Macquarie Library, Australia, 3rd ed, 1997) at 1504.

Humans are not omniscient. Although the world is rich with information[2] we can only[3] access information by our five senses.[4] By my sense of touch I can be informed of heat (closeness to a fire) and rough gravel if walking barefoot. My sense of smell can tell me that my favourite meal is being cooked and my sense of taste that it is as good as usual. I can hear all sorts of noises which convey different information. I hear, for example, burbling magpies and know that it is spring. I can see the physical world around me and observe all kinds of interesting and disturbing things. All animals have these 5 senses and have access to and can understand information.[5] One of the defining features of humans is our higher cognitive skill.[6] What precisely these higher cognitive skills are is a question of some debate. Some point to our ability to conceptualise (the ability to group and to discriminate; to generalise and abstract) as the height of these skills.[7] Others regard selectiveness as the hallmark of the human brain.[8] Exploring and resolving this issue is not necessary in this thesis; most people accept the high cognitive abilities of humans.

These higher cognitive skills allow for the richness of our interactions with one another. We communicate with each other using our five senses but most predominantly using language, either verbal or written. Language is incredibly sophisticated and allows for communication of the whole gamut of our experience. Language, and also but to a lesser extent numbers, symbols and images, is the medium of our communication.[9] It is this process of communication which generates information. Without communication by information I would only have very limited knowledge of what others think and do. This

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2 Campbell, *Grammatical Man* (Penguin Books, London, 1983) at 204 states "[a]n observer is immersed, drenched, in this information".

3 Some information is not directly accessible by the five senses. Besides the microscopic, there are noises beyond human hearing frequencies or light beyond our vision which can nonetheless be regarded as information. For example DNA molecules, which shape our identity at conception, are quite appropriately described as information; see Campbell, *Grammatical Man* (Penguin Books, London, 1983) at 19, 67 and 112.

4 Kemp, *The Nature of Knowledge* (Clive Bingley, London, 1976) at 36; Lakoff, 'Body, Brain, and Communication', in Brook and Boal (eds), *Resisting the Virtual Life: The Culture and Politics of Information* (City Lights, San Francisco, 1995) at 122 to 123; cf Foerster, 'Epistemology of Communication' in Woodward (ed), *The Myths of Information: Technology and Postindustrial Culture* (Routledge, London, 1980) at 21 who, drawing from neurophysiology, considers it a misconception that "the senses....are responsible for allowing us to see, hear, and taste the world as it is in all its glorious variety and abundance". However at 23 Foerster goes on to say "sensation is necessary, but not sufficient for perceiving". I discuss the process of sensation, perception and conceptualisation in more detail in the next chapter under the heading 'Psychology'.
It is interesting to consider a hypothetical person born with absolutely none of the five senses but otherwise organically sound and in particular with a perfectly sound brain. Would such a person have any information, any thoughts even? I find that question unfathomable (and certainly untestable).

5 See Masuda, *The Information Society as Post-Industrial Society* (Institute for the Information Society, USA, 1981) at 54 for an explanation of the information system of one of the lower levels of living organism, the amoeba.

6 Davies, *The Mind of God* (Simon & Schuster, Great Britain, 1992) at 22; although this statement is not completely free from controversy; see Kemp, *The Nature of Knowledge* (Clive Bingley, London, 1976) at 41.

7 Kemp, *The Nature of Knowledge* (Clive Bingley, London, 1976) at 48 to 49.

8 Campbell, *Grammatical Man* (Penguin Books, London, 1983) at 195 and at 239 where he states "The distinguishing characteristic of *Homo sapiens* is...a highly developed capacity for abstract thought, reasoning, imagination, language, and a concept of the future".

9 Interestingly language may be a function of the left side of the brain, see Campbell, *Grammatical Man* (Penguin Books, London, 1983) at 243.

knowledge would be limited by my direct personal interactions with others and would clearly be much shallower. That is, I am not omniscient about what others think and do and certainly I do not have the skill of telepathy.

Subject to the serious limitation of our own self-awareness, each of us is self aware and knowledgeable about ourselves. We consciously contemplate our own thought process and give ourselves a good talking to. However we do not communicate with ourselves, generate information, at all in the same way as when we communicate with others. For the purposes of this thesis, ideas in the mind do not qualify as information until they have found expression in some form. In some ways this is an artificial distinction, because the idea and the way it is represented may be identical. For example I can think "I like surfing" and I can write "I like surfing". Although the distinction is artificial as a matter of substance, it helps to clarify the difference between knowledge in minds and knowledge that has been reduced to material form.

So how does this philosophising relate to corporations? In some small proprietary companies the shareholders are also the directors, or in the new one person proprietary companies, the shareholder is the director.[10] In these types of companies there is a limited form of omniscience; the shareholders know what they are doing as directors and the communication of information is not a critical issue.[11] However in larger companies, particularly listed public companies with many hundreds if not thousands of shareholders,[12] the directors are people different from the shareholders.[13] Where there is a separation of ownership and control[14] the shareholders will not innately know what the directors collectively think, decide or do. That is, there is necessarily a knowledge/information gap between shareholders and directors. Unless directors communicate with shareholders then shareholders will be informationally poor and ignorant of the affairs of the company. Therefore in these companies shareholders have acute information needs.

In this thesis I deconstruct the concepts of information and the identity and role of shareholders in order to fathom their information needs. It is my thesis that the law has either not considered, or taken an overly narrowly view of, these core concepts. This myopia arises at several levels, which has necessarily jaundiced the law's view of the legitimate information needs of shareholders. I develop a model of shareholders to understand their information needs and whether those needs are being met (described below).

Chapter 2 examines definitions, and the characteristics and qualities, of information. There is a rich interplay between knowledge, information and communication. I take an inter-disciplinary approach to these issues, drawing from philosophy, psychology, sociology, science and information theory in order to try to come to working definitions of these concepts. The inherent characteristics of information are:

- inconsumability (no matter how often information is used it does not deteriorate or disappear);

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10 CL ss 114 & 221(1).

11 Note that small proprietary companies in normal circumstances are excused from the usual requirements of producing annual audited financial statements: CL ss 292(2), 301(2), 327(1A).

12 Listing Rule 12.4 requires listed companies to "maintain a spread of security holdings which ....is sufficient to ensure there is an orderly and liquid market in its securities".

13 Some shareholders may have nominees on the Board but certainly all shareholders will not have such nominees on the Board.

14 A phrase attributable to Berle & Means, *The Modern Corporation And Private Property* (Macmillan, New York, 1940).

- untransferability (information may be communicated but is not thereby no longer known to the speaker);
- indivisibility (information only exists in sets, for example a single vowel is not ordinarily relevant information);
- accumulativeness (information can be accumulated whilst it is being used time and again);[15]
- spreadability (information has a natural tendency to spread since human nature necessarily involves communication);[16] and
- that it is regarded by many as a public good.[17]

These inherent characteristics must be borne in mind in any legal analysis particularly as they create tension, if not outright conflict, with competing legal doctrines such as confidentiality. For example confidentiality is concerned with keeping information secret and scarce which is contrary to the inherent spreadability of information and the characterisation of information as a public good. Finally in this chapter I develop thorough criteria to measure the quality of information. Those qualities are its accuracy (including completeness), credibility, comparability, comprehensibility, relevance, accessibility, confidentiality, timeliness and cost. The material in this chapter, in particular the quality criteria, provides a framework for the subsequent chapters. A systematic assessment of the information shareholders receive using this type of framework has not occurred. Yet only by using this framework is it possible to make a rigorously informed assessment of the quality of the information provided and whether disclosure of information is otherwise warranted.

Chapter 3 explores legal conceptions of information. No legal thesis concerning information would be complete without an examination of what the law regards as information. This chapter examines the areas in which the law is willing to grant private rights to information, the justification for such rights, their juridical basis and the implications of such rights for shareholders. The law has paid particular attention to the nature of information in the context of the protection given to confidential information. This raises the issue of whether this protection of confidential information is proprietary in nature. These private rights to information are the greatest legal impediment to the free flow of information between shareholders and directors and this warrants close analysis.

The definition, from chapter 2, of communication is "the endeavour of passing knowledge, by information, from one person to another" (with information defined as a material representation of knowledge). This definition is purposive. It considers who is speaking, to whom (audience) and why. The general purpose of information is to enable people to plan their lives in a rational way and to take particular actions.[18] Purpose can

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15 Masuda, 'Future Perspectives for Information Utility', in Inose (ed), *Evolutions in Computer Communications: Proceedings of the Fourth International Conference on Computer Communication* (North-Holland, Amsterdam, 1978) at 388.

16 Drahos, *A Philosophy of Intellectual Property* (Dartmouth, England, 1996) at 171.

17 Above at 171 to 174; Hammond, 'Quantum Physics, Econometric Models and Property Rights to Information' (1982) 27 McGill LJ 47 at 72.

18 Discussed in chapter 2 but consider on the issue of rationality Peck, *In Search of Stones* (Simon and Schuster, Great Britain, 1996) at 5:

> Roughly three hundred years ago, Western civilisation emerged into what is frequently called the age of reason. As far as I know, we are still in it. What this means is that the educated people of this civilisation and age have come to believe that there is, if you just dig deep enough, a rational explanation for everything.

therefore be ascertained by examining the nature of the relationship between speaker and audience and in particular the objectives of the audience. The identity and role of shareholders is deconstructed in order to properly assess their information needs. This necessarily involves considering the nature of "for profit" companies and the reason shareholders invest in shares. This chapter also looks at traditional legal conceptions of who shareholders are. The conclusion from this chapter is that shareholders have a need for information as they are the principal and comprehensive monitors of the directors and they are investors seeking to make money. If shareholders are to be able to monitor the performance of their appointed directors and the company then they must have timely access to meaningful, relevant information. Without pertinent information people must make decisions in ignorance, perhaps relying on guesswork or intuition. This converts a decision to invest in shares, which inherently involves a measure of risk taking, into a complete gamble.[19] This situation is completely unacceptable in our society which values educated and rational decision making. A person cannot act rationally without the benefit of relevant information.

Chapter 5 argues that shareholders are a class of citizens because the governance of corporations is styled in a democratic mould. The first part of Chapter 5 looks at the importance placed on information in the political context. This is closely tied to freedom of speech and freedom of the press. The chapter draws upon the rich debate, particularly from the US, concerning the philosophical underpinning to free speech and freedom of the press. In the political context the role of the media is, to say the least, significant. The role of the media in the political arena is considered and compared with its reporting on companies. This comparison has important implications for corporate information and, in particular, for its credibility. This chapter also considers two aspects of the information rights of citizens, namely the various Freedom of Information Acts in Australia and the right to the reasons for the decisions made by government bodies under administrative law. The question is should the information rights citizens enjoy under these two regimes apply to companies and if so, how.

In Chapters 4 and 5 I argue that the law has developed an inappropriately narrow view of who shareholders are. This narrow view has arisen for a variety of reasons, including the obfuscation caused by the separate entity doctrine and attempting to apply traditional but inappropriate legal concepts to understand who shareholders are and their appropriate role in corporations. This overly narrow view of who shareholders are has resulted in a concomitantly atrophied view of the information they should receive. A broader view of who shareholders are (namely monitors, investors and citizens) is developed and used as a model for three purposes. First, to determine if the information shareholders currently receive is justifiable based on this model. That is, is the information currently disclosed to shareholders legitimately directed to satisfying the needs of shareholders in their role as monitors, investors or citizens? For shareholders to properly function in those different roles requires and justifies the disclosure of different information. Second, shareholder's tripartite role is also used to analyse whether additional topics of information and improvements to existing disclosures or disclosure methods are justified. Third, the model is used to assess whether the information shareholders currently receive

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On this point see also Davies, *The Mind of God* (Simon & Schuster, Great Britain, 1992); Richardson, 'The Duty to Give Reasons: Potential and Practice' (1986) Public Law 437 at 441 & 446.

19 Cox, 'Institutional Ownership in a Changing World: Is There a Need for a Segmented Market?' paper presented at a conference 'Corporate Governance & Australian Competitiveness: The Role Of Institutional Investors' conducted by the Business Council Of Australia and the Australian Investment Managers Group on 11 November 1993 emphasises the point that investing in shares inherently involves a measure of risk taking and that this should not be seen as something to be avoided.

is suited and useful to their needs, the model predicating what those needs are. The purpose of analysing the suitability and utility of corporate information brings into play the quality criteria discussed above. In summary, the model is a systematic and theoretically based approach to examining the information needs and rights of shareholders.

Subsequent chapters consider different topics of information shareholders receive or should receive using the model of shareholders as monitors, investors and citizens in the manner described in the previous paragraph. The chapters and the information they consider are as follows.

Chapter 6 considers financial information. The financial statements have traditionally been the most important information shareholders regularly receive. The most important information examined in this chapter is the profit and loss statement, balance sheet and statement of cash flows. A substantial number of rules regulate this information, including the accounting standards and the rules regulating the audit of this information. This chapter does not exhaustively deal with all financial disclosures. In subsequent chapters the disclosures made are also often of a financial nature. For example disclosure of directors' and executive remuneration is considered in chapter 7.4 and the limited mandatory disclosure requirements concerning social information result in financial style information being disclosed (see chapter 9.4). So chapter 6 does not hermetically seal all financial information within itself; certain disclosures are discussed under discrete topics even though the nature of the information disclosed is financial.

Chapter 7 examines management information. The financial performance of the company, as measured in the financial statements, is the usual measure of the performance of the company's managers. This chapter questions that correlation and argues in favour of information that more directly measures the performance of managers. It also deals with whether there is or should be disclosure requirements about the identity and qualifications of the managers and their compliance with legal standards (principally their fiduciary duties).

Chapter 8 explores corporate information. Corporate information comprises three loosely related topics which are:

(1) the business activities of the company;
(2) the capital structure of the company and identity of the people who own that capital; and
(3) information about the separate entity that is the company.

Chapter 9 considers social information (such as product safety and environmental impacts) disclosed by corporations. All the previous chapters considered business style information. This chapter considers whether shareholders should receive information about the social impacts of the corporations in which they invest and what form such reporting should take. There are currently very few mandatory disclosure rules in this area although there is voluntary reporting by corporations on some of their social impacts. A major thrust of this chapter is whether the law should be reformed in this area so that mandatory disclosures that meet quality criteria is required.

Chapter 10 considers a range of other methods by which shareholders have access to information. This chapter is about processes by which shareholders obtain information. These processes are not tied to any particular topic of information. Disclosure of any type of information may occur under these processes depending on the underlying circumstance that triggers their operation. This chapter considers three areas:

(1) the continuous disclosure regime provided for in the Listing Rules as supported by the Corporations Law;
(2) the information shareholders are entitled to when they are asked to consider a matter in general meeting; and
(3) the right of shareholders to inspect corporate documents pursuant to section 247A of the Corporations Law. The particular issue here is whether this right of inspection could be improved by utilising Freedom of Information principles.

This thesis uses as its reference point the orthodox position that shareholders are the principal stakeholders in the company. Whilst this orthodoxy has been seriously questioned and criticised,[20] it nonetheless remains the orthodox position and any thesis needs some fixed reference points. Therefore the thesis is about the information rights of shareholders, not of other stakeholders in the company (such as creditors, employees or interested members of the public) or other consumers of information (such as regulators). This is because shareholders have the closest connection with the company and its directors. Shareholders can be regarded as insiders of the company (ie those involved with the internal governance of the corporation). Whereas other stakeholders are less intimately connected with the company and can be regarded as outsiders to the company (such as suppliers and customers who deal with the separate entity which is the company and in the normal course have no role to play in its internal governance). This proposition is acknowledged by the law and becomes evident from my analysis of what is the company in chapter 4.4. Shareholders therefore have the strongest claim to information and that is why I concentrate on them. Of course information provided to shareholders of public listed companies is normally in the public domain and these other stakeholders can piggy-back on the information provided for the benefit of shareholders and also use this information.

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20 Buxbaum, 'Comparative Aspects of Institutional Investment and Corporate Governance' at 4 in Baums, Buxbaum and Hopt (eds), *Institutional Investors and Corporate Governance* (Walter de Gruyter, Berlin 1993) calls it "a one-legged concept of corporate governance". See also Hadden, 'Corporate Governance By Institutional Investors? Some Problems From an International Perspective' at 89 in Baums, Buxbaum and Hopt (eds), *Institutional Investors and Corporate Governance* (Walter de Gruyter, Berlin 1993); Stokes, 'Company Law and Legal Theory' in Twining (ed), *Legal Theory and Common Law* (Basil Blackwell, U.K., 1986); Millon, 'Communitarianism in Corporate Law: Foundations and Law Reform Strategies' in Mitchell (ed), *Progressive Corporate Law* (Westview Press, USA, 1995). See generally Berns and Baron, *Company Law and Governance: An Australian Perspective* (Oxford University Press, Melbourne, 1998) at 146 to 157.

CHAPTER 2

DECONSTRUCTING INFORMATION

2.1 INTRODUCTION

Corporate information is a subset of information. Therefore it is important to deconstruct the concept of information before examining the more specific genre of corporate information. By defining information and examining its inherent characteristics and qualities a conceptually sound and rigorous analysis of corporate information is possible.

This chapter is divided into three parts. First, I undertake a fundamental examination of the three concepts of information, knowledge and communication. These three concepts are all dense and multifaceted; they also complement and overlap with each other. The interplay and circularity between the concepts is evident from my definition of information. I define information as the means by which knowledge is communicated.[21] Information is necessary since we are not omniscient and do not otherwise communicate by telepathy. Note that my definition does not have any human subjects. At this stage this is deliberate, although the word communicate implies human actors (speaker and audience). I take an inter-disciplinary approach to information, knowledge and communication in order to try to come to working definitions of them. This analysis is useful not just for the working definitions but also for a deeper understanding of the underlying concepts. These fundamental concepts form a framework for my entire thesis. That is, the fundamental ideas developed in this chapter on knowledge, information and communication inform the more specific issues of what comprises corporate information and the underlying corporate knowledge on which it is based and how that can be and whether it is effectively communicated.

Second, I examine the characteristics of information which are its inconsumability, untransferability, indivisibility, accumulativeness and spreadability. Also many regard information as a public good. These characteristics must be understood in order to evaluate any particular type of information, in this instance, corporate information.

Finally I consider the qualities of information. Those qualities are its accuracy (including completeness), credibility, comparability, understandability, accessibility, confidentiality, timeliness and cost. As with anything, quality is fundamentally important to users. These are the measuring rods of the quality of information.

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21 Others have similar definitions. For example *The Macquarie Dictionary* (The Macquarie Library, Australia, 3rd ed, 1997) at 1095 defines information as "knowledge communicated or received about some fact or circumstance"; Machlup, *Knowledge: Its Creation, Distribution, and Economic Significance* (Princeton University Press, New Jersey, 1980) at 56 states "the act of informing is designed to produce a state of knowing in someone's mind"; see also Drahos, *A Philosophy of Intellectual Property* (Dartmouth, England, 1996) at 171 who defines information as "the daily lifeblood of human agents as communicating beings".

2.2 KNOWLEDGE, INFORMATION AND COMMUNICATION

Knowledge

I start with knowledge because knowledge precedes information and communication. As humans we enjoy high cognitive abilities and thinking must occur in order for knowledge to be generated which allows information to be produced and communicated. As a race, and individually, we have knowledge of incredible sophistication, depth and breadth. One commentator has classified knowledge into five types, namely practical, intellectual, small talk and pastime, spiritual and unwanted knowledge.[22] This thesis is about a type of intellectual knowledge, namely corporate knowledge. By corporate knowledge I adopt the broadest possible meaning; any knowledge about the corporation, its business activities and impacts in society and the behaviour of its officers in managing its affairs. It is intellectual knowledge which the following analysis principally considers.

Different fields of academic inquiry have grappled with the topic of knowledge. The academic fields examined below are philosophy, psychology, sociology, science and information theory. Each field brings its unique perspective to what is knowledge. The concepts that unfold from this analysis limit and condition our ideas of knowledge and in turn information. Thus they provide core principles which inform our notions about 'information' (including the qualities of information).

Philosophical Concepts of Knowledge

Philosophers have struggled with the concept of knowledge for centuries and even have their own name for this field of study, epistemology.[23] A central problem of epistemology is: what does it mean to know something and how much, if anything, can we know?[24] It must at the outset be acknowledged that philosophers use a very strong sense of knowledge, stronger than how non-philosophers may use the word in everyday usage.[25] Philosophers examine the concept of knowledge in the sense of what can someone be absolutely certain is true.[26] Some philosophers doubt whether such absolute certainty is possible and advance a variety of reasons for this scepticism, including:

- there is always some equivocation, it is simply impossible to be absolutely certain;[27]
- any "knowledge" presupposes and relies on other "knowledge", which other is inherently uncertain;[28]

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22 Machlup, *Knowledge: Its Creation, Distribution, and Economic Significance* (Princeton University Press, New Jersey, 1980) at 108. There are of course other classifications, many of which are explored in Malchup's work. Also this list may be incomplete; for example this classification concentrates on knowledge derived from rational thinking and ignores knowledge derived from the emotions or intuitively; see for example Goleman, *Emotional Intelligence* (Bantam, New York, 1995).

23 Kemp, *The Nature of Knowledge* (Clive Bingley, London, 1976) at 30 to 31 who states "The branch of philosophy which is concerned with the nature of knowledge is called 'epistemology' derived from the Greek word *episteme*, which can be approximately translated as knowledge". See also Rorty, *Philosophy and the Mirror of Nature* (Basil Blackwell, Great Britain, 1980) at 140.

24 Rorty, *Philosophy and the Mirror of Nature* (Basil Blackwell, Great Britain, 1980) at 3 and 132.

25 Machlup, *Knowledge: Its Creation, Distribution, and Economic Significance* (Princeton University Press, New Jersey, 1980) at 37.

26 Dretske, *Knowledge and the Flow of Information* (Bradford Books, Massachusetts, 1981) at 108 to 111.

27 Above at 109; Kemp, *The Nature of Knowledge* (Clive Bingley, London, 1976) at 33 who also draws from statistical probability which states that "there is no such thing as dead certainty".

- it is very difficult to distinguish satisfactorily between the concepts of knowledge, true opinion, belief and probabilities based on evidence.[29]

As a result of such philosophical difficulties, the conclusion of many philosophers is that "precious little can ever be known".[30] In particular it is doubted whether second hand knowledge is at all possible.[31] This is relevant to corporate information principally in two ways. First, the source of corporate information is important. This thesis considers information about the company derived from the company and its officers, not from other second hand sources. Second, these conclusions bring into serious scrutiny the quality of the accuracy of information (which I pursue below).

However other philosophers take a more pragmatic view of knowledge. They consider that knowing does not necessarily require that what I claim to know is really true, that I am sure of it, and that I have a right to be sure of it. Rather they concede that knowing involves the "proper attitude of always conceding the possibility that I may be wrong".[32] This type of approach does not require absolute certainty in a matter for there to be knowledge; sufficient confidence in a matter is enough to qualify as knowledge. There is obviously an untraversable conceptual divide between the pragmatists and the absolutists. I am unable to construct a bridge over the divide, and for my purposes I do not need to. The important point to take from the debate is that absolute certainty in a matter is very difficult, if not impossible to have, yet adequate certainty in the matter may exist so that we are confident it is true. This also impacts upon the quality of accuracy and softens the concerns raised earlier.

Other philosophers reject this whole approach to the concept of knowledge.[33] These philosophers reject the underlying paradigm upon which this view of knowledge is based (that is, of an absolute world which can be absolutely known). They do not regard the mind as a mirror of nature, faithfully reflecting what appears in the natural world.[34] They regard knowledge (and justification, in the sense of knowing something) not as a special relation between ideas and objects, but of conversation, of social practice.[35] Under this model knowledge is not based on perception, but on rational certainty obtainable by conversation with our fellows.[36] As a result, perhaps the only conclusion is that there is not a definitive conclusion, just different views from different philosophers about what knowledge is (if there is such a thing). However notable to all three approaches is doubt as to our ability to be adamant about the outside reality. This has clear implications concerning how accurate knowledge and hence information can be (examined later in this chapter).

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28 Kemp, *The Nature of Knowledge* (Clive Bingley, London, 1976) at 32.

29 Above at 31 to 34.

30 Dretske, *Knowledge and the Flow of Information* (Bradford Books, Massachusetts, 1981) at 109.

31 Above at 105; Machlup, *Knowledge: Its Creation, Distribution, and Economic Significance* (Princeton University Press, New Jersey, 1980) at 37.

32 Machlup, *Knowledge: Its Creation, Distribution, and Economic Significance* (Princeton University Press, New Jersey, 1980) at 37.

33 The views of these philosophers are usefully summarised in Part II of Rorty, *Philosophy and the Mirror of Nature* (Basil Blackwell, Great Britain, 1980).

34 Above at 12 to 13 and chapters 3 and 4.

35 Above at 170. See also Snook, 'Language, Truth and Power: Bourdieu's Ministerium' in Harker, Mahar and Wilkes (eds), *An Introduction to the Work of Pierre Bourdieu* (MacMillan, London, 1990) and Burr, *An Introduction to Social Constructionism* (Routledge, London, 1995) at 3.

36 Rorty, *Philosophy and the Mirror of Nature* (Basil Blackwell, Great Britain, 1980) at 156 to 157. Rorty regards thinking as not just aimed at the attainment of knowledge of an objective world, but of self-formation, of edification (in the sense of increasing self knowledge and awareness) (at 359 to 360).

Psychology and Knowledge

Psychology is the science concerned with human knowledge and of mental life.[37] There are five psychological processes concerning knowledge, namely learning, creating, retaining, communicating and using.[38] The first process, learning (the acquisition of knowledge), involves the three stages of sensation, perception and conceptualisation.[39] Sensation involves physical stimulation through any of the five senses and perception is the instantaneous recognition of this. For example if I attempt to eat a pie that is too hot, my mouth will be burnt and then I will appreciate that my mouth hurts. Conceptualisation is the broader process of ordering and making sense of our experiences. Concepts are vehicles for thought (labels for things in common).[40] Conceptualisation is the process of classification and involves discrimination and grouping (which is further reliant on the ability to abstract and generalise).[41] So extending my example I learn the concept that pies fresh from the oven are too hot to eat; I must be patient and let them cool down before trying to eat them.

Psychologists have explored factors which affect the process of sensation, perception and conceptualisation.[42] Those factors include:

- how the brain works. The brain is made up of billions of neurones which pass and convert electrical and chemical pulses to each other.[43] These neurones do not just behave predicably and reliably; there is an element of randomness to their behaviour.[44] Brains cannot simply be regarded as 'docile receptacles for energy coming from outside the brain';[45]
- many functions of the brain, such as visual perception and memory, involve not a faithful recording of the outer world but an amount of selectiveness and structuring.[46] The conclusion drawn from this selectiveness is that perception is personal and unique to each individual so that all seeing must be regarded as interpretation;[47]
- knowledge depends on previous experience,[48] including our socialisation (see further below under the next heading).[49] In many ways this is self-evident. Any knowledge

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37 *The Macquarie Dictionary* (The Macquarie Library, Australia, 3rd ed, 1997) at 1721 defines psychology as "the science of mind, or of mental states and processes; the science of human nature". See also Kemp, *The Nature of Knowledge* (Clive Bingley, London, 1976) at 41.

38 Kemp, *The Nature of Knowledge* (Clive Bingley, London, 1976) at 42.

39 Above at 47.

40 Above at 44.

41 Above at 48. Campbell, *Grammatical Man* (Penguin Books, London, 1983) at 199 calls this the ability of humans to organise and pattern information. Campbell also makes the point (at 251 and 253) that conceptualisation may be a right brain activity.

42 There is a rich relationship between conceptualisation and language, for words are also labels for things in common. I explore this relationship below under the heading Information.

43 Campbell, *Grammatical Man* (Penguin Books, London, 1983) at 190.

44 Above at 195 to 196.

45 Above at 194.

46 Above at 195; Dretske, *Knowledge and the Flow of Information* (Bradford Books, Massachusetts, 1981) at 113 and also at 183 where he states:

> A cognitive system is not one that renders a faithful reproduction of its input in its output. Quite the reverse. If a system is to display genuine cognitive properties, it must assign a *sameness of output* to *differences of input*. In this respect, a genuine cognitive system must represent a *loss of information* between its input and its output.

47 Campbell, *Grammatical Man* (Penguin Books, London, 1983) at 196 to 212.

48 Kemp, *The Nature of Knowledge* (Clive Bingley, London, 1976) at 49; see also Campbell, *Grammatical Man* (Penguin Books, London, 1983) at 226 who similarly speaks of the tendency of people "to interpret new information in the context of their previous knowledge".

49 Kemp, *The Nature of Knowledge* (Clive Bingley, London, 1976) at 53.

I have is restricted to the totality of the experiences I have had. But the psychological evidence also shows "that, consciously or subconsciously, adults tend to resist changing their concepts";[50]

- humans are affected by their preconceptions (ie perceptions are affected by what people think they ought to perceive).[51] There are even examples of scientists who, whilst explicitly endeavouring to be objective, nonetheless were affected by their preconceptions.[52]

The conclusion available is that the mental process of each person is unique. Of course people have a shared experience of the world so there will be many similar psychological positions but nonetheless each individual's experience remains unique. This conclusion also impacts on the accuracy and understandability of information.

Sociological Knowledge

Sociology is "the science or study of the origin, development, organisation, and functioning of human society; the science of the fundamental laws of social relations, institutions, etc".[53] The world is not just a homogenous mass of people. There are different nations, and within nations other social fields.[54] These fields are diverse and range across the political, occupational, sporting, cultural etc. The social fields to which people belong influence their knowledge base and also their perspective/bias.[55] This clearly extends to issues of race and gender, which profoundly affects peoples' perspective.[56] People bring their unique perspective to bear on all their dealings, including making sense of the world and communications they give and receive. Consequently there will be an accepted "discourse"[57] and specialised language for different fields.[58]

Professions are an example of a social field.[59] In my opinion corporations can also be regarded as a social field. The role of business (in particular big business) has become increasingly specialised and professionalised.[60] These business specialists deal in sophisticated concepts and have, to some extent, a specialist discourse and language (which at least involves also the language of accountants). The people who prepare corporate information can be identified as professional business people. But it is also

50 Above at 51. Kemp goes on to say that the "scientific evidence is that adults are much more receptive to facts or ideas which tend to strengthen or confirm their existing concepts, than they are to those facts which would require them to alter them".

51 Above at 51.

52 Above at 51 to 52.

53 *The Macquarie Dictionary* (The Macquarie Library, Australia, 3rd ed, 1997) at 2012.

54 Harker, Mahar and Wilkes, 'The Basic Theoretical Position' in Harker, Mahar and Wilkes (eds), *An Introduction to the Work of Pierre Bourdieu* (MacMillan, London, 1990) at 8 to 10.

55 Kemp, *The Nature of Knowledge* (Clive Bingley, London, 1976) at 85 and 95; Burr, *An Introduction to Social Constructionism* (Routledge, London, 1995) at 6.

56 See generally Davies, *Asking the Law Question* (The Law Book Company, Sydney, 1994) in Chapter 6 "Feminisms".

57 Burr, *An Introduction to Social Constructionism* (Routledge, London, 1995) at chapter 3.

58 Kemp, *The Nature of Knowledge* (Clive Bingley, London, 1976) at 87 gives the example of desert Arabs who have "a vocabulary of about 600 different terms for camels and things associated with them". See also Snook, 'Language, Truth and Power: Bourdieu's Ministerium' in Harker, Mahar and Wilkes (eds), *An Introduction to the Work of Pierre Bourdieu* (MacMillan, London, 1990) at 170 to 173.

59 Kemp, *The Nature of Knowledge* (Clive Bingley, London, 1976) at 85 and 90.

60 Clark, 'The Four Stages Of Capitalism; Reflections On Investment Management Treatises' (1981) 94 Harvard Law Review 561.

important to consider their audience to see whether they belong to the same field and the implications this has for corporate communications. In particular, is the information communicated by a speaker understandable to its entire audience?[61]

Scientific Knowledge

Science has been in hot pursuit of knowledge for centuries now. Science, with its traditions, methodology and philosophy, has its own view about what is knowledge.

Put at its simplest, traditional science starts with a hypothesis, derived by inductive or deductive reasoning, which it then sets out to prove by experiment.[62] Part of the scientific method is to publish the hypothesis, the method of experimentation, the resulting data (ie the results of the experiments) and the scientist's conclusions.[63] In particular publication of the methodology and of the raw data enables other scientists to repeat the test to independently verify the results.[64] The general scientific community is then able to decide if there is sufficient data for the hypothesis to be regarded as proved and therefore to be viewed as a theory or law of science (rather than just a hypothesis).[65]

One problem of scientific argument is that any conclusion drawn from inductive reasoning (arguing from the particular to the general) is that it is necessarily predictive of the future. For example, if the hypothesis is that potato plants grow better in ashy soil, this impliedly contains the prediction that in the future potato plants will grow better in ashy soil.[66] The problem is that the future is inherently uncertain. The argument raised is "the fact that something has happened in the past is no grounds for believing that it will happen in the future".[67]

A scientist called Popper has addressed this problem. Popper's starting point is that it is impossible to prove anything (and is therefore similar to some of the philosophers discussed above). The purpose of testing in the scientific method becomes not to try to prove or verify a hypothesis but to attempt to discredit it. Credibility, but not absolute truth, depends on the absence of negative evidence despite attempts to find such negative evidence by a variety of tests. Credibility of a scientific statement also depends on its consistency with other scientific statements that are regarded as credible. Therefore the consensus of competent opinion on issues and hence publication of scientific material is also crucial according to Popper. Popper's views have gained widespread, but certainly not universal or uncritical, acceptance.[68] Popper's views are important in considering the accuracy of information and in particular in the corporate context the role of auditors and the "problem" of the audit expectation gap.

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61 Comprehensibility is also a quality I explore later in this chapter.

62 Kemp, *The Nature of Knowledge* (Clive Bingley, London, 1976) at 63 to 65.

63 Above at 65.

64 Above at 69 and 75 to 76.

65 Above at 65, who lists the four different levels of inference that scientists have as being speculation, hypothesis, theory and law.

66 The example used in Kemp, *The Nature of Knowledge* (Clive Bingley, London, 1976) throughout chapter 6.

67 Above at 72; see also the views of Weiner, discussed in Campbell, *Grammatical Man* (Penguin Books, London, 1983) at 28.

68 See Wishart, 'Resuscitating Popper: Critical Theory and Corporate Law' (1996) 3 Canberra Law Review 99; Davies, *Asking the Law Question* (Law Book, Sydney, 1994) at 99 to 104; Kemp, *The Nature of Knowledge* (Clive Bingley, London, 1976) at 72 to 74.

There is clearly tension between the concepts of accuracy and credibility. These concepts are important not just for scientific purposes but also for information generally. Important questions are whether information is accurate and credible.

Information Theory and Knowledge

Information theory was developed by mathematicians and engineers during this century to deal with problems surrounding electronic communication and encoding.[69] Information theory endeavours to examine how sequences of characters can be most effectively encoded for transmission.[70] The primary problem information theorists have to tackle is the presence of "noise" over a channel, that is electromagnetic currents which are always present and corrupt messages sent over an electronic channel.[71] Put slightly differently, entropy applies to electronic communication (entropy is the tendency of all things to become less orderly when left to themselves).[72]

Entropy also helps to explain a more common characteristic of normal human communication. There is at least a small amount of equivocation in adjacent links in any communication chain.[73] The amount of equivocation accumulates over successive links so that in the end very little of the original message may be left.[74] Many of us would have experimented with this by whispering a message to one person who attempts to pass it on verbatim to another, and so on. What the last person ultimately declares as the message usually bears little resemblance to the original.

The role of entropy is important in the corporate context when considering the long lines of communication channels both within the corporation (from employees to middle managers to senior executives to directors) and then to the outside world. The risk of increased entropy, and hence unreliability of information, will be ever present and the challenge for corporations is the same as that for the information theorists. That challenge is to devise information systems that ensure the integrity of information despite the corrupting effects of entropy.

The survey of philosophy, psychology, sociology, science and information theory for their insights on knowledge is now complete. Each of these disciplines, from its unique perspective, illuminates our understanding of knowledge. Having this background appreciation of knowledge it is now possible to consider meaningfully the concept of information and in turn its more specialised sub-category, corporate information.

Information

Information is a material representation of knowledge. As mentioned in the introductory chapter, for the purposes of this thesis, ideas in the mind (or in a computer) do not qualify as information until they have been reduced to material form intelligible to its intended audience. In some ways this is an artificial distinction, because the idea and the way it is represented may be identical. Although the distinction is artificial as a matter of

69 Pierce, *Symbols, Signals and Noise* (Hutchinson, London, 1962) at 41; see also Campbell, *Grammatical Man* (Penguin Books, London, 1983) at 16.

70 Pierce, *Symbols, Signals and Noise* (Hutchinson, London, 1962) at 64; Foerster, 'Epistemology of Communication' in Woodward (ed), *The Myths of Information: Technology and Postindustrial Culture* (Routledge, London, 1980) at 20.

71 Pierce, *Symbols, Signals and Noise* (Hutchinson, London, 1962) at 29.

72 Campbell, *Grammatical Man* (Penguin Books, London, 1983) at 18.

73 Dretske, *Knowledge and the Flow of Information* (Bradford Books, Massachusetts, 1981) at 103.

74 Above at 104 to 106.

substance, it helps to clarify the fact that there is a difference between knowledge in minds and knowledge that has been reduced to material form.

The principal type of corporate information (a form of intellectual knowledge) is written communication in the form of language, numbers, symbols and images. Of these, it is principally by language that we communicate with each other.[75] For any communication to be successful the speaker and listener must use the same language.[76] Assuming this is so, then communication can be reasonably successful. But even within the same language there is not necessarily a "one-to-one correspondence between words and concepts".[77] For words can have more than one meaning. This is particularly so given words commonly have both a denotation and a connotation.[78] Denotation is the literal meaning of words and the role of dictionaries is to set them out alphabetically. Of course even denotation has a certain amount of flexibility and few words have a rigidly agreed universal definition. But within this tolerable level of flexibility there are generally agreed meanings to words. If this were not so then language would lose its purpose and communication would be impossible.[79] Our own everyday experience tells us that we successfully communicate (and sometimes that we miscommunicate). On the other hand connotation is the emotional connection each person has with something.[80] For example newlyweds may be delighted with the idea of marriage, but someone who is recently divorced may be disgruntled or even bitter about marriage. So a word's connotation is personalised.[81] This imprecision and personalisation of connotation also brings into question whether information can be absolutely accurate.

An issue for people interested in information is whether information is objective or subjective. Some people argue that it is necessarily subjective; that is, it necessarily involves each individuals subjective perception, interpretation and understanding of information. For example Lakoff argues that knowledge can not simply be transferred from one person to another, and therefore concludes that information can not be objective.[82] However I disagree with this conclusion, for the reasons advanced by Dretske. In the following passage Dretske discusses the subjective view and then advances the reason why he rejects that view:

> something only *becomes* information when it is assigned a significance, interpreted as a sign, by some cognitive agent. Beauty is in the eye of the beholder, and information is in the head of the receiver. To speak of information as *out there*, independent of its actual or potential use by some interpreter, and

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75 Interestingly language may be a function of the left side of the brain, see Campbell, *Grammatical Man* (Penguin Books, London, 1983) at 243.

76 Lakoff, 'Body, Brain, and Communication', in Brook and Boal (eds), *Resisting the Virtual Life: The Culture and Politics of Information* (City Lights, San Francisco, 1995) at 117.

77 Kemp, *The Nature of Knowledge* (Clive Bingley, London, 1976) at 44 and 53. Poststructuralists certainly do not hold such a view, see Burr, *An Introduction to Social Constructionism* (Routledge, London, 1995) in chapter 2.

78 Above at 54.

79 Pierce, *Symbols, Signals and Noise* (Hutchinson, London, 1962) at 122 who states "For the words to be useful, hearers must understand them in the same sense that the speaker means them"; Kemp, *The Nature of Knowledge* (Clive Bingley, London, 1976) at 55.

80 Kemp, *The Nature of Knowledge* (Clive Bingley, London, 1976) at 55.

81 Above at 55.

82 Lakoff, 'Body, Brain, and Communication', in Brook and Boal (eds), *Resisting the Virtual Life: The Culture and Politics of Information* (City Lights, San Francisco, 1995) at 116 to 117. The view that information can simply be transferred from one persons' head to another's is called the "conduit metaphor", which Lakoff believes is false. See also Foerster, 'Epistemology of Communication' in Woodward (ed), *The Myths of Information: Technology and Postindustrial Culture* (Routledge, London, 1980) at 19.

> antedating the historical appearance of all intelligent life, is bad metaphysics. Information is an artefact, a way of describing the significance *for some agent* of intrinsically meaningless events. We *invest* stimuli with meaning, and apart from such investment, they are therefore informationally barren.
>
> This is one way of thinking about information. It rests on a confusion, the confusion of *information* with *meaning*. Once this distinction is clearly understood, one is free to think about information (though not meaning) as an objective commodity, something whose generation, transmission and reception do not or in any way presuppose interpretive processes.[83]

I disagree with Dretske that the generation and reception of information does not involve interpretive processes. Our understanding of knowledge drawn from philosophy, psychology and sociology convince me otherwise. But I consider that information does have an objective existence in the material form in which it exists. In my opinion this accords with the reality of our world, which amongst other things houses libraries full of information. I think that when someone comes along to consume and understand this information they will bring their subjective view to this process (more under the next heading, Communication). Therefore my view is not completely objective, and is certainly less objective than Dretske. In substance my view may not be that different from the subjective position, except in nomenclature (which helps to establish the previous point that language contains inherent uncertainty). So for corporate information, it has an objective existence as information but necessarily involves subjective interpretation processes both at the stage of its generation and subsequent reception by its intended audience. At the generation stage of the process, this points to the potential for bias and the need for credibility checks, in the corporate context the most important being independent perusal by auditors of financial information. At the reception stage, focus on the intended audience and in particular their ability to understand the information sent to them is important. Beyond this, audiences will interpret and understand information in a variety of ways including in ways not intended by the speakers. But this is inevitable and necessary as we are all autonomous beings who are free to think for ourselves.

Communication

Corporate intellectual knowledge is predominantly conveyed by written language (and by images)[84] and also verbally, thus the two principal senses used are those of sight and sound. As mentioned earlier, we can communicate a lot of things directly, without the intermediary of information. A caress can communicate love, a punch hate. But my concern is with corporate information, a type of intellectual knowledge, which requires information for communication to occur.

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83 Dretske, *Knowledge and the Flow of Information* (Bradford Books, Massachusetts, 1981) at (vii). For another view that supports the objective view of information, although for different reasons, see Masuda, *The Information Society as Post-Industrial Society* (Institute for the Information Society, USA, 1981) at 50 to 52.

84 McQueen, 'The Corporate Image-The Evolution of the Annual Report in Australia 1950-1990' conference paper delivered at the Corporate Law Teachers Association Conference, The University of Melbourne Law School, February 1997 (author on file).

Communication is the endeavour of passing knowledge, by information, from one person to another.[85] That is, communication is purposive. This claim is at its weakest concerning small talk and pastime knowledge where the purpose may not go beyond the immediate pleasure involved in the process of communicating. But in communicating other types of knowledge, and in particular intellectual knowledge, purpose becomes clearer and more important. The essential set of questions becomes who is speaking, to whom and for what purpose? That is, it is imperative to identify speaker and audience and to analyse the purpose of their communication. The general purpose of communicating intellectual knowledge is to enable people to rationally plan their lives,[86] or more specifically to take some particular action.[87] The purpose of any particular communication can be ascertained by analysing the nature of the relationship between speaker and their audience and in particular the needs and interests of the audience.[88] Focus on the audience is necessary because it is they who need information in order to plan their affairs. In the corporate context it is the needs and interests of shareholders which drive the need for information. I undertake an analysis of the nature of the relationship between directors and shareholders in chapters 4 and 5.

I describe communication as the endeavour of passing knowledge, rather than the passing of knowledge, because of the lessons drawn from the previous discussion from psychology and sociology.[89] Both of these disciplines make it clear that individuals subjectively use their socialisation and preconceptions as the context for their understanding. Therefore in any examination of communication it is not appropriate to concentrate solely on the speaker and the content of their message. The broader context and the experience of the intended audience, who will use their previous experience and preconceptions to interpret the message, are also important.[90] In particular it is important to ascertain whether all of the audience is within the same social field as the speaker and if not, the ramifications this has for the effectiveness of any attempted communication.

In summary I have reached fundamental definitions of the key concepts of knowledge, information and communication. This has involved an inter-disciplinary approach to these concepts. These form the framework for the entire thesis. This discussion also informs the quality of information, which I discuss later in this chapter.

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85 *The Macquarie Dictionary* (The Macquarie Library, Australia, 3rd ed, 1997) at 445 where "communicate" is defined as "to give to another as a partaker; impart; transmit; to impart knowledge of; make known".

86 Drahos, *A Philosophy of Intellectual Property* (Dartmouth, England, 1996) at 174.

87 Masuda, *The Information Society as Post-Industrial Society* (Institute for the Information Society, USA, 1981) at 55 who describes cognitive information as "an informed situational relation between a subject and an object that makes possible the action selection by which the subject itself can achieve some sort of use value". Whilst this author uses very technical and inaccessible language his use of the words "action selection" and "use" point to the use of information to take particular action.

88 See Institute of Chartered Accountants in England and Wales, *The Corporate Report* (Institute of Chartered Accountants in England and Wales, London, 1975) at 1.1 who state that corporate reports should satisfy "the information needs of users".

89 That communication is an endeavour has also been recognised by a non-academic, see Winterson, *Gut Symmetries* (Granta, London, 1997) at 163 who states:

> Common that people [sit face to face], rare that they understand each other. Each speaks a private language and assumes it to be the lingua franca. Sometimes words dock and there is a cheer at port and cargo to unload and such relief that the voyage was worth it. 'You understand me then?'

90 Campbell, *Grammatical Man* (Penguin Books, London, 1983) at 196 to 197.

2.3 CHARACTERISTICS

Before looking at the qualities of information it is desirable to examine the characteristics of information. Masuda suggests that information displays the following characteristics:

> information, unlike goods, has four inherent properties that have made self-multiplication possible. Information is (1) inconsumable, (2) untransferable, (3) indivisible, (4) accumulative.
>
> (1) Inconsumable--Goods disappear through use. Information does not disappear but remains unchanged however much it is used.
>
> (2) Untransferable--When a good is transferred from A to B, it is moved completely from A to B, but when information is transferred from A to B, the original information remains at A.
>
> (3) Indivisible--Goods used as materials (electricity, water, etc) can be divided and used, but information can only be used when it constitutes 'a set'.
>
> (4) Accumulative--The only way to accumulate goods is not to use them. Information, however, because it cannot be consumed or transferred, can be accumulated while it is being used time and time again. Information of a higher quality is produced by adding new information to the information that has been accumulated previously.[91]

Masuda made these observations in the context of a public information utility. The proposed public utility "is information infrastructure consisting of public information processing and service facilities that combine computer and communication networks. From these facilities anyone anywhere at any time can easily, quickly, and inexpensively obtain the information he needs".[92] The characteristics Masuda identifies are generally applicable to all types of information, but require some modification for information of a less public nature (as discussed below). Each of the characteristics described by Masuda deserves separate consideration.

Inconsumability of information is radically different than the consumability of most goods. Whether it is food which is eaten or perishes or more permanent things like a table or car which become worn out and dilapidated or obsolete, these things are consumable and ultimately will no longer exist in their original form. Not so with information which can be used but not consumed. Of course information can become dated or lost but this does not mean that it is consumable. Drahos has made the same point but dressed in the language of economics, in the following terms:

> information is not a scarce resource. The supply of information to one person does not diminish the amount available for supply to another person. Information has, in the language of economics, the property of being non-rivalrous in consumption.[93]

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91 Masuda, 'Future Perspectives for Information Utility', in Inose (ed), *Evolutions in Computer Communications: Proceedings of the Fourth International Conference on Computer Communication* (North-Holland, Amsterdam, 1978) at 388.

92 Above at 387.

93 Drahos, *A Philosophy of Intellectual Property* (Dartmouth, England, 1996) at 171.

Whilst this analysis is generally correct it does not take account of secrets where the person(s) with knowledge of the secret regards it as a scarce resource and determinedly wants to keep it that way (I discuss trade secrets under the next heading and in the next chapter).

The characteristic of nontransferability of information generally holds true. If I tell you something then I do not thereby lose the knowledge that the information represented. But where information is reduced to a material form it is possible to transfer the only copy of that information from one person to another (for example common in personal correspondence, but not for business correspondence). Of course the transferor could attempt to recreate that information, but that is unlikely to be a completely successful exercise. The law intrudes in the private domain, in particular in the world of private commerce, by granting limited private rights to information and allows the sale and transfer of information. This intrusion affects the generality of Masuda's second point about untransferability.

The indivisibility of information is also generally true. However it must be recognised that a set may have a subset which may be used independently of the larger set. For example use can be made of a chapter of a book without reference to the wider work.[94] Identification of the set becomes important. For some purposes this may be a single sentence, for others a complete book or even a body of knowledge in a particular discipline. But a point is reached where information must be part of a set for it to be meaningfully used. What that set is will be a matter of what is the intended use of the information.

The accumulative nature of information is generally true and seems to be a result of the two principal characteristics of inconsumability and untransferability. The most vivid comparison is with money; you can not both spend money and retain it (although you can spend it on something that you hope will earn you more money).

Another characteristic of information is "its natural tendency to spread".[95] This arises because humans are by their nature "information gatherers and exchangers".[96] For example we are all aware of the phenomenon of informal information networks (colloquially called the grapevine) which operates to convey gossip and more serious information. It is also self evident given the rise of global communication networks such as television and by the internet.

Looking at information from a different perspective, it is also perceived as a primary good.[97] Drahos, drawing explicitly from the work of Rawls, defines a public good in the following terms:

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94 I acknowledge that this may rob the reader of the broader context and that cross referencing within the book may make this task difficult, but in my opinion my point about subsets nonetheless holds true.

95 Drahos, *A Philosophy of Intellectual Property* (Dartmouth, England, 1996) at 171.

96 Above at 172.

97 Above at 171 to 174. Similarly see; Jones, *Sleepers, Wake! Technology and the Future of Work* (Oxford University Press, Australia, 4th ed, 1995) at 183 and 185 to 192; Hammond, 'Quantum Physics, Econometric Models and Property Rights to Information' (1982) 27 McGill LJ 47 at 52 and 72 regards information as "a collective good". Also Masuda's call for a public information utility is posited on information being a public good; Masuda, 'Future Perspectives for Information Utility', in Inose (ed), *Evolutions in Computer Communications: Proceedings of the Fourth International Conference on Computer Communication* (North-Holland, Amsterdam, 1978).

> Primary goods can be natural or social. For Rawls, the chief social primary goods are rights, liberties, powers, opportunities, [self-respect], income and wealth. These things are primary goods in the sense that every rational person is presumed to want them because they have such a crucial role in the implementation of one's life projects, whatever they may be.[98]

Drahos goes on to argue that information is also a primary good. His argument is that implementation of one's life projects involves rational planning which necessarily itself relies on information. Drahos states:

> Given that individuals know that they will be the rational formulators of plans, it is also likely that they will want some basic level of information and access to information as one of their primary goods. After all, the act of planning requires information. Plans take their shape according to the information available to the planners. The more information they have about the world to which their desires, purposes and goals relate, the more specific their plans can be. The less information individuals have, the more general their plans have to be. In a world where the amount of information available for planning was ever diminishing, a point would be reached where planning could not take place.[99]

This justification of information as a public good can be tied to the individual but not restricted to their planning. We each value our personal autonomy and our basic human right to think as we see fit.[100] This would be unacceptably interfered with if others could tell us that we were not free to think this or that because they owned or had exclusive rights to those particular ideas. This simple moral precept has considerable force.

These are very individualistic justifications of the importance of information. A broader argument drawing from the perspective of the progress of society is also available. This argument is that the progress of society depends on the free flow of information which fuels development and innovation,[101] which is the springboard for economic development (so valued in our capitalist society).[102] This is particularly evident given that information is an embodiment of knowledge and the advancement of knowledge is a positive result. This is nowhere more evident than in the scientific (and other academic) tradition of publishing the results of experiments, data, arguments, theories and conclusions.

These sets of arguments point to the need for as wide dissemination of as much information as is feasible, with any restrictions on the release of information needing special justification and to be closely constrained.[103]

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98 Drahos, *A Philosophy of Intellectual Property* (Dartmouth, England, 1996) at 173.

99 Above at 174.

100 See the discussion in chapter 5 of the personal autonomy justification for freedom of speech, which really is the creation and communication of information. For the link between the justification of information as a public good and freedom of speech see Drahos, *A Philosophy of Intellectual Property* (Dartmouth, England, 1996) at 177.

101 Weinrib, 'Information and Property' (1988) University of Toronto Law Journal 117 at 124; McKeough and Stewart, *Intellectual Property in Australia* (Butterworths, Sydney, 2nd ed, 1997) at [3.3].

102 Drahos, *A Philosophy of Intellectual Property* (Dartmouth, England, 1996) at 179 who states "Roughly the chain of causation thought to hold true is that human capital as embodied knowledge and skills is the springboard for technological and scientific development which, in turn, is an important (or perhaps *the*) condition of economic growth".

103 Above at 192 to 193.

2.4 QUALITIES

Besides these general characteristics, any particular set of information may or may not display certain qualities or display them to different degrees. The qualities of information are accuracy (including completeness and information overload), credibility, relevance, comparability, understandability, accessibility, confidentiality, timeliness and cost.[104] I consider each of these in turn.

Accuracy

Information is accurate to the extent it correctly represents reality/facts. Some realities are relatively simple, for example a person's name and their occupation. So information about the identity of a corporation's directors at any given time should be able to be described accurately. Other realities are less simple. For example a corporation's financial affairs are complex and sophisticated, involving not just how many widgits were sold in a given period but concepts such as depreciation of fixed assets and goodwill. Arguably there is not a simple underlying financial reality that can be represented as fact.

This difficulty with accuracy is compounded from a variety of sources. Whilst some philosophers question whether there is any underlying reality or whether we can know anything others are more pragmatic. These pragmatic philosophers acknowledge that absolute certainty is difficult but consider that adequate certainty is possible. Even these pragmatic philosophers are sceptical of 100% accuracy. Psychology also points to the uniqueness of each person's sensation, perception and conceptualisation. In effect each person's perception is her or his own perspective on the world. Perspective is necessarily something other than a faithful representation of reality. In my opinion these arguments from philosophy and psychology become more critical the more complex the realities we are dealing with.

Also information theory acknowledges that entropy decays accuracy; that is the impact of noise and entropy increases along successive chains of communication. This impact is present in public companies where there are long lines of communication. It will be most evident in the very large, multi-national corporations which operate diversified businesses. Clearly the onus is on such companies to have reliable information systems in place in order to address this issue. But in my opinion no system is able to combat perfectly the endemic problem of entropy.

Language is also inherently imprecise, particularly given words can have a personalised connotation. All of these arguments show that the more complex and sophisticated information is, the more relative accuracy becomes. Accuracy becomes an ideal to be striven for rather than an absolute concept. To the extent possible and within these constraints information should be as accurate as possible. This shortcoming in accuracy means that other qualities, such as credibility and comparability, become even more critical.

Of course information can be about things other than facts. Information can concern opinion or prediction. Opinion concerns belief as to some existing situation and prediction belief as to something in the future. The touchstone for belief is not its accuracy but the genuineness of the belief. Having said that, a genuine belief (rather than faith) will be based on underlying facts. Thus belief can be judged according to the

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104 For a similar list see Chartered Accountants in England and Wales, *The Corporate Report* (Institute of Chartered Accountants in England and Wales, London, 1975) at 3.3

quality (including accuracy) of the information upon which the belief is based. So accuracy is a relevant indicator of the quality of opinion or prediction in an underlying way.

An aspect of accuracy is completeness. Is the whole story being told or only part of it? A little knowledge is dangerous. People armed with only part of the story may come to very different assessments and decisions from those who know the full story. Telling only part of a story is a common tactic used to manipulate information. Therefore it is important that any information provided is complete. This is Masuda's point that information is indivisible and is only useful when it constitutes a set (discussed above). Of course there are subsets but in the normal course information should be provided in as complete a set as is possible. Completeness should be judged according to how much information exists on a particular issue and the information needs of users.

However completeness must be taken with a pinch of salt. Completeness suggests that a point can be reached where all bases are covered; ie perfection. However such a state is a chimera; just as it comes within sight it slips away again.[105] The pursuit of perfection is a worthy and necessary task but one that will never be completely fulfilled. This is because life, including commercial practice, itself is continually changing and evolving. Therefore mandatory rules seeking to ensure complete disclosure will necessarily always be playing catch-up. Clearly completeness is a matter of evolution and is a relative, not an absolute, concept.

Completeness merges into another topic. For to be complete certainly means providing more information than previously. A countervailing force to completeness is the spectre of information overload.[106] Information overload occurs when members of an audience receive more information than they can reasonably digest. This is another opportunity for speakers to manipulate information.[107] Speakers can provide an unnecessary amount of detail in order to swamp the intended audience so that key meanings are lost. (That is an inability to see the forest because of the trees). However to be complete does not necessarily mean to provide an inordinate amount of detail; succinctness and completeness can be bedfellows. Clearly a balance needs to be struck between completeness and the provision of an unnecessary amount of detail.

The law regularly deals with accuracy of information. The law does not positively require information to be accurate but approaches it in the negative. The law imposes liability for 'false and misleading statements' in a variety of contexts. This occurs most notably in the consumer context where there are a range of laws concerning misleading and deceptive conduct[108] and more specific laws concerning labelling of products.[109]

105 "In 1859, when Lord Palmerston was re-elected as Prime Minister for the last time, he told his colleagues that the range of subjects which could be legislated on would be exhausted within the life of that parliament (seven years). Palmerston's judgment has not been vindicated." Jones, *Sleepers Wake! Technology And the Future of Work*, (Oxford University Press, Melbourne, 2nd ed, 1990) at 175. See also Andrews, 'What Would Sir Samuel Griffith Have Said? Postmodernism in the 1990's Company Law Classroom' at 28, paper presented at the 1998 Corporate Law Teachers National Conference held at the School of Law, Flinders University of South Australia, 9 to 11 February 1998 (author on file).

106 Hammond, 'Quantum Physics, Econometric Models and Property Rights to Information' (1982) 27 McGill LJ 47 at 54.

107 Interestingly companies satisfy one of several cumulative exceptions under the continuous disclosure regime if the company would be forced to disclose "an inordinate amount of detail"; see Australian Stock Exchange, *Guidance Note On Continuous Disclosure: Rule 3.1* at paragraph 17.

108 Most notably ss 52 & 53 of *The Trade Practices Act* (Cth)1974.

Some of these general laws overlap into the corporate area[110] but there are also specialist corporate laws.[111]

Credibility

Credibility is inexorably linked to the (in)accuracy of information. Because of the problems with accuracy, audiences are also legitimately concerned with the credibility of the speaker. It is not just the message but also the messenger that is important. The importance of credibility is also seen from Popper's views from science. Popper thinks absolute truth (nee absolute accuracy) is an impossibility. Truth or accuracy is a chimera; the important thing is credibility. Credibility is reached by laying bare the methodology and data in support of knowledge/information and independently attempting to discredit it.

There is a broad range of shades from the credible to the incredible. The psychological and sociological material indicates that each person brings their unique perspective to the world. It is impossible for any person to divorce themselves from their perspective. At the other end of the spectrum are people who are willing to manipulate, if not fabricate, information to suit their own ends. The propensity to manipulate, if not fabricate, information is well known. The law in areas other than the corporate context has grappled with this propensity. For example the courts in administering justice are concerned with this propensity and many of the rules of evidence are directed at this very issue.[112]

In the corporate context there is a separation of roles between directors/executives and shareholders. Managers prepare and communicate information to shareholders and are in effect reporting on their own performance. Clearly there is an inherent risk of bias. That bias may be subtle; managers' belief in their competency will colour what they report. They are inherently more likely to put a favourable slant on information. The bias may be more blatant with managers deliberately refusing to release any information that reflects poorly on their own performance. Thus there is an intuitive scepticism about the credibility of information prepared by managers.

Clearly the law needs to deal with this problem of credibility. In the area of financial reporting the law has shown a real concern for credibility. That concern is manifested not only by substantive rules governing the content of the financial statements but also by insisting that independent accounting experts audit them, called auditors. I explore whether this in itself is adequate and the credibility of other areas of information in subsequent chapters.

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109 For example see *The Trade Practices Act* (Cth)1974 sections 65D and 65E and in particular the consumer product information standards made thereunder.

110 *Fraser v NRMA* (1995) 15 ACSR 590 in which NRMA was held liable for false and misleading statements in a prospectus pursuant to section 52 of *The Trade Practices Act* (Cth)1974. The present government regards the overlap as undesirable and proposes to remove the overlapping liability in the Trade Practices Act; see Treasury, *Corporate Law Economic Reform Program: Proposals For Reform: Paper No. 2: Fundraising* (AGPS, Canberra, 1997) at 3 and 40 to 43.

111 For example sections 995 and 996 concerning prospectuses and sections 1308 and 1309 concerning other documents required to be lodged pursuant to the Corporations Law. See the further discussion at Chapter 8.3.

112 Such as requiring witnesses to give evidence under oath and the hearsay rule, see Murphy, *A Practical Approach to Evidence* (Financial Training Publications, Great Britain, 2nd ed 1985) at paragraph 1.1.2.

Relevance

Since communication is purposive and information is a public good used for rational planning, information must be relevant to that purpose and the planning process. So once that purpose and plan have been identified, any information must be judged according to this yardstick to see if it is relevant. If it is not relevant then for that purpose/planning it is worthless.

In addition to relevance at this practical level there is the issue of legal relevance. There are many liability rules which apply to misinformation (whether because of misstatement or omission). I describe these liability rules as they arise throughout the thesis. However whether shareholders can use these liability rules and obtain meaningful remedies influences the legal relevance of this information. If shareholders do not have such rights then the information is legally irrelevant to them.

Comparability

Shareholders are consumers of a product (shares) and have an incredibly broad choice of products to choose from. Do they invest in the shares of company A, B or C etc? To assist in that choice and to be able to make ongoing comparisons between companies the information provided must be standardised to a certain extent. This is particularly so given the inherent problems with accuracy especially when it comes to the more esoteric types of financial information such as goodwill and depreciation. For this type of information the quest is not so much for an elusive underlying reality but standardised reporting rules so users of the information know the basis on which it has been prepared. If other companies are required to report on the same basis then users can make meaningful comparisons.[113] Arguably those philosophers who are not searching for any underlying truth but rational certainty obtained by conversation would emphasis comparability over accuracy. Standardised disclosure rules which facilitates conversation on the basis of a common understanding leads to rational certainty. However the need for comparability should not be taken to extremes for comparability must be tempered by the recognition that there is value in diversity.

Understandability

The effectiveness of communication can be gauged by the extent to which the information is understandable by the audience (even if the audience goes on to interpret or discredit that information).[114] That is, for information to be of any value, it must be understandable by its intended audience. To take two extreme but obvious examples, it is sheer folly to address an audience in a foreign language[115] or to present primary school

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113 The law requires not just comparisons between different companies, the financial statements of any particular company must include a comparison of this years financial results with last years; see AASB 1034 'Information to be Disclosed in Financial Reports' at paragraph 14. See also AASB 1018 'Profit and Loss Accounts' at paragraphs 20 to 21 and AASB 1026 'Statement of Cash Flows' at paragraph 13.

114 Foerster, 'Epistemology of Communication' in Woodward (ed), *The Myths of Information: Technology and Postindustrial Culture* (Routledge, London, 1980) at 21 even goes so far to argue that information is created only when a listener choses to take some action on the information. In my opinion this is confusing the inherent quality of information with the purpose of communication.

115 Stevens, Stevens and Stevens, 'Measuring the Readability of Business Writing: The Cloze Procedure Versus Readability Formulas' (1992) 29 The Journal of Business Communication 367 at 372; Epstein and Pava, *The Shareholder's Use of Corporate Annual Reports* (JAI Press, Connecticut, 1993) at 4.

children with advanced calculus. Corporations and their affairs are sophisticated and complex, so corporate information will necessarily reflect this.[116] Corporate information should be made as simple and understandable as possible but there is clearly a limit as to how far this can be taken. As Einstein said "everything should be made as simple as possible but not simpler".[117] The level and specialisation of a person's education is clearly going to impact on the ability to comprehend corporate style information. Also psychology regards the mental processes of each person as unique and sociology that social fields affects each person's knowledge base and their perspective. These factors will clearly affect meanings derived from any information. So audience is a critical factor and the issue of the demography of shareholders is important. Are they a cohesive group from one social field so that communication can be pitched at them? or are they a diverse group which will make effective communication more difficult?[118]

Connected with understandability is the readability of any written communication. Readability is principally "text centred" and concerned with the "syntactical difficulty of text".[119] Whereas understandability is "reader centred and is contingent on the reader's background, prior knowledge, the purpose of the reader, interest, and general reading ability. Background most certainly includes educational background".[120] Obviously there is a connection between the two, with difficult texts making understanding more difficult and vice versa.[121] For this reason some commentators treat the concepts synonymously,[122] although the distinction between the two does have merit.[123] There is a body of scholarship devoted to readability.[124] This scholarship is not simply theoretical but has developed a vast range of methods/tests to measure the readability of written prose.[125] Such tests rank written work along a scale from easy to read to very difficult.[126]

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116 The hypothesis of one researcher is that as a firm grows in size and complexity that firm's annual report necessarily becomes more sophisticated and difficult to read; see Jones, 'A Longitudinal Study of the Readability of the Chairman's Narratives in the Corporate Reports of a UK Company' (1988)18 Accounting and Business Research 297. This hypothesis must be treated with caution given the author studied only one company.

117 Quoted in Asprey, *Plain Language for Lawyers* (Federation Press, Sydney, 2nd ed., 1996) at 26. See also Chartered Accountants in England and Wales, *The Corporate Report* (Institute of Chartered Accountants in England and Wales, London, 1975) at 3.5.

118 I explore these issues further in chapter 4 and reach a conclusion about understandability in chapter 4.6.

119 Jones, 'Readability of Annual Reports: Western Versus Asian Evidence-A Comment to Contextualize' (1996) 9 Accounting, Auditing and Accountability Journal 86 at 86 to 87.

120 Courtis, 'Readability of Annual Reports: Western Versus Asian Evidence' (1995) 8 Accounting, Auditing and Accountability Journal 4 at 5.

121 However the precise relationship between readability and understandability is disputed by some; see Jones and Shoemaker, 'Accounting Narratives: A Review of Empirical Studies of Content and Readability' (1994) 13 Journal of Accounting Literature 142 at 172 and 175.

122 Mkwinda-Nyasulu, *The Australian Corporate Annual Reports: Some Factors Contributing To Low Readability Scores* (Ph.D thesis, University of Adelaide, 1994) at 34 to 35.

123 Harrison, *Readability in the Classroom* (Cambridge University Press, Cambridge, 1980) at 33; Jones, 'Readability of Annual Reports: Western Versus Asian Evidence-A Comment to Contextualize' (1996) 9 Accounting, Auditing and Accountability Journal 86 at 86 to 87; Lewis, Parker, Pound and Sutcliffe, 'Accounting Report Readability: The Use of Readability Techniques' (1986-Summer) Accounting and Business Research 199 at 200.

124 See Gilliland, *Readability* (Unibooks, London, 1972) and his selected annotated bibliography of principal texts at 110 to 117; Bentley, *How and Why of Readability* (Centre for the Teaching of Reading, United Kingdom, 1985); Harrison, *Readability in the Classroom* (Cambridge University Press, Cambridge, 1980).

125 Gilliland, *Readability* (Unibooks, London, 1972) at Part 3; Bentley, *How and Why of Readability* (Centre for the Teaching of Reading, United Kingdom, 1985) at 10 to 35; Adelberg, 'A Methodology For Measuring The Understandability of Financial Report Messages' in Courtis

Whilst these tests have their limitations they are generally perceived to be useful in testing readability.[127] This form of testing has been utilised in the corporate context and where it has been I refer to it.[128]

Accessibility

For information to be useful people must be able to get to it reasonably easily. Releasing information but in a highly inaccessible place is an exercise in frustration for users (and possibly an exercise in manipulation, but ultimate justification, for those who release the information). Information must be accessible to be useful. An allied topic to accessibility is equality of access, that is providing the same information to the entire audience. In a fair world a speaker should not favour one member or a part of the intended audience over others but should treat them all equally.[129]

Timeliness

Information loses its potency over time. Information must be available on a timely basis if it is to be vital and capable of being acted upon (ie used in decision making), rather than as a record of history.[130] For shareholders to be able rationally to plan their financial affairs and to exercise meaningfully the powers they enjoy (even to institute legal proceedings within limitation periods) they must receive information on a timely basis.

The components of timeliness are:

1) Interval--the period of time between the preparation of successive reports;
2) Delay--the period of time between the cut-off point (when no more transactions are accepted for inclusion in the report) and the distribution of reports to users.
3) Reporting period--the length of time that an operating report covers.[131]

Cost

It costs money to generate information that displays the qualities listed above. This is a fact of daily life where we pay for newspapers, magazines and books and endure advertising as the price for information/entertainment on radio and television. It costs money for managers to generate and disseminate information and for users to obtain and

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126 Courtis, 'Readability of Annual Reports: Western Versus Asian Evidence' (1995) 8 Accounting, Auditing and Accountability Journal 4 at 6.

127 Above at 6; Still, 'The Readability of Chairmen's Statements' in Courtis (ed), *Communication Via Annual Reports* (Financial Management Research Centre, Armidale, 1981) at 164; Stevens, Stevens and Stevens, 'Measuring the Readability of Business Writing: The Cloze Procedure Versus Readability Formulas' (1992) 29 The Journal of Business Communication 367.

128 Particularly see chapter 6.6 'Annual Report'.

129 Information parity underpins the prohibition on insider trading; see Corporations Law Part 7.11 Division 2A.

130 Garsombke, 'The Timeliness of Corporate Financial Disclosure' in Courtis (ed), *Communication Via Annual Reports* (Financial Management Research Centre, Armidale, 1981) 204 at 204 to 206.

131 Above at 206; see also Davis and Whittred, 'The Association Between Selected Corporate Attributes and Timeliness in Corporate Reporting: Further Analysis' in Courtis (ed), *Communication Via Annual Reports* (Financial Management Research Centre, Armidale, 1981) 219 at 219.

digest that information.[132] The benefit of information, which may be able to be quantified in monetary terms, must be weighed against this cost.[133] The cost of providing perfect information may be prohibitive if the cost is higher than the benefits it provides.[134]

Accessibility, timeliness and cost are bound together like a three corded rope. Computer technologies that currently exist if utilised could greatly improve all three of these qualities. Companies, rather than printing and delivering their information to each shareholder, could create a web site and place all relevant information on it. Shareholders could then access the information this way and if they desire a hard copy, download and print it.[135] Whilst companies would still bear the costs of producing information, the significant printing and distribution costs would be eliminated. Companies would bear the costs of establishing and maintaining a web site. Indeed web sites are becoming increasingly commonplace and some companies already have them.[136] Shareholders would need to pay for the costs of the necessary hardware and software and subscribe to an internet service provider. However these costs are not prohibitive.[137] Certainly all institutional investors would already have these services. In addition Australia has more Internet users per capita than anywhere (except for the US) and the third highest number of personal computers per capita in the world.[138] Despite this, some shareholders do not and will not use this technology. For these people the company would have to continue to disseminate information in the traditional way. But for others the use of computers would enable more timely information because the printing and delivery times would be eliminated. This in itself may be sufficient incentive for them to forego the use of hard copies. Alternatively these technologies could be used in advance of the hard copies. So timeliness (and accessibility) could be improved, at least for those with internet facilities. Although not universally utilised yet, the potential for this is clear and undercuts the argument against providing information because of its cost.

Confidentiality

Confidentiality involves secrets. Secrets arise and can be justified on two separate bases, namely privacy and commercial-in-confidence. Each of these relates to different types on information. Privacy relates to information "about" a person and commercial-in-confidence to information "of" a person.[139] Information "about" a person is of a biographical nature, such as what they did yesterday or their favourite food (or for a company, its financial performance over the last half-year). In the normal course it is

132 See McEwin, 'Australia's Continuous Disclosure Regime: Some Comments' (1992) Australian Journal of Corporate Law 77.

133 The weighing of these costs as against their benefits has long been recognised by economists who talk of the "agency costs" of the modern corporation. See for example Easterbrook and Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, USA, 1991) at 10.

134 Or at a time of financial difficulty perfect information may be a luxury the company can ill afford.

135 See generally McGregor-Lowndes, 'Corporate Disclosure, the Internet and the Australian Securities Commission' (1996) 14 Companies and Securities Law Journal 219.

136 For example Westpac's home page is at http://www.westpac.com.au. Other home pages are accessible via the ASX homepage at http://www.asx.com.au.

137 See generally McGregor-Lowndes, 'Corporate Disclosure, the Internet and the Australian Securities Commission' (1996) 14 Companies and Securities Law Journal 219 at fn 42 estimates these costs to be between $3,000 to $4,000 for the hardware and for the subscription $95 start up costs and a small access fee per month.

138 See generally above at 227.

139 A distinction suggested to me by Justice Paul Finn whilst he was a visiting judicial fellow at Flinders University during 1997.

possible to keep such information secret. But for companies, it is precisely this type of biographical information that laws mandate disclosure of (discussed in subsequent chapters). In addition, Australian law has no general right of privacy.[140] So generally there is no legal right to protect this type of information.[141] Therefore as a general proposition it is not possible to justify non-disclosure by corporations of information "about" themselves on the basis that the information is private.

However information "of" is information about any topic that a person may possess. One type of such information is information involving trade secrets or commercial-in-confidence, for example technical know-how (described further in the next chapter). Corporation by their nature possesses a lot of confidential and sensitive information which would prejudice it commercially if its competitors or others knew the information. The law has traditionally protected this type of information.

However the idea of private rights to information is contrary to the notion of information being a public good and to its inherent spreadability. Therefore such private rights require special justification in order to be legitimate. Also these private rights should be as circumscribed as possible so that they intrude as little as possible the public good notion of information. In this thesis whilst I generally take a generous view of what information should be provided to shareholders the one exception is confidential information. This justifies a thorough examination of the issue of confidential information and its legitimate reach, which occurs in the next chapter.

2.5 CONCLUSION

These fundamental definitions of knowledge, information and communication provide the framework for the rest of this study. The characteristics and qualities of information must be understood in order to assess corporate information adequately. Clearly, a systematic assessment of corporate information using this type of framework and these characteristics and qualities has not occurred. Only by using this framework and these characteristics and qualities is it possible to make a rigorously informed assessment of the quality of the information provided and whether disclosure of information is otherwise warranted.

140 Richardson, 'Breach of Confidence, Surreptitiously Or Accidentally Obtained Information and Privacy: Theory Versus Law' (1994) 19 Melbourne University Law Review 673 at 675 to 678. Richardson argues that in limited circumstances the law does, and generally should, protect the privacy of personal information. There are limited rights of privacy under the *Privacy Act* 1988 (Cth), which relates to information handled by government agencies and consumer credit information and concerning tax file numbers. The Act does not regulate "unwanted intrusions into an individual's private life or activities"; *Federal Privacy Handbook* (CCH, Australia, 1988) at [1-050].

141 Unless it is disclosed in circumstances of confidence to a restricted audience and there is no competing and overriding public policy justification to require disclosure; *Prince Albert v Strange* (1849) 64 ER 293; *Argyll v Argyll* [1965] 1 All ER 611; Gurry, 'Breach of Confidence' in Finn (ed), *Essays in Equity* (Law Book Company, Sydney, 1985) at 111; Neave and Weinberg, 'The Nature and Functions of Equities' (Part II) (1978) 6 University of Tasmania Law Review 115 at 116; Ricketson, 'Confidential Information-A New Proprietary Interest? Part I' (1977) 11 Melbourne University Law Review 223 at 223; c.f. Wilson, 'Privacy, Confidence and Press Freedom: A Study in Judicial Activism' (1990) 53 Modern Law Review 43, who argues that there must also be a pre-existing relationship of confidentiality.

CHAPTER 3

LEGAL CONCEPTIONS OF INFORMATION

3.1 INTRODUCTION

The preceding chapters have considered information generally and from the perspective of a variety of disciplines. This chapter considers information from a legal perspective. It focuses on the areas in which the law is willing to grant private rights to information. The importance of this is twofold. First, since information is a public good and has the characteristic of spreadability, any restriction on the free dissemination of information requires special justification and needs to be as circumscribed as possible. Therefore the extent and nature of the protections granted need to be examined in order to ensure this. Second, since this thesis is a legal thesis it would measure poorly against the quality of completeness without an analysis of the legal nature of information.

This chapter examines intellectual property regimes which grant private rights to information. The chapter considers copyrights, patents, designs, trademarks and trade secrets. I examine whether the grant of such rights is justified, their juridical basis and the implications of such rights for shareholders. However the focus is on trade secrets and commercial-in-confidence information, since this is the category of legal protection which of itself restricts disclosure of the information involved. By contrast the other regimes, whilst granting private rights to information, do not necessarily require information to be kept secret (indeed patents grant monopoly rights but require full disclosure of the invention). In the normal course trade secrets are information "of" the company and therefore disclosure to shareholders is not ordinarily required. Nonetheless in the context of a thesis about the disclosure of information to shareholders to discharge accountability, any restriction on disclosure is critical and needs to be examined and justified.

3.2 LEGAL CONCEPTIONS

The principal area in which the law has dealt with information is intellectual property.[142] The law has recognised and enforces several private rights to various types of information. For example intellectual property rights include:[143]

- copyright, which grants exclusive rights to original literary, artistic, dramatic or musical works (and some others)[144] for a substantial period of time, usually the life of

142 This is not the only area. For example the criminal law grapples with the issue of whether information is capable of being stolen; see Weinrib, 'Information and Property' (1988) 38 U Tor LJ 117 and issues of insider trading based on inside information, see CL s1013.

143 There are others, for example the rights granted by *The Circuit Layouts Act* 1989 (Cth) and *The Plant Breeder's Rights Act* 1994 (Cth), discussed in McKeough and Stewart, *Intellectual Property in Australia* (Butterworths, Sydney, 2nd ed, 1997) at [9.23] to [9.26] and [15.20] to [15.24] respectively.

144 *Copyright Act* 1968 (Cth) sections 85 and 89 (sound recordings), 86 and 90 (cinematographic films), 87 and 91 (sound and television broadcasts), 88 and 92 (published editions) and Part XIA (live performances). Discussed in Ricketson and Richardson, *Intellectual Property: Cases, Materials and Commentary* (Butterworths, Sydney, 2nd ed., 1998) at [4.2.45] to [4.2.60]; McKeough and Stewart, *Intellectual Property in Australia* (Butterworths, Sydney, 2nd ed, 1997) at [5.7].

the creator plus 50 years.[145] It is important to note that copyright protects an actual material form of expression of ideas (or knowledge) but does not grant any exclusive rights to the ideas themselves;[146]

- patents, which grant monopoly rights to the commercial exploitation of a novel invention for a period of time (generally 20 years),[147] once the invention has been registered and at the cost of information about the invention (specifications) entering the public domain.[148] Patents do not protect theoretical research ("discoveries on how the world works") but only applied research which ends in an invention;[149]
- designs, whereby monopoly rights are granted over the appearance of industrial articles which display a new or original and distinctive shape, configuration, ornamentation or pattern.[150] Monopoly rights are given to appearances, not methods or principles of construction nor functionality.[151] (This is similar to the idea/expression dichotomy in copyright, since appearance is a form of expression whereas functionality is the underlying concept or idea which is not protected.) Once registered the owner of the design enjoys monopoly rights up to a maximum period of 16 years;[152]
- trademarks, which are distinctive signs used to distinguish one trader's goods or services from another's.[153] Once registered, the owner of the trademark enjoys

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145 *Copyright Act* 1968 (Cth) section 33(2), discussed in Ricketson and Richardson, *Intellectual Property: Cases, Materials and Commentary* (Butterworths, Sydney, 2nd ed., 1998) at [4.3.1]; McKeough and Stewart, *Intellectual Property in Australia* (Butterworths, Sydney, 2nd ed, 1997) at [6.52].

146 *Nationwide News Pty Ltd v Copyright Agency Ltd* (1996) 34 IPR 53 at 69; *Skybase Nominees Pty Ltd v Fortuity Pty Ltd* (1997) 36 IPR 529 at 531. Discussed in Ricketson and Richardson, *Intellectual Property: Cases, Materials and Commentary* (Butterworths, Sydney, 2nd ed., 1998) at [3.5.4C] to [4.5.7]; McKeough and Stewart, *Intellectual Property in Australia* (Butterworths, Sydney, 2nd ed, 1997) at [6.1], who also note that this distinction between form and idea is being strained when it comes to computer programs.

147 *Patents Act* 1990 (Cth) section 67; Ricketson and Richardson, *Intellectual Property: Cases, Materials and Commentary* (Butterworths, Sydney, 2nd ed., 1998) at [14.7.15]; McKeough and Stewart, *Intellectual Property in Australia* (Butterworths, Sydney, 2nd ed, 1997) at [11.27] to [11.28]. Although for petty patents the term of the patent is only 6 years; *Patents Act* 1990 (Cth) section 68; Old, *Inventions, Patents, Brands & Designs: The How, What, When, Where & Why of Intellectual Property Protection* (Patent Press, New South Wales, 1993) at chapter 14.

148 *Patents Act* 1990 (Cth) chapter 4; Ricketson and Richardson, *Intellectual Property: Cases, Materials and Commentary* (Butterworths, Sydney, 2nd ed., 1998) at [14.7.13]; McKeough and Stewart, *Intellectual Property in Australia* (Butterworths, Sydney, 2nd ed, 1997) at chapters 11 to 15; the usefulness of such disclosures have been criticised, see Vaver, 'Intellectual Property Today: Of Myths and Paradoxes' (1990) 69 Canadian Bar Review 98 at 123 to 124.

149 Vaver, 'Intellectual Property Today: Of Myths and Paradoxes' (1990) 69 Canadian Bar Review 98 at 117, who is critical of this distinction.

150 *Designs Act* 1906 (Cth); Phillips, *Protecting Designs: Law and Litigation* (Law Book Company, Sydney, 1994); Old, *Inventions, Patents, Brands & Designs: The How, What, When, Where & Why of Intellectual Property Protection* (Patent Press, New South Wales, 1993) at chapters 50 to 58; McKeough and Stewart, *Intellectual Property in Australia* (Butterworths, Sydney, 2nd ed, 1997) at chapter 10, particularly at [10.1], [10.12] and [10.18].

151 *Designs Act* 1906 (Cth) sections 4(1) (definition of design) and 17(1); McKeough and Stewart, *Intellectual Property in Australia* (Butterworths, Sydney, 2nd ed, 1997) at [10.2], [10.3] and [10.14]; Ricketson and Richardson, *Intellectual Property: Cases, Materials and Commentary* (Butterworths, Sydney, 2nd ed., 1998) at {9.3.13] to [9.3.15].

152 *Designs Act* 1906 (Cth) section 27A; McKeough and Stewart, *Intellectual Property in Australia* (Butterworths, Sydney, 2nd ed, 1997) at [10.8].

153 *Trade Marks Act* 1995 (Cth) section 41; Old, *Inventions, Patents, Brands & Designs: The How, What, When, Where & Why of Intellectual Property Protection* (Patent Press, New South Wales, 1993) at 93 to 94; Ricketson and Richardson, *Intellectual Property: Cases, Materials and Commentary* (Butterworths, Sydney, 2nd ed., 1998) at [18.1.1] to [18.1.3]; McKeough and Stewart, *Intellectual Property in Australia* (Butterworths, Sydney, 2nd ed, 1997) at [19.4].

potentially perpetual monopoly rights to the mark (by way of an indefinite number of ten year renewals);[154]

- trade secrets, where the law protects the confidential disclosure of secret information from misappropriation. Trade secrets involve any information of a confidential nature that a business uses in pursuing profit. Categorisation is therefore difficult, but McKeough and Stewart suggest the following as a non-exhaustive list:
  - *ideas in their protean form* - discoveries, plans or suggestions which are held in someone's head but not yet fully worked out, or which have been reduced to material form but may nonetheless be readily appropriated without breach of copyright;
  - *unpatentable or unpatented inventions* - ideas for products or processes which have been fully developed, but which cannot be patented for lack of some characteristic such as novelty (in the sense either of being the first to invent or the first to file), or alternatively which the inventor chooses not to patent;
  - *technical know-how* - practical expertise that does not consist of a secret formula or process or design as such, but simply accumulated knowledge (often gathered by trial and error) as to what works and what doesn't;
  - *customer information* - information as to the identity and special needs of an organisation's clientele; and
  - *organisational information* - managerial techniques, structures or strategies whish are distinctive to a particular organisation and which contribute to its market position.[155]

In addition to the items on this list, there are other types of commercial-in-confidence information which necessarily requires protection in a competitive marketplace. Such information includes the cost to the corporation of its goods or services, its target consumers, marketing strategies. Also included are the plans managers have for their businesses, such as entering a new market or acquiring a new business (which also requires protection because otherwise their competitors may seize the opportunity from them).[156]

Consideration should be given to the complementary tort of passing off developed by the common law (and the statutory equivalents, principally s52 of the *Trade Practices Act* 1974 (Cth). This tort does not just protect the misappropriation of a mark but broader commercial interests a trader has in its imaging; see Ricketson and Richardson, *Intellectual Property: Cases, Materials and Commentary* (Butterworths, Sydney, 2nd ed., 1998) at chapter 16; Old, *Inventions, Patents, Brands & Designs: The How, What, When, Where & Why of Intellectual Property Protection* (Patent Press, New South Wales, 1993) at chapter 29; McKeough and Stewart, *Intellectual Property in Australia* (Butterworths, Sydney, 2nd ed, 1997) at chapters 16 to 18.

154 *Trade Marks Act* 1995 (Cth) sections 72 and 77; Ricketson and Richardson, *Intellectual Property: Cases, Materials and Commentary* (Butterworths, Sydney, 2nd ed., 1998) at [18.4.8]; McKeough and Stewart, *Intellectual Property in Australia* (Butterworths, Sydney, 2nd ed, 1997) at [19.19].

155 McKeough and Stewart, *Intellectual Property in Australia* (Butterworths, Sydney, 2nd ed, 1997) at [3.3]; see also *R v Stewart* (1983) 149 DLR (3d) 583 at 599, quoted in Weinrib, 'Information and Property' (1988) University of Toronto Law Journal 117 at 123 to 124; Ricketson, 'Confidential Information-A New Proprietary Interest? Part I' (1977) 11 Melbourne University Law Review 223 at 226.

156 Barry, *The Rise and Rise of Kerry Packer* (Bantam, Australia, 1993) at 172 where Packer is quoted as saying, in the context of the introduction of world series cricket:

> Obviously, if you're going to start something which is going to be controversial, and all the cards are held by the other party....you would be some form of mental deficient if you went along to the other party and said, 'Look, this is what I think I am going to do.' Of course I was secretive about it, but I have been secretive about every business deal I've ever been in to start with, as has everybody else who has ever done something successful.

The first four categories of protection involve statutory regimes. Understandably legislatures are reluctant to lock up general knowledge. This is evident by the idea/expression dichotomy in copyright law, the appearance/functionality dichotomy in designs and granting patents only for applied research and for a limited time and by forcing the patentee to put the specifications of the invention in the public domain. The principal justifications for granting these private rights are as a reward and ongoing incentive for the cost and effort of creative activity/research and development and the moral concept of not allowing someone else to commercially reap where they have not sown.[157] Whilst these arguments are not without their problems[158] the naked reality is that these private rights to information exist and those responsible for making the law obviously find the arguments for protection sufficiently persuasive.

In creating these regimes legislatures invent certain protections for certain types of information and tailor those rights as they see fit. The relevant statutes typically provide that the rights they grant are rights of personal property.[159] Noticeably though, the protection is for a limited period of time whereas traditionally property is regarded as a perpetual right (discussed below). So this aspect of property has been modified. Because legislatures invent these regimes and designate them as personal property, albeit based on common models existing throughout the world, there is not within them a thoroughgoing analysis of the legal nature of information. However the topic of trade secrets is a creature of judge-made law and therefore there is a richer analysis of the legal nature of this type of information. The analysis centres around whether the protection granted by the law of trade secrets is merely equitable or proprietary in nature.[160] This is a particularly important question since property rights are the strongest set of rights a person can have over something.[161] However since any incursion into the free flow of information should be as circumscribed as possible it is important to question whether this is appropriate (or even correct).

157 McKeough and Stewart, *Intellectual Property in Australia* (Butterworths, Sydney, 2nd ed, 1997) at [1.20] to [1.27] and [3.3]; Ricketson and Richardson, *Intellectual Property: Cases, Materials and Commentary* (Butterworths, Sydney, 2nd ed., 1998) at [11.11.1] to [11.11.2]. From an economic perspective the moral problem of reaping where one has not sown is the problem of free rider; see Hammond, 'Quantum Physics, Econometric Models and Property Rights to Information' (1982) 27 McGill LJ 47 at 55.

158 For a sceptic's view of these problems see Vaver, 'Intellectual Property Today: Of Myths and Paradoxes' (1990) 69 Canadian Bar Review 98.

159 *Copyright Act* 1968 (Cth) s 196(1); *Patents Act* 1990 (Cth) s 13(2); *Designs Act* 1906 (Cth) s 25C(1); *Trade Marks Act* 1995 (Cth) s 106; *Plant Breeder's Rights Act* 1994 (Cth) s11; *Circuit Layouts Act* 1989 (Cth) s45(1); discussed in McKeough and Stewart, *Intellectual Property in Australia* (Butterworths, Sydney, 2nd ed, 1997) at [1.17].

160 Historically there have been other contenders, such as contract, trust, fiduciary relationship and copyright. These others have been successfully criticised and are no longer seriously regarded as appropriate explanations of the jurisdiction. Equity and property are the modern contenders; see Hammond, 'The Origins of the Duty of Confidence' (1979) 8 Anglo-American Law Review 71; Ricketson, 'Confidential Information-A New Proprietary Interest? Part I' (1977) 11 Melbourne University Law Review 223 at 224; but c.f. North, 'Breach of Confidence: Is There A New Tort?' (1972) 12 Journal of the Society of Public Teachers of Law 149, who argues that the basis of liability is tortious. North's is a lone voice.

161 Weinrib, 'Information and Property' (1988) University of Toronto Law Journal 117 at 120; Bird, 'A Critique of the Proprietary Nature of Share Rights in Australian Publicly Listed Corporations' (1998) 22 Melbourne University Law Review 131 at 149. For a post modern criticism of the primacy of private property, see Edgeworth, 'Post-Property?: A Post Modern Conception Of Private Property' (1988) 11 UNSW Law Journal 87. However the power of private property is alive and kicking, particularly in the corporate law context; see *Gambotto v W.P.C. Ltd* (1995) 131 ALR 263.

Despite historical uncertainty and a troubled upbringing, equity traditionally protected confidential information on the basis of a breach of a confidential relationship,[162] drawing from the principle of good faith.[163] This remains the orthodox position, with courts, including the High Court, generally rejecting a property analysis.[164] However the courts have imposed remedies against people who were not party to any relationship of confidence (for example a thief).[165] Such people can be restrained by injunction from using or disclosing the information to others. As a matter of principle, the doctrine is no longer explicable on the narrow basis of a confidential relationship.[166] Is it explicable on a property basis?

Analysis of Property

Despite the long tradition of property law (and somewhat surprisingly) there is no clear-cut, universal definition of what property is. The search for a universal definition is a vexed issue for the law. Some commentators regard this quest as impossible because they regard property as "a category of illusory reference".[167] Whilst there is much merit in this view, particularly at the margins, it is important to attempt an analysis, for property is a powerful legal reality. There are many different frameworks for analysing what property is, but I prefer the one adopted by Teh and Dwyer because it is comprehensive and picks up the points raised by others.[168] Teh and Dwyer offer six guidelines in identifying property. They stress that these are guidelines only; the guidelines should not be regarded as strict rules that must be satisfied in order for property to exist in something (ie there is fluidity in these guidelines).[169] The six guidelines, punctuated with my views on how they apply to confidential information, are:

(1) "Whether with regards to goods or land, property is often seen as the *object* owned. More accurately, however, property is an *interest* in a thing. It is the *relationship* between a person and a physical or intangible thing with regards to other persons."[170]

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162 *Saltman Engineering Co Ltd v Campbell Engineering Co Ltd* (1948) 65 RPC 203.

163 Hammond, 'The Origins of the Duty of Confidence' (1979) 8 Anglo-American Law Review 71; more recent authority is derived from cases such as *Moorgate Tobacco Co Ltd v Philip Morris Ltd* (1984) 156 CLR 414; *Smith Kline and French Laboratories (Australia) Ltd v Secretary, Department of Community Services and Health* (1990-91) 99 ALR 679 at 691 to 692; cf Gummow J at first instance (1990) 95 ALR 87 at 134 to 136.

164 *Breen v Williams* (1996) 186 CLR 71; McKeough and Stewart, *Intellectual Property in Australia* (Butterworths, Sydney, 2nd ed, 1997) at [3.14] and [3.15].

165 See for example *Talbot v General Television Corp Pty Ltd* [1980] VR 224; and *Johns v Australian Securities Commission* (1993) 178 CLR 408. Gurry, 'Breach of Confidence' in Finn (ed), *Essays in Equity* (Law Book Company, Sydney, 1985) at 121 to 123; Ricketson, 'Confidential Information-A New Proprietary Interest? Part I' (1977) 11 Melbourne University Law Review 223 at 223 to 224.

166 McKeough and Stewart, *Intellectual Property in Australia* (Butterworths, Sydney, 2nd ed, 1997) at [3.16] to [3.17]; Neave and Weinberg, 'The Nature and Functions of Equities' (Part II) (1978) 6 University of Tasmania Law Review 115 at 117 (who assert that property is the only appropriate theory).

167 Gray, 'Property in Thin Air' (1991) 50 Cambridge Law Journal 252 at 305.

168 Teh and Dwyer, *Introduction To Property Law* (Butterworths, Sydney, 1992). For different analyses of the indicia of property see Meagher, Gummow and Lehane, *Equity: Doctrine and Remedies* (Butterworths, Sydney, 3rd ed, 1992) at [403]; Fisher, *Commercial and Personal Property Law* (Butterworths, Sydney, 1997) at [1.7] to [1.9].

169 These concepts of property, derived from a common law tradition, are open to challenge by native title (both on their own terms and at their point of intersection); see *Mabo v Queensland [No. 2]* (1992) 175 CLR 1.

170 Teh and Dwyer, *Introduction To Property Law* (Butterworths, Sydney, 1992) at paragraph [104].

From my preceding discussion and proposed definition of information (a material representation of knowledge), information is something of sufficient substance for it to be the subject of property rights.[171] In terms of legal analysis it is classified as an intangible (the law distinguishing between, for example, the paper information is written on and the information represented by the writing).[172] It is possible to have a relationship between a person and information. In that the law protects confidential information, there is a relationship between the person granted the remedy and the confidential information.

(2) "Private property is a creature of law...Land and other gifts of nature are free for everyone to use; they become private property when appropriated by individuals backed by laws designed to protect such appropriation...It is only laws which bar the general community from things claimed by me that make those things my property."[173]

Drahos and others argue that information is a public good, to be freely available and useable by all.[174] This characterisation is challenged when it comes to confidential information. It is clear that the protection given to confidential information, whether it is on the basis of property or some other, is the initiative of the law. Also it has been argued that in the case of intangibles such as information, which is the product of human creative effort, there is a stronger case for private ownership rights to that information.[175]

(3) "Property in a thing is a bundle of rights, privileges and powers that a person has in a thing. The three most commonly identified are the right to use and enjoy a thing, the right to sell and alienate it, and the right to exclude others from its use. The right to exclude, in particular, is said to be the most critical without which no interest could be regarded as proprietary."[176]

A person who possesses confidential information clearly has a right to use and enjoy it. This criterion is satisfied and is uncontroversial.

The second criterion is the right to sell and alienate.[177] This necessarily involves a transfer of the thing from seller to buyer. Communication I have previously defined as the endeavour of passing knowledge, by information, from one person to another. So communication certainly involves a transfer. Certainly the law facilitates the transfer of information. It happens everyday when we buy newspapers or watch the television. However as Masuda notes, it is a usual quality of information that it is "untransferable"

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171 See also McKeough and Stewart, *Intellectual Property in Australia* (Butterworths, Sydney, 2nd ed, 1997) at [3.1] who state that "information may be sufficiently discrete, identifiable and capable of objective valuation to 'belong' to someone"; cf Gray, 'Property in Thin Air' (1991) 50 Cambridge Law Journal 252 at 299 who states "the limits on "property" are fixed, not by the "thinglikeness" of particular resources but by the physical, legal and moral criteria of excludability" (discussed further below).

172 Weinrib, 'Information and Property' (1988) University of Toronto Law Journal 117 at 122.

173 Teh and Dwyer, *Introduction To Property Law* (Butterworths, Sydney, 1992) at paragraph [105].

174 Discussed in chapter 2.3.

175 Libling, 'The Concept of Property: Property in Intangibles' (1978) 94 The Law Quarterly Review 103.

176 Above at paragraph [106]. Other authors also adopt the 'bundle of rights' approach to property; see Weinrib, 'Information and Property' (1988) University of Toronto Law Journal 117 at 120; and Gray, 'Property in Thin Air' (1991) 50 Cambridge Law Journal 252 at 252 and 259 (who also emphasises the "excludability" criterion of property at 292 to 295).

177 Gray, 'Property in Thin Air' (1991) 50 Cambridge Law Journal 252 at 292 talks of the same concept as "assignability".

(ie the original remains with the seller).[178] His point is not that the recipient does not receive anything, but that the knowledge remains with the sender. Whilst Masuda's observation is generally true it is not a complete answer to our inquiry. Masuda was concerned with public information, where our concern is with private information and whether it is appropriate to regard it as private property. Masuda's observation appears to have been made untrammelled by considerations of these legal implications (which for his purposes was quite appropriate). Certainly if confidential information is sold the new owner can injunct the old owner from using the information (assuming it was an exclusive sale). But this relates to the previous criterion and who holds the rights that the law will protect. The law does not impose a kind of forgetting on the seller, as this simply is not possible. The reality that there can not be a complete transfer of information was part of the reasoning used by Justices Dawson and Toohey in *Breen v Williams* in denying property rights to medical records (information) by a patient.[179] The conclusion on this criterion is paradoxical; there can be a transfer, but not a complete one.

The third and critical criterion is the power to exclude others from the thing. That is property rights grant exclusive rights to the thing.[180] The obvious contrast is with "public goods", things which are freely available for everyone to use.[181] Common examples are the high seas and upper stratum,[182] the air we breathe, the rain that falls from the heavens[183] and what our eyes may happen to see.[184] As argued above, generally information is categorised as a public good. So whether someone should have exclusive rights to information (ie is able to exclude others from it) requires special justification.

Gray regards a resource as being excludable "only if it is feasible for a legal person to exercise regulatory control over the access of strangers to the various benefits inherent in the resource".[185] This may not be feasible (ie the resource is non-excludable) on three basis, namely physical, legal and moral.[186] "*Physical non-excludability* arises where it is not possible or reasonably practicable to exclude strangers from access to the benefits of a particular resource in its existing form."[187] Where only a discrete audience knows certain confidential information then it is physically possible to exclude others from it. For example files can be marked strictly confidential and locked away or computer files accessed only by a secret code.

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178 Discussed above. This is the fundamental problem in situations where an inventor sells his secret information to two different people who were each expecting to receive exclusive rights; see *De Beer v Graham* (1891) 12 NSWR (Eq) 144 (discussed in Neave and Weinberg, 'The Nature and Functions of Equities' (Part II) (1978) 6 University of Tasmania Law Review 115 at 126).

179 (1996) 186 CLR 71 at 90.

180 Weinrib, 'Information and Property' (1988) University of Toronto Law Journal 117 at 120.

181 Gray, 'Property in Thin Air' (1991) 50 Cambridge Law Journal 252 at 268 who states "unpropertised resources remain in the commons, available for use and exploitation by all"; see also Weinrib, 'Information and Property' (1988) University of Toronto Law Journal 117 at 124.

182 Gray, 'Property in Thin Air' (1991) 50 Cambridge Law Journal 252 at 256.

183 According to *The Bible: Revised Standard Version* (Collins, New York, 2nd ed, 1971) at Matthew 5:45 God "makes his sun rise on the evil and the good, and sends rain on the just and on the unjust".

184 The High Court has held that there is no property in a "spectacle": *Victoria Park Racing and Recreation Grounds Co. Ltd v Taylor* (1937) 58 CLR 479.

185 Gray, 'Property in Thin Air' (1991) 50 Cambridge Law Journal 252 at 268.

186 Above at 269.

187 Above at 269. This criterion explains the result in *Victoria Park Racing and Recreation Grounds Co. Ltd v Taylor* (1937) 58 CLR 479; discussed in Gray, 'Property in Thin Air' (1991) 50 Cambridge Law Journal 252 at 264 to 269 and 282.

However there is an inherent problem concerning the physical excludability of trade secrets (ie information "of" the corporation). Certainly a person can physically exclude others from their version of such information.[188] But as information is an embodiment of knowledge there is always the possibility that somebody else will independently think of it. One author claims that the "history of science and invention suggests that the phenomenon of simultaneous discovery is the rule, not the exception".[189] This is not the same as two people owning the same good (say a mass produced consumer item) and each having property rights to their good. For the rights to confidential information do not attach to the information in its own right but only to its confidential nature. Once the confidential nature has been lost, by independent creation, there is no longer a legitimate claim to protection. Of course the new creator may restrict access and the information may remain relatively restricted. But excludability means the ability to exclude all others (ie property rights are enforceable against all the world). The law grants private rights to confidential information whilst it is only known by one group, but this is more problematic when another group legitimately possesses the same information. This inherent risk militates against granting the strong and permanent right of property in confidential information.

By legal non-excludability Gray is speaking of self help remedies. The law seeks to balance "self-reliance, self-determination and community regulation" and "individualism and paternalism".[190] A resource is legally non-excludable if it is protectable against strangers by legal means (such as by contract or by intellectual property rights) but the person fails to adopt such protections.[191] Confidential information as a category is generally protected by the law (ie is legally excludable),[192] but any particular item of information may or may not deserve to be treated as confidential depending on the nature of the information and the behaviour of the person who possesses it.

Moral non-excludability arises "from the fact that there are certain resources which are simply perceived to be so central or intrinsic to constructive human coexistence that it would be severely anti-social that these resources should be removed from the commons".[193] As argued in chapter 2, information was categorised as a public good and therefore obviously falls within this category.[194] But what of confidential information? The arguments that justify the grant of intellectual property rights generally also justify the protection of confidential information. That is, society wants to encourage people to invest in research and development. This would be stifled if there wasn't a reward for

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188 "Ideas are free, but while the author confines them to his study, they are like birds in a cage, which none but he can have the right to let fly; for till he thinks it proper to emancipate them they are under his own dominion." Willes J in *Millar v Taylor* (1769) ER 201 at 242 (quoted in Hammond, 'The Origins of the Duty of Confidence' (1979) 8 Anglo-American Law Review 71 at 79).

189 Vaver, 'Intellectual Property Today: Of Myths and Paradoxes' (1990) 69 Canadian Bar Review 98 at 100. The courts are sceptical of claims of "independent creation" made by organisations who have previously received the same idea in confidence: see the cases discussed in Neave and Weinberg, 'The Nature and Functions of Equities' (Part II) (1978) 6 University of Tasmania Law Review 115 at 121.

190 Gray, 'Property in Thin Air' (1991) 50 Cambridge Law Journal 252 at 279.

191 Above at 273 to 274.

192 Although this analysis casts doubt on McKeough and Stewarts' classification of 'unpatented inventions' as a legitimate category of confidential information. This is because the invention is patentable but the potential patentee has chosen not to pursue that form of protection.

193 Gray, 'Property in Thin Air' (1991) 50 Cambridge Law Journal 252 at 280.

194 *Victoria Park Racing and Recreation Grounds Co. Ltd v Taylor* (1937) 58 CLR 479; discussed in Gray, 'Property in Thin Air' (1991) 50 Cambridge Law Journal 252 at 281 to 283.

this (ie confidentiality). There is also the "can't reap where you haven't sown" argument. These are strong arguments that justify the protection of confidential information, but whether it is so strong that it should result in the protection being proprietary depends on balancing all the indicia of property.

(4) "Property in a thing may be the object of several types of...different proprietary *interests*."[195]

There is more than one sense in which different property interests can exist in a thing. The estate in fee simple is the most complete property interest and out of this interest other interests can be carved, such as a lease or an easement. But the law also developed the notion of legal and equitable property rights.[196] This of necessity means that property is a relative concept depending on the nature of the property interest in question. This is most critical in the context of the fifth of Teh and Dwyer's guidelines.

An important point is that unless legal and equitable ownership is split by some legal act or use of the thing then it is inappropriate to talk of separate legal and equitable interests; there is only a complete property right to the thing.[197] As Maitland states:

> Its no use for Equity to say that A is a trustee of Blackacre for B unless there can be some court that can say that A is the owner of Blackacre. Equity without common law would have been a castle in the air, an impossibility.[198]

However when it comes to confidential information the commentators who argue in favour of a property analysis either fail to distinguish between legal or equitable proprietary interest or they call it an equitable proprietary interest without considering Maitland's point. Certainly courts, which have traditionally given protection to confidential information, have been, or have been purporting to, exercise an equitable jurisdiction. The simple but important point to make at this stage is that it is not appropriate in accordance with established property doctrine to just have an equitable property interest floating in the air without the full property interest existing somewhere and possessed by someone. Once again the importance of this becomes evident in considering the next guideline.

(5) "Unlike contractual and other personal interests, property may be defined as an interest enforceable against more persons than the contracting parties."[199]

This criterion is linked to the issue of "excludability". The uncontroversial point is to distinguish property rights from mere contractual rights, which are only enforceable between the contracting parties (ie privity of contract). It is necessary to explore which

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195 Teh and Dwyer, *Introduction To Property Law* (Butterworths, Sydney, 1992) at paragraph [107].

196 See Sackville and Neave, *Property Law: Cases and Materials* (Butterworths, Sydney, 5th ed, 1994) at 222 to 238.

197 Meagher, Gummow and Lehane, *Equity: Doctrine and Remedies* (Butterworths, Sydney, 3rd ed, 1992) at [413], who cite *Commr of Stamp Duties v Livingston* [1965] AC 694 per Viscount Radcliffe at 712 as authority for this proposition.- See also *DKLR Holdings Co (No2) v Commissioner of Stamp Duties* [1980] 1 NSWLR 511 per Hope J.

198 Maitland, *Equity; A Course of Lectures* (University Press, Cambridge, Great Britain, 1936) at 19; see also Bradbrook, MacCallum and Moore, *Australian Property Law: Cases and Materials* (Law Book Company, Australia, 1996) at 4.45.

199 Teh and Dwyer, *Introduction To Property Law* (Butterworths, Sydney, 1992) at paragraph [108]. See also McPherson, 'Information as Property in Equity' in Cope (ed), *Equity: Issues and Trends* (The Federation Press, Queensland, 1995) at 240 to 241.

other people property rights are enforceable against, particularly relative to other forms of protection which also are not proprietary in nature.

Full legal title, the most common form being (for real property) the estate in fee simple, is generally regarded as being enforceable against the entire world. This is so even though such a person derives their right from the sovereign and is potentially subject to compulsory acquisition.

However since there are different proprietary interests it can not be that each proprietary interest is enforceable against all the world, at least where there is conflict between competing proprietary interests. That is why in property textbooks whole sections are devoted to priorities between people with competing proprietary interests.[200] This is particularly critical when considering the clash between equitable owners and subsequent bona fide purchasers for value of a legal estate without notice of the equitable interest. Generally such a purchaser enjoys their legal estate free of the equitable interest they did not have notice of.[201]

How do these property principles apply to confidential information? There is no doubt that the right of confidential information is not based merely on contractual protection (since people not privy to any contractual relationship can be injuncted from misusing confidential information).[202] Also, as mentioned above, injunctive relief runs against people who were not party to any relationship of confidence. (Some commentators use this criterion as the principal basis on which they argue that confidential information is property.[203] However this is only one of the indicia of property and is not, in itself, conclusive.)[204] At this stage I think it is appropriate to outline the range of other people against whom a remedy may be sought by the original possessor of the confidential information. The people who are potentially subject to a remedy are, broadly speaking:

(1) parties to a confidential but non-contractual relationship;
(2) people who receive information from a party to a confidential relationship who know, or ought to know, of its confidentiality;
(3) bona fide purchasers without notice of the original owner's interest in the confidential information; and
(4) people who independently create the information.

It is relatively uncontroversial that the law does and should grant remedies against the first two categories of people. Dicta from most cases and commentators believe the

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200 For example see chapter 6 of Tooher, Dwyer and Teh, *Introduction to Property Law* (Butterworths, Sydney, 3rd ed, 1997). This is the point of some other commentators who argue that it is possible to have property rights even if the right to exclude only applies to certain people and only excludes their use for limited purposes (ie prohibits commercial use); see Libling, 'The Concept of Property: Property in Intangibles' (1978) 94 The Law Quarterly Review 103.

201 Tooher, Dwyer and Teh, *Introduction to Property Law* (Butterworths, Sydney, 3rd ed, 1997) at [6.33] to [6.34].

202 McKeough and Stewart, *Intellectual Property in Australia* (Butterworths, Sydney, 2nd ed, 1997) at [3.4].

203 Ricketson, 'Confidential Information-A New Proprietary Interest? Part II' (1977) 11 Melbourne University Law Review 289 at 308; Gray, 'Property in Thin Air' (1991) 50 Cambridge Law Journal 252 at 301; McKeough and Stewart, *Intellectual Property in Australia* (Butterworths, Sydney, 2nd ed, 1997) at [3.17].

204 Courts certainly so not find this conclusive, see *Smith Kline & French Laboratories (Aust) Ltd v Secretary, Department of Community Services and Health* (1990) 22 FCR 73 at 121 per Gummow J; *Breen v Williams* (1996) 186 CLR 71 per Brennan CJ at 81 to 82, Dawson and Toohey JJ at 90 and Gummow J at 129.

defence of bona fide purchaser should also apply to confidential information.[205] Also in my opinion it is inappropriate to grant any remedy against an independent creator.[206] In the context of confidential information, being first does not warrant exclusivity as against someone else who has independently also created it. The result of this is that a legal proprietary interest to confidential information is not appropriate because it gives too strong rights to the information (ie it would inappropriately grant a remedy against the bona fide purchaser and the independent creator).[207] An equitable proprietary interest is appropriate in terms of justifying the grant of remedies against the first two categories of people, but not the third and fourth category. But it is at this point that Maitland's point becomes critical. The problem is it is impossible to see a different owner of a greater legal proprietary interest to the confidential information out of which an equitable interest can be carved.[208]

(6) "..property is generally a perpetual right."[209]

Traditionally this has been a strong part of the indicia of property.[210] Although the owner of property may change, the thing itself remains the subject of property rights (perhaps until the thing is completely destroyed). This cannot be said of confidential information. The legal rights attach to a characteristic of the information, confidentiality (or scarcity), which characteristic can be lost. The characteristic can be lost by voluntary or involuntary disclosure or, as mentioned above, by independent discovery (for information "of"). Where the information has been disclosed against the wishes of the person who possesses it and it has become public knowledge, then an injunction is not available;[211] the only feasible remedy is damages. It is not that the information has been destroyed, just its scarcity and hence its value to its original owner has been lost. In my

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205 Gurry, 'Breach of Confidence' in Finn (ed), *Essays in Equity* (Law Book Company, Sydney, 1985) at 122 to 123; Neave and Weinberg, 'The Nature and Functions of Equities' (Part II) (1978) 6 University of Tasmania Law Review 115 at 122 to 127; Ricketson, 'Confidential Information-A New Proprietary Interest? Part II' (1977) 11 Melbourne University Law Review 289 at 313 TO 314 (also in Part I of this article at 244 to 245); and McPherson, 'Information as Property in Equity' in Cope (ed), *Equity: Issues and Trends* (The Federation Press, Queensland, 1995) at 240 to 242; c.f Toulson and Phipps, *Confidentiality* (Sweet and Maxwell, London, 1996) at 7-06 to 7-09.

206 Although this is the result under patent law with its monopoly rights.

207 Certainly some of the intellectual property regimes, such as copyright. grant property rights which are effective against bona fide purchasers and independent creators. But these regimes are special statutory regimes, grant rights for limited periods and do not involve the locking up of knowledge. They are distinguishable because of this.

208 Ricketson, 'Confidential Information-A New Proprietary Interest? Part II' (1977) 11 Melbourne University Law Review 289 at 314 to 315 recognises this as a "problem" but does not fully address how this may impact on his conclusion that confidential information is "a loose sort of proprietary interest perhaps best described as an 'undefined equity' ".

209 Teh and Dwyer, *Introduction To Property Law* (Butterworths, Sydney, 1992) at paragraph [109].

210 *National Provincial Bank Ltd v Ainsworth* [1965] AC 1175 per Lord Wilberforce at 1247 to 1248. Gray, 'Property in Thin Air' (1991) 50 Cambridge Law Journal 252 at 292 to 296 has questioned this and himself regards property as a "relative" and "dynamic" concept. He bases this argument on his observation (at 295) that "since the physical, legal and moral conditions of excludability may vary according to time and circumstance, it becomes clear that the notion of "property" in a resource is not absolute but relative". However most of his succeeding arguments are directed to whether someone can own property and the traditional point that there can be several different property rights in the same thing. With this I agree; but in my opinion permanence is still an important criteria of property. That is, just as absolutist arguments about property should not be taken too far, neither should Gray's argument; that is property is not so fluid and dynamic that as a general proposition permanence is not a relevant indicia.

211 *Marcel v Commissioner of Police of the Metropolis* [1992] Ch. 225; applied in *Johns v Australian Securities Commission* (1993) 178 CLR 408.

opinion it is intuitively wrong to attach property rights to a temporary characteristic rather than to the thing itself.[212] In addition a perpetual right is significantly stronger than the specific statutory regimes of protection of intellectual property discussed above, which limit themselves to a set period of time. It simply seems inappropriate to grant exclusive and permanent rights to information and hence knowledge.

Many commentators regard property as the most appropriate jurisdictional basis for the protection of confidential information.[213] Confidential information meets many of Teh and Dwyer's guidelines, so such an analysis is feasible. However in my opinion information should not be regarded as property.[214] Given information is a representation of knowledge it is simply not appropriate to regard this as property with its exclusive and perpetual rights.[215] As Vaver argues "allocating property rights in knowledge makes ideas artificially scarce and their use less frequent-and, from a social point of view, less valuable".[216] Knowledge is capable of independent formation and is inherently spreadable so property is too strong a designation. It is simply not appropriate to attach property rights to a quality of information (ie its confidentiality) which can be lost. Although equitable property is in some senses a more suitable characterisation it is wholly inappropriate when full legal ownership does not exist.

Part of the problem with the current debate is that commentators regard equitable protection or the property justification as completely discrete categories with hard and fast boundaries. However there are no hard-edged boundaries to what is and what is not property. In my opinion the two different bases of protection should not be regarded as distinct categories. As mentioned previously, certainly property rights are the strongest set of rights a person can have over something. Also there are different types of proprietary interests. But it is a continuum between property and other forms of protection. There is a "hierarchy of equitable estates and interests", some of which are proprietary in nature and others which are not.[217]

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212 Hammond, 'Quantum Physics, Econometric Models and Property Rights to Information' (1982) 27 McGill LJ 47 at 58; Weinrib, 'Information and Property' (1988) University of Toronto Law Journal 117 at 127. Weinrib dismisses this argument on the basis that other property rights are also extinguished over time. But his examples concern (1)who owns property, not whether property in the thing exists; and (2) intellectual property regimes that expire after a fixed period. The specialist statutory regimes in my opinion should be regard as special cases that do not speak of the inherent nature of property. I therefore regard Weinrib's conclusion as unconvincing. See also McPherson, 'Information as Property in Equity' in Cope (ed), *Equity: Issues and Trends* (The Federation Press, Queensland, 1995) at 238 to 239.

213 McKeough and Stewart, *Intellectual Property in Australia* (Butterworths, Sydney, 2nd ed, 1997) at [3.17]; Gray, 'Property in Thin Air' (1991) 50 Cambridge Law Journal 252 at 300 to 301; Weinrib, 'Information and Property' (1988) University of Toronto Law Journal 117 at 136 to 139; McPherson, 'Information as Property in Equity' in Cope (ed), *Equity: Issues and Trends* (The Federation Press, Queensland, 1995) at 242.

214 Toulson and Phipps, *Confidentiality* (Sweet and Maxwell, London, 1996) at 2-03 to 2-25; Finn, *Fiduciary Obligations* (Law Book Company, Sydney, 1977) at 293 to 296.

215 A view expressed by Latham C.J. in *FCT v United Aircraft Corporation* (1944) 68 CLR 525 at 534 (quoted in Neave and Weinberg, 'The Nature and Functions of Equities' (Part II) (1978) 6 University of Tasmania Law Review 115 at 116 to 117).

216 Vaver, 'Intellectual Property Today: Of Myths and Paradoxes' (1990) 69 Canadian Bar Review 98 at 126; Ricketson, 'Confidential Information-A New Proprietary Interest? Part I' (1977) 11 Melbourne University Law Review 223 at 229.

217 Meagher, Gummow and Lehane, *Equity: Doctrine and Remedies* (Butterworths, Sydney, 3rd ed, 1992) at [403] and [4.29]; see also Tooher, Dwyer and Teh, *Introduction to Property Law* (Butterworths, Sydney, 3rd ed, 1997) at [6.18] who cite as authority for this proposition *Swanston Mortgage Pty Ltd v Trepan Investments* [1994] 1 VR 672.

I am persuaded that equity does and should protect confidential information. However I am not persuaded that this should be, or necessarily has to be, because that protection is proprietary in nature, which seems to be the inevitable conclusion of some commentators.[218] If it is accepted that equity can intervene and grant equitable style remedies without the need for a proprietary interest then clearly it is not a necessary conclusion that confidential information is equitable property. However in my opinion confidential information is worthy of protection in the hierarchy of rights. Traditionally confidential information was protected by courts of equity on the basis of the confidential relationship between the parties. This is no longer appropriate because remedies have been and should be granted against people not party to a confidential relationship. In my opinion the protection should attach to the secrecy of the information. So people have an equitable interest in the information, but this interest falls short of a property interest in the hierarchy of estates and interests.[219] If the secrecy is lost, by a bona fide purchaser or by independent creation, then the basis for the protection is also lost. Also if by whatever means information enters the public domain then an injunction will no longer be an appropriate remedy.

3.3 CONCLUSION

The law by a variety of mechanisms grants private rights to information. The majority of these rights are statutory based, namely copyright, patents, designs and trademarks. Whilst these statutory regimes grant property rights to the their owners, the regimes are careful not to grant exclusive rights to the knowledge/ideas/concepts that underlie the information the subject of the rights. The rights granted are also usually not perpetual. In the non-statutory context the common law also rightly protects confidential information. However in my opinion this protection should not be regarded as proprietary largely because this would entail locking up the underlying knowledge in perpetuity, which is inappropriate. This point is supported by the public goods nature of knowledge, which dictates that any protection be as circumscribed in its extent and nature as possible.

However it is clear that the law protects confidential information. So the company has a legally enforceable right to injunct people who wrongly use its confidential information, other than the bona fide purchaser for value and an independent creator. Such protection is justified even though it detracts from the "public good" nature of information. The justifications are that protection encourages and rewards research and development and the moral precept of not allowing people to reap where they have not sown. An additional justification is that if the information was known by its competitors or others this would prejudice it commercially. In a capitalist society which endorses competitive advantage and the pursuit of profit to the exclusion of others, then the notion of private rights to confidential information is relatively uncontroversial.

A separate issue is whether corporations are entitled to keep confidential information secret from its own shareholders. In my opinion companies are so entitled, but not because of the nature of the relationship between the company and its shareholders

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218 For example Neave and Weinberg, 'The Nature and Functions of Equities' (Part II) (1978) 6 University of Tasmania Law Review 115 at 129 conclude that it is an "undefined proprietary equity".

219 That is, the interest is sui generis; see McKeough and Stewart, *Intellectual Property in Australia* (Butterworths, Sydney, 2nd ed, 1997) at [3.18]; Gurry, 'Breach of Confidence' in Finn (ed), *Essays in Equity* (Law Book Company, Sydney, 1985) at 115; Toulson and Phipps, *Confidentiality* (Sweet and Maxwell, London, 1996) at 2-24.

(discussed in the next chapter). The reason to disentitle shareholders to this information is much more pragmatic. Large public companies have thousands of shareholders and disclosure to them would necessarily destroy the confidential nature of the information.[220] Once disclosure to shareholders has occurred then the information is effectively in the public domain, accessible by competitors and the curious alike. Disclosure would be antithetical to the commercial interests of the company and hence the shareholders. In addition investors have no real reason to know this type of information. In my opinion shareholders do not need to know this type of business information in order for them to fulfil their role.[221] Throughout this thesis I make many proposals for increased disclosure but usually qualify that proposal with a right to confidentiality. Wherever that qualification is made, I am referring to the type of corporate/confidential information examined in this chapter.

The issue of confidentiality can not be abstracted from its place in time. Often over time as information becomes a part of history it loses its sense of confidentiality. For example the marketing strategy of a company becomes obvious or its plans go stale or come to fruition (and therefore to a certain extent has become a matter of public knowledge). At this time the information loses its confidentiality and there is no longer a basis to warrant its non-disclosure if disclosure is otherwise justified.

However the right to protect confidential information does not justify a general right to secrecy. Many organisations tend to secrecy, probably out of a sense that it is not anyone else's business to know the information. A lot of the sensitivity to disclosure may be based on the idea of I do not know what you are doing so therefore I won't let you know what I'm doing.[222] However if every company was required to disclose the same information then this sensitivity would evaporate.

Secrecy begs the questions, who know the secret and who are they keeping it secret from? Translated to the corporate context, should companies be able to keep information secret from their shareholders? Following from the previous analysis the blunt answer must be no, unless the non-disclosure can be specially justified, as it can be for confidential information. Given that companies do not have property rights to their information then they do not have exclusive rights to it and particularly not to the exclusion of shareholders. Therefore any blanket claims by corporations that shareholders should not have access to corporate information because it is corporate property are spurious. This also means that any claims by corporations that information is a trade secret or otherwise commercially-in-confidence needs to be carefully scrutinised to ensure that the claim is legitimate rather than just based on the illegitimate desire to keep secrets.[223]

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220 Disclosure to a small number of shareholders in small proprietary companies may be appropriate if they were bound by the same obligation of confidentiality.

221 I consider business information is chapter 8.2.

222 There was an initial outcry with the introduction of the public audit of financial statements. See chapter 7.3 "Business Performance". There is a similar reluctance to voluntarily publish other information that the law does not mandate disclosure of, such as quarterly reports; see the discussion in McBride and Peirson, 'Timing and Frequency of Financial Reports: Present Requirements and Proposals for Change' (1993) 11 C&SLJ 183.

223 The same tension between disclosure and legitimate secrecy occurs in the public/political arena; see Auditor General of South Australia, *Report for the Year Ended 30 June 1998: Audit Overview Part A.3* (South Australian Government Printer, South Australia, 1998) at A.3-31 to A.3-43.

CHAPTER 4

DECONSTRUCTING THE CONCEPT OF SHAREHOLDERS

4.1 INTRODUCTION

Having dealt with the legal treatment of information and in particular the principal restriction to disclosure (confidential information), it is possible to pursue more central concerns. As the definition of communication made clear, it is vital in any information exchange to identify the speaker, the intended audience and the purpose of the communication. Translated to the corporate context this means considering directors, shareholders and the purpose of their communication. It steals little from the analysis to state from the outset that given the controlling position of directors in corporations and the concomitant reliant position of shareholders, the key issues become defining who shareholders are and from this considering what their information needs are.[224] This in turn necessarily requires deconstructing who shareholders are and their role in the modern corporation in order to understand them and therefore their information needs. In formalised and structured relationships, which directors and shareholders are a typical example of, the needs of the audience should dictate the information provided by the speaker.[225] Speakers in such contexts should not be free to choose whether and what information they provide to their audience, as is common with informal relationships. Therefore in this chapter I propose to examine who shareholders are and what their rights and interests are. Only from a clear understanding of this can a reasoned judgment be made of the information needs of shareholders and in turn whether those needs are currently being satisfied.

The issue of who shareholders are can be approached at various levels.[226] It can be approached by:

- considering differing legal concepts and principles which have been invoked in an attempt to explain who shareholders are. For example do shareholders enjoy rights of property, are their rights merely contractual or are they principals with directors as their agents?;
- examining the role and functions of shareholders in the company and particularly their position relative to the directors who are the other principal players in the company. These roles and functions are largely set out in each company's constitution and to a lesser extent in the Corporations Law;

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224 This "needs of users" based analysis is explicitly adopted in the context of the financial statements, see Statement of Accounting Concept 2 'Objective of General Purpose Financial Reporting' at paragraphs 3 and 11.

225 The teacher/student relationship is another example of a formalised relationship and education literature states that teachers should focus on the information needs of their students (called "student centred learning"); for example see LeBrun and Johnstone, *The Quiet Revolution: Improving Student Learning in Law* (Law Book Company, Sydney, 1994) particularly at 89 to 91.

226 I do not attempt to understand the role of shareholders by resort to traditional legal theories, such as the concessionist, aggregate or corporatist view of the corporation. Others have already done this very well. See for example Bottomley, 'Taking Corporations Seriously: Some Considerations for Corporate Regulation' (1990) 19 Fed LR 203; Wishart, *Company Law in Context* (Oxford University Press, Australia, 1994) in chapter 6; and Tomasic, Jackson and Woellner, *Corporations Law: Principles, Policy and Process* (Butterworths, Australia, 3rd ed, 1996) in chapter 3. It is not that I regard this style of theorising as inappropriate, just that I regard a more analytical approach to be a different way of approaching the issue.

- identifying the people who own shares and whether this has any impact on the more theoretical question of who they are;
- considering what the company is and using this perspective to endeavour to understand who shareholders are; and
- regarding shareholders as investors.

I examine each in turn.

4.2 LEGAL CONCEPTIONS OF SHAREHOLDERS

The legal literature advances many conceptions of who shareholders are in relation to the directors and the company.[227] Many of these are by analogy to traditional legal concepts as the law grapples with this difficult question. The traditional legal concepts used are trustee/beneficiary, principal/agent, property or contract. I also discuss the argument that shareholders are mere bystanders.

Trustee/Beneficiary

Many cases over a long period of time have stated that directors may be regarded as trustees with shareholders as their beneficiaries.[228] The main and significant similarity between companies and trusts is that one group of people (the directors and the trustees) have control over funds and assets which other people (the shareholders and beneficiaries) have a (beneficial) interest in.[229] Shareholders have to trust (in the colloquial sense) the directors to exercise their discretionary powers in the interests of shareholders. This point is obvious just by considering the extremely broad management powers delegated to directors without resort to a trust analogy. In most other ways modern corporate practice and corporate rules mean that the company does not resemble a trust at all.[230] As Sealy points out:

- whilst the trustees have legal title to the trust property directors do not. Corporate property is owned by the separate legal entity, the company;[231]
- trustees must ordinarily act unanimously whereas directors decide by a majority vote at a meeting with a valid quorum;[232] and
- trustees are supposed to conserve the trust fund and avoid exposing it to unnecessary risks whereas directors of a commercial company necessarily take risks in the pursuit of profit.[233] This puts a "gloss on" the standard of care that can be expected of trustees compared with ordinary directors.[234]

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227 Hill, 'The Shareholder as Cerberus: Redefining the Shareholder's Role in Modern Australian Corporate Law', paper presented at the 1995 Corporate Law Teachers Conference' (copy on file of author).

228 See the cases listed in Sealy, 'The Director As Trustee' [1967] Cambridge Law Journal 83.

229 Above at 86.

230 This was recognised by Vaughan Williams J in *Re Kingston Cotton Mill (No. 2)* [1896] 1 Ch. 331 at 335 who stated "a director is in no sense a trustee"; quoted in Sealy, 'The Director As Trustee' [1967] Cambridge Law Journal 83 at 86.

231 Sealy, 'The Director As Trustee' [1967] Cambridge Law Journal 83 at 87.

232 Above at 87.

233 Above at 89.

234 *ASC v AS Nominees* (1995) 18 ACSR 458 per Finn J at 469. Finn at 470 also describes as an "arid debate" whether directors are trustees. Finn J leaves as an open question whether corporate or professional trustees in certain circumstances should be held to an even higher standard of care.

For these reasons it is neither appropriate nor helpful to consider the company as a trust in order to try to understand who shareholders are and their legitimate role in the company.

Principal/Agent

It is possible to view shareholders as principals with directors as their agents. In the legal context this view of the relationship between shareholders and directors has never held sway,[235] at least to the extent of saying directors are not mere agents.[236] Many legal rules are implicitly based on the view that directors are not mere agents of shareholders,[237] and at least one rule is explicitly so based. One of the fiduciary duties imposed on directors prohibits them from fettering their discretion.[238] This rule prohibits a director, even if appointed by a significant shareholder, from agreeing in advance to exercise their discretion in a particular way. If directors were mere agents it would be perfectly proper for them to fetter their discretion in accordance with the wishes of their principals, the shareholders.

Despite the lack of support for the principal/agent theory of the relationship between shareholders and directors it merits examination anyway, starting with a definition of agency. An agent is "one person who has authority to create legal relations between a principal and third parties".[239] This definition suggests a linear analysis of principal-agent-third parties. However the analysis is not this straight forward in companies because of the separate entity doctrine. Shareholders appoint directors who are authorised to create legal relations between the company (not the shareholder appointors) and third parties. There is no doubt that the directors are the agents of the company in this sense. This is orthodox corporate law doctrine according to general law and enshrined in the Corporations Law.[240] The only complicating factor is that directors are empowered to create legal relations for one person (the company) but a different person (the shareholders) appointed them. Once again in my opinion this should not be allowed to muddy the analysis. This typifies the artificiality of the company when considering the relations between shareholders and directors. In my opinion it is perfectly acceptable to regard the directors as agents of the shareholders acting on behalf of the company.

However the main argument in this context is not the status of shareholders but the assertion that directors are not mere agents. Mere agency suggests the agent is at the beck and call of the principal, subject to the principal's every wish. Under the law of agency an "agent is bound to obey all lawful and reasonable instructions of his principal in relation to the manner in which the agent carries out his duties".[241] The characterisation simply does not accord with the role of directors. They are delegated

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235 Economists freely talk of directors being the agents of the shareholders; see for example Fama and Jensen, 'Separation Of Ownership And Control' (1983) 26 Journal Of Law And Economics 301; Jensen and Meckling, 'Theory Of The Firm: Managerial Behaviour, Agency Costs And Ownership Structure' (1976) 3 Journal of Financial Economics 305. However such authors are not referring to the legal concept of principal/agent which this section of the thesis is concerned with.

236 See discussion below about the exclusive management power cases.

237 See the legal rules listed under the heading below Shareholders as Bystanders.

238 *Thorby v Goldberg* (1964) 112 CLR 597; *ANZ Executors & Trustees Co Ltd v Quintex Australia Ltd (Recs & Mgrs apptd)* (1990) 2 ACSR 676.

239 Gooley, *Corporations & Associations Law* (Butterworths, Sydney, 1995) at 85.

240 CL s126, 127 & 129(2) & (3); Ford, Austin and Ramsay, *Ford's Principles Of Corporations Law* (Butterworths, Sydney, 9th ed., 1999) at Chapters 12 and 13.

241 Reynolds, *Bowstead On Agency* (Sweet and Maxwell, London, 16th ed., 1996) at 175 to 176; see also Fridman, *Law Of Agency* (Butterworths, London, 6th ed., 1990) at 16.

very broad powers of management which necessarily involves the exercise of discretion. Discretion involves choice and where there is room for choice there is room for legitimate difference of opinions. It is therefore antithetical to repose a broad discretion in a small group of people but then regard them as mere agents. A similar line is drawn between employees and independent contractors. One feature of the dividing line between the two is the degree of control the employer/contractor has over the manner in which the work is undertaken.[242] It is an established principle that directors are not employees[243] (unless they are also employees such as the managing director).[244] This conclusion is consistent with not regarding a director as a mere agent.[245]

The state of modern business is another factor which supports the view of directors not being mere agents. Modern business is increasingly complex and sophisticated. This has led to an increased professionalisation of the role of managers. The increased complexity makes it more difficult for shareholders to comprehend what directors are doing and act as a traditional principal. This led to the recognition of a separation between ownership and control.[246] The resulting legal rule which was pro-management was that full control of management decisions must reside in the directors (or their delegates).[247]

There is obvious merit in these arguments that directors are not the mere agents of shareholders. However the arguments have traditionally been juxtaposed in black and white terms. The argument that directors are not mere agents has been taken to the extreme position that they must have absolute control of the company to the complete exclusion of shareholders. There is no compelling reason to take such an absolutist position.[248] To say that directors are not mere agents does not have to result in oligarchy. Due to procedural restraints (shareholders must act in general meeting which is called with appropriate notice) shareholders would presumably only intervene in particularly important matters, if at all. These procedural restraints and associated costs prohibit shareholders from acting on a day to day basis and if they wished to so act it would obliterate the need for directors. I develop and justify this point below under the heading "Shareholders As Bystanders".

It is clear though that an analysis of shareholders and directors as principal and agent is not a suitable description of their relationship. But such an analysis advances our understanding and is therefore useful.

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242 *Performing Right Society Ltd v Mitchell & Booker Ltd* [1924] 1 KB 762 at 767 to 768, quoted in Creighton and Stewart, *Labour Law; An Introduction* (The Federation Press, Sydney, 2nd ed., 1994) at 132. There are other tests to determine whether the a relationship of employment, or merely a contract for services, exists. But the control test remains the most important test or indicia. See above at 133.

243 *Hutton v West Cork Railway Co* (1883) 23 Ch D 654 at 672. See Redmond, *Companies And Securities Law: Cases And Materials* (Law Book Company, Sydney, 2nd ed., 1994) at 277.

244 *Anderson v James Sutherland (Peterhead) Ltd* [1941] S.C. 203 at 218.

245 Although the reasoning used in *Hutton v West Cork Railway Co* (1883) 23 Ch D 654 is not based on a lack of control. The reasoning used was that directors payments were a gratuity, which obviously meant to the judge that they could not therefore be an employee. In the face of directors remuneration being commonplace and often significant the reasoning used must now be regarded as dubious, although the decision may be sound.

246 Berle & Means, *The Modern Corporation And Private Property* (Macmillan, New York, 1940).

247 This idea is developed in Clark, 'The Four Stages Of Capitalism; Reflections On Investment Management Treatises' (1981) 94 Harvard Law Review 561 at 563.

248 Buxbaum, 'The Internal Division of Powers in Corporate Governance' (1985) 73 California Law Review 1671 at 1672.

Property

Under this category I analyse whether shareholders can be regarded as owners.[249] If shareholders enjoy rights of property this would be a significant finding. Property rights are the strongest rights a person can have in something else. Many people commonly describe shareholders as owners.[250] This is illuminating in itself; it may be attributable to looseness of language or to an intuitive sense for the underlying legal position. In this part I subject this common perception to legal analysis.

My first sentence under this heading begs the question, owners of what? Three possibilities arise. Shareholders can be regarded as owners of their shares, the company or the underlying assets of the company. It is clear that the current and orthodox legal position is that shareholders enjoy rights of property in their shares (which legal categorisation has a statutory foundation[251] and has recently been reinforced by the High Court).[252] Shares are clearly a form of personal property (a legal chose in action),[253] but this characterisation does not say much about the nature of the relationship between shareholders and directors. Certainly it is shares that link people to corporations. Such shareholdings, in conjunction with corporate constitutions and corporate laws, gives shareholders their rights in corporations. But these rights arise by reason of this shareholding link and supporting legal rules, which is not affected by whether the link is proprietary in nature or not. As mentioned in the introduction, the role of shareholders that arise because of this link is analysed on its merits later in this chapter.

To see shareholders as owners of the company necessarily involves considering what the company is and whether it is capable of being subject to property rights. However this is not done as an abstract exercise. The point of such an analysis is to try to appreciate the role of the shareholder in the company, especially in relation to directors.

As in the previous chapter, to determine if property exists or not the six guidelines of Teh and Dwyer[254] are useful. The six guidelines, punctuated with my views on how this applies to shareholders and their company, are:

(1) Property is an *interest* in a thing.[255]

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249 Two authors posit an interesting and eclectic view. They recognise the prevailing view of shareholders as owners but regard this as a deliberately fabricated myth in an attempt to disguise shareholders as essentially gamblers who buy chances to make money; see Ferrara and Zirlin, 'The Institutional Investor and Corporate Ownership' (1991) 19 Securities Regulation Law Journal 341 at 348.

250 As is evident from the famous phrase of there being a "separation of ownership and control"; see Berle & Means, *The Modern Corporation And Private Property* (Macmillan, New York, 1940). See also Cadbury Committee, *The Financial Aspects of Corporate Governance* (Gee, Great Britain, 1992) at paragraph 6.1.

251 CL s1085.

252 *Gambotto v W.P.C. Limited* (1995) 127 ALR 417. *Gambotto* has unleashed a torrent of legal discussion. One recent critique which questions the proprietary designation is Bird, 'A Critique of the Proprietary Nature of Share Rights in Australian Publicly Listed Corporations' (1998) 22 Melbourne University Law Review 131.

253 *Archibald Howie Pty Ltd v Commissioner of Stamp Duties (NSW)* (1948) 77 CLR 143 at 156; see Ford, Austin and Ramsay, *Ford's Principles Of Corporations Law* (Butterworths, Sydney, 9th ed., 1999) at paragraph [17.200].

254 Teh and Dwyer, *Introduction To Property Law* (Butterworths, Sydney, 1992). For a different analysis of the indicia of property see Meagher, Gummow and Lehane, *Equity: Doctrine and Remedies* (Butterworths, Sydney, 3rd ed, 1992) at [403].

255 Teh and Dwyer, *Introduction To Property Law* (Butterworths, Sydney, 1992) at paragraph [104].

The immediate question is whether the company is a thing, that is something of sufficient substance to be capable of being the subject of property rights. To address this question properly requires some view of what the company is. Is it a separate legal entity, the commercial enterprise which the company operates, something else or, at least as between shareholders and directors, so artificial as to be nonexistent? To explore this issue I think it is necessary to start from the basics.

The law says that a company is a separate legal entity, a separate legal personality. In terms of strict analysis this is correct.[256] When a company is incorporated it has an existence, something is there. It makes sense to regard the company as a separate legal entity when analysing the relationship between the company and outsiders. These outsiders have their relationship with the company and the separate entity doctrine means that ordinarily they have no relationship with, or recourse against, either the shareholders or directors. Perhaps being a separate entity is all the company is when considering its relations with outsiders, but in other contexts this does not fully describe what the company is.

So what is the company in the context of examining who shareholders are and what their role in the company is, especially in relation to the directors? One possible response is that the company is the separate legal entity that the law creates. In my opinion it is nonsensical to interpolate the company as a separate legal entity when analysing the relationship between directors and shareholders (ie between insiders of the company). In a sense the very word "separate" suggests this because it necessarily begs the question, separate from what or whom? Surely the answer is separate from the shareholders and directors. However once past this point of linguistics, when we ask the question, who or what is the company, the answer is that the company is a wholly artificial creature, a legal fiction.[257]

This artificiality is evident when we compare companies with humans and ask the corresponding question, who am I? That question can be answered in many ways that do not really address the profundity of the question. Some of those answers, and an analysis of how this does not address the centrality of the question are set out below together with a comparison with companies.

ANSWER	COMMENT	COMPARISON WITH COMPANIES
I am Julian Blanchard	This tells you my name, a convenient label[258] but nothing of who I am.	All companies must also have a name [259] but this is similarly non-defining.

[256] CL s119; *Salomon v Salomon & Co. Ltd* [1897] A.C. 22.

[257] This is the central thesis of the traditional concession theory of the corporation: see Tomasic and Bottomley, *Corporations Law In Australia* (The Federation Press, Sydney, 1995) at 49.

[258] In some cultures the name does, or is meant to, signify at least something of who the person is. It seems though that this is only somewhat descriptive of, rather than defining, who they are. Such cultures include the American Indians and Jewish people.

[259] CL Part 2B.6. Their name may consist of their company number; CL s148(1)(b).

I live at 5 Murray Street Blackwood, and am domiciled/resident in South Australia.	This only tells you where I live and the current place with which I have the closest connection but this can change at any time without altering who I am.	Companies also have a registered office,[260] and are incorporated in a certain jurisdiction.[261]
I am a lawyer/academic	This describes what I do in order to sustain my existence, but not a lot about who I am. It tells something of who I am, but only a part. I can, and have, changed occupations but I remain.	Companies carry on businesses with a view to profit. Similarly companies can, and often do, buy and sell businesses; it is strained to correlate the company with the commercial enterprise it is currently conducting.[262] Therefore the commercial enterprise should not be regarded as the company.[263]
I am heterosexual.	Once again this describes a certain aspect of me, my sexuality. It is certainly not all defining of who I am.[264]	No equivalent.

To properly address the question, "who am I?" requires a more essential approach than looking at things about me. I can be regarded as body,[265] soul[266] and spirit. These three combine with my accumulated experience to constitute the unique individual that I am.[267]

In the corporate context, in no real sense do corporations have a body, soul or spirit.[268] Certainly for the purposes of considering the liability of companies for crimes involving mens rea, courts have constructed a type of person from participants in the company.

260 CL s142.

261 The company is incorporated in the jurisdiction in which the application for registration was lodged; CL s118(1)(iv).

262 Posner, *Economic Analysis Of Law* (Little, Brown And Company, Boston, 3rd ed., 1986) at 382 to 383 who distinguishes between the firm and the corporation.

263 There are conceptual difficulties with this statement which are explored below. However see McPherson, 'Duties Of Directors To Shareholders And Creditors' paper presented in Company And Securities Law After The Market Crash (Legal Research Foundation Inc, Australia, 1989). In this article McPherson argues that corporate purposes (in terms of the commercial entity) is the company (for the purpose of determining in whose or what interests directors should act).

264 Unfortunately language used by certain people suggests that they pigeon hole people into categories and regard certain aspects of a person as all-defining; eg. he is gay, she is lesbian.

265 Paradoxically, even though my body is an essential aspect of me, all cells of my body are replaced in a 7 year cycle. See Hale, *The History of the Common Law of England* (Rothman and Co, Colorado, 1987) at 60.

266 Encompassing (at least) personality, mind, emotions and will.

267 This can be analysed more specifically and identity can be regarded as an interweaving of age, class, ethnicity, gender, sexual orientation and so on; see Burr, *An Introduction to Social Constructionism* (Routledge, London, 1995) at 51.

268 "Did you ever expect a corporation to have a conscience, when it has no soul to be damned, and no body to be kicked", Edward, First Baron Thurlow, 1731-1806 Lord Chancellor of England, quoted in King, *Public Policy and The Corporation* (Chapman and Hall, London, 1977) at 1. Although some commentators argue that corporations have a reputation and are concerned about their prestige; Fisse and Braithwaite, *The Impact of Publicity on Corporate Offenders* (State University of New York Press, USA, 1983) at 247. However reputation and prestige concern the public's perception of the corporation and I accept that the notion of the company does have meaning and reality when it comes to its dealing with outsiders.

Persons occupying certain managerial positions are identified as being the directing will and mind of the company.[269] A similar, although broader, approach is part of the *Criminal Code Act* 1995 (Cth).[270] In some senses this analysis seems appropriate. In terms of the business enterprise conducted by the company then the directors and managers can be regarded in organisational terms as the brain of that business enterprise. But as I have argued in the table above, both a human being and a company are something much more than their current occupation or business. Therefore it is not necessarily appropriate to regard the directors and managers as the directing mind of the corporation (rather than the business). This is particularly so given corporate decision making power is shared between directors, shareholders and sometimes even creditors (such as membership, internal rules, capital requirements and corporate planning). Therefore the identification analysis has its limitations. Notably the identification analysis is used to establish criminal liability of the company to outsiders.

However in my opinion as between shareholders and directors (insiders to the company) the artificiality of the company is total; there is simply nothing there. Corporations can not be regarded as things of sufficient substance so as to be capable of being owned by shareholders. This conclusion does not deny that shareholders have a relationship with directors and the company (albeit that is an ephemeral being). As mentioned previously, that relationship exists because people hold shares in corporations and that relationship is fleshed out by the corporate constitution and corporate laws. But that shareholding and resultant relationship is not, and does not need to be, posited on a conclusion that the company is something of sufficient substance that it is capable of being owned by shareholders.

The inappropriateness of interpolating the company between shareholders and directors can be further demonstrated by two examples, one from company law and the other from international law. One of the duties of directors is to act "bona fide in the best interests of the company". So the test is formulated in terms of the company, as if it has some real significance and substance. However the courts quickly recognised the artificiality of companies by saying the best interests of the company means the best interests of shareholders (and sometimes creditors). By "shareholders" the courts mean all present[271] and future[272] shareholders, not just the majority[273] or a particular class of shareholders.[274] It is generally regarded that creditors' interests only have to be taken into account where

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269 *Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd* [1915] AC 705 at 713; *Tesco Supermarkets Ltd v Nattrass* [1972] AC 153 at 170. Proponents of this view are grouped in the organic theory of the corporation; see Bottomley, 'Taking Corporations Seriously: Some Considerations for Corporate Regulation' (1990) 19 Fed LR 203 at 211 to 213.

270 *Criminal Code Act* 1995 (Cth) at section 12.3(2)(a) and (b) identify the board of directors and high managerial agents as capable of satisfying any mental fault element for criminal laws that may apply to corporations. The other way such mental states can be satisfied is by a corporation having a prevalent corporate culture that tolerated the criminal activity or failed to have a corporate culture to prevent such crimes; see s12.3(2)(c) and (d).

271 *Ngurli v McCann* (1953) 90 CLR 425 at 438.

272 *Provident International Corporation v International Leasing Corp Ltd* [1969] 1 NSWR 424; *Gaiman v National Association for Mental Health* [1971] Ch. 317 at 330 per Megarry J; discussed in Heydon, 'Directors Duties and the Company's Interests' at 123 in Finn (ed), *Equity and Commercial Relationships* (Law Book Company, Sydney, 1987); cf Renard, 'Commentary [on this chapter]' at 138 to 139. See also Gower, 'Corporate Control: The Battle For the Berkeley' (1955) 68 Harvard Law Review 1176 at 1185.

273 *Ngurli v McCann* (1953) 90 CLR 425 at 440.

274 *Mills v Mills* (1938) 60 CLR 150 at 164.

the company is insolvent or nearing insolvency.[275] This concession to creditors is warranted because at the time of insolvency or doubtful solvency the directors are effectively dealing with the creditors' money.[276] Despite how the test is formulated it makes substantive sense to identify the content of the duty with the shareholders (and sometimes creditors). The logical consequence of trying to tie the bona fide test to the company is to end up with a meaningless test because of the complete artificiality of companies.[277] In this sense companies are juristic black holes; there is something there but it is devoid of content. The courts whilst paying lip service to the separate legal entity doctrine in this context side-stepped its logical consequence in a bid to embrace the perceived reality.

The other illustrative example is from international law. The federal government has the power to negotiate, make and ratify international treaties on behalf of Australia.[278] Australia is a "legal person with full capacity for all purposes of international law".[279] These treaties bind Australia in its international relations even though Australian legislation is required before these treaties "establish operative rules of law for the domestic situation".[280] So clearly Australia is an entity for the purposes of its relations with outsiders (other nations). However this conception of ourselves as a nation does not intrude into the relations between citizens and their elected representatives, the government of the day. The government of the day is directly responsible to the electorate (at least in theory). In considering the relationship between citizens and the government it is meaningless to attempt to interpose imbetween the participants to those relationships the entity of Australia. Although once again this is not to say that the relationship between citizens and their elected representatives is not governed by the Australian constitution and other democratic principles which inform our system of government. That relationship and those principles are not dependent on the reality of Australia as a separate entity for international purposes. In my opinion it is similarly inappropriate to interpose the company between shareholders and directors.

A completely different approach to understanding companies can also be reached by considering the meaning of the word "company". The word "company" has been defined as "a body of persons associated together for the purposes of trade or business".[281] The company is in a real sense the body of persons associated together.[282] That "body of

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275 *Walker v Wimborne* (1976) 137 CLR 1 at 6 per Mason J; *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 3 ACLC 215 at 222; and *Grove v Flavel* (1986) 4 ACLC 654.

276 This was the justification used by Jacobs J. in *Kinsela v Russell Kinsela Pty Ltd* (in liq) (1986) 4 ACLC 215 at 222.

277 Heydon, 'Directors Duties and the Company's Interests' in Finn (ed), *Equity and Commercial Relationships* (Law Book Company, Sydney, 1987) at 125 states that the "interests of the corporation apart from those of the members have an abstract, conceptual, merely metaphysical life, or at least they seem to at first sight".

278 *R v Burgess; ex parte Henry* (1936) 55 CLR 608; *Koowarta v Bjelke-Peterson* (1982) 153 CLR 108; Ryan, *International Law In Australia* (Law Book Company, Sydney, 2nd ed., 1984) at 37. This power seems to be a combination of sections 51(29) and 61 of the *Commonwealth Of Australia Constitution Act*.

279 Ryan, *International Law In Australia* (Law Book Company, Sydney, 2nd ed., 1984) at 35.

280 *Walker v Baird* (1892) AC 491; *Koowarta v Bjelke-Peterson* (1982) 153 CLR 108 at 224 per Mason J; Ryan, *International Law In Australia* (Law Book Company, Sydney, 2nd ed., 1984) at 48.

281 Mozley & Whitely, *Law Dictionary* (Butterworths, Great Britain, 10th ed,. 1988); *Australian Corporations Law* (Butterworths, Australia, Loose Leaf Service) at paragraphs 2.1.0005 and 2.1.0010 by Corcoran.

282 This view roughly corresponds with the aggregate theory of the corporation; see Tomasic and Bottomley, *Corporations Law In Australia* (The Federation Press, Sydney, 1995) at 49.

persons" is of course the shareholders. If this analysis is correct then the shareholders are collectively the company. However these arguments have been undermined by the introduction of one person companies and by the historical development of corporate legislation.[283]

There is one additional complicating factor which also points to the inappropriateness of a property analysis, although it is not a particularly strong argument. The argument starts by considering the topic of the property rights, namely a company which is a separate legal person. Nowadays it is considered morally repugnant to view a person as a piece of property to be owned by another. We do not allow slavery[284] and no longer regard a married woman as a chattel owned by her husband.[285] However it is not so morally repugnant to view an artificial person such as a company as property. Support for this last statement is available by considering euthanasia. Euthanasia is a particularly contentious topic in our society.[286] Yet there are no moral qualms involved in allowing a special majority of shareholders to wind up (effectively kill) the company,[287] although courts are reluctant to wind up solvent companies when only a minority of shareholders want this result.[288]

So at this stage companies may be regarded as a separate legal entity, completely artificial or the shareholders themselves. Which is correct? In my opinion an "either/or" analysis is inappropriate while an "and/both" analysis is appropriate. All three are correct and incorrect (in the sense of not describing the complete reality). So it becomes a choice, in any given context, which is the most appropriate reality. In my opinion in the context of considering whether the company is capable of being subject to proprietary rights the answer is that it is not. This is so either because of its artificiality or because the shareholders are the company and cannot own themselves.

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283 The Corporations Law previously provided that "the subscribers to the company's memorandum ... are an incorporated company", CL s123(1); cf. the language of s114. See Heydon, 'Directors Duties and the Company's Interests' at 125 in Finn (ed), *Equity and Commercial Relationships* (Law Book Company, Sydney, 1987); and Heydon, 'Commentary [to this chapter]' at 138. These sections were repealed by the *Company Law Review Act* 1998 (Cth). The stated reason for the proposed change was said to be "consistent with the move away from the concept of a group of persons to the concept of creating a new legal entity through registration" (see the commentary to the exposure draft of the *Second Corporate Law Simplification Bill* 1995 at 7).

284 *De Francesco v Barnum* (1890) 45 Ch D 430 at 438. Under modern law a court will not even specifically enforce a contract of employment, although the person may be prohibited for a time from working for a competitor. See Creighton and Stewart, *Labour Law: An Introduction* (The Federation Press, Sydney, 2nd ed., 1994) at 176 and 190 to 193 (and the 1st edition at 154); Gray, 'Property in Thin Air' (1991) 50 Cambridge Law Journal 252 at 300.

285 Married women historically were viewed as having no legal rights. Whilst perhaps not called the property of their husbands, some commentators equated married women to slaves. See the materials quoted in Graycar and Morgan, *The Hidden Gender Of Law* (The Federation Press, Sydney, 1990) at 113 to 118.

286 As evidenced by the furore surrounding the introduction of legislation allowing euthanasia in the Northern Territory: *The Rights Of The Terminally Ill Act* 1995 (NT).

287 For winding up by shareholders under CL s491 courts are only concerned that the appropriate procedures have been followed; see Tomasic, *Australian Corporate Insolvency Law* (Butterworths, Australia, 1993) at 254 to 255.

288 This arises where minority shareholders are seeking relief from a court for oppressive or unfair conduct. In such cases a winding up order is a remedy of last resort; CL sections 467(4) and 246AA(4) & (6); *Re Dalkeith Investments* (1984) 9 ACLR 247 at 252; Boros, *Minority Shareholder Remedies* (Clarendon Press, Oxford, 1995) at 176.

If this view of the company is correct then a property analysis is completely unsuitable. In my opinion this is correct but for the sake of completeness I will nonetheless proceed with the rest of the analysis.

(2) Private property is a creature of law.[289]

If anything is a creature of law then it is a corporation. It is an entirely artificial creature that only has an existence because the law says so. Another point is that since corporations are such artificial creatures it is harder to regard them as a gift of nature freely available for everyone to use (which means they should not be regarded as public goods). Arguably shareholders are the ones who by their initial injection of capital breathe life into the corporation. On the other hand the promoters, who may not be shareholders, at least have a part to play in creating the corporation. Either way, because of their artificiality corporations are particularly suitable to be regarded as private property.

(3) "Property in a thing is a bundle of rights, privileges and powers that a person has in a thing. The three most commonly identified are the right to use and enjoy a thing, the right to sell and alienate it, and the right to exclude others from its use."[290]

I will examine these three in turn. First is the right to use and enjoy a thing. In the corporate context this poses difficulties. A company is not something that people think of using and enjoying, even with commercial uses in mind. This may largely be because companies are not a tangible thing, but an artificial legal construct. It is simply very difficult to conceive of a company in this way. This also makes the third criteria difficult to analyse.

The second criterion is the ability to sell and alienate the thing. If a majority of shareholders sell their shares then the new shareholder will be in a position to control the company, which is in effect a sale and purchase of the company. Although not made explicit by Teh and Dwyer, concomitant to the right to sell and alienate must be the right to destroy.[291] As the owner of a book I can sell it but I am also entitled to throw it on a fire. Similarly shareholders are entitled to wind up their company even if it is a going concern.[292] For these two reasons I consider shareholders have this right.

The third criterion is the right to exclude others from use of the thing. As discussed above since the company is not a tangible thing this concept does not easily translate to companies. However in some ways shareholders have exclusive rights to the company. Only by being a shareholder, by being entered on the register of shareholders, does a person have the right to participate in the governance of the company. In proprietary companies this is a strong right because their constitutions commonly contain a limited prohibition on the transfer of shares (ie pre-emptive rights).[293] However in listed public companies there are no restrictions on the right to transfer shares and there is a market

289 Teh and Dwyer, *Introduction To Property Law* (Butterworths, Sydney, 1992) at paragraph [105].

290 Above at paragraph [106].

291 Hammond, 'Quantum Physics, Econometric Models and Property Rights to Information' (1982) 27 McGill LJ 47 at 54 regards "the right to change the asset's form" as a characteristic of property.

292 Discussed later in this chapter.

293 Prior to the *First Corporate Law Simplification Act* 1995 (Cth), CL s116(a) required all proprietary companies to contain a restriction in their constitution about the transfer of shares.

for those shares.[294] It must be borne in mind that the criterion talks of rights to exclude others, not what occurs in practice. So if I own real property I may be happy for people to regularly walk across my property but this does not affect my right to exclude them if I see fit. Conversely the fact that others may be excluded from becoming shareholders because none of the existing shareholders wish to sell their shares and no new shares will be issued does not affect the rights (or lack of them) involved. So in one sense the rights are non-exclusive. There is no right to exclude people from becoming shareholders (and if a property analysis is correct, then no right to stop other people being your co-owners). In another sense the criterion seems to be looking at excluding people other than fellow owners from the property. Creditors, customers, employees and other people have a very different relationship to the company and in no way could be regarded as the owners of the company. As stated above even the law reinforces this by excluding these people from their conception of the company when considering the directors' duty to act in the best interests of the company. Although formulated in terms of the best interests of the company the courts quickly recognise the artificiality of the company by saying the best interests of the company means the best interests of shareholders. But the company does not mean the employees,[295] customers[296] or others. Therefore relative to these people shareholders have exclusive rights to the company. On balance though this analysis is inconclusive.

(4) "Property in a thing may be the object of several types of...different proprietary *interests*."[297]

This proposition may be illustrated by an example. An owner of the fee simple of real property who leases it retains proprietary rights and the lessee also has a proprietary interest. The owner usually retains significant rights but gives up significant other rights, notably the day to day use of the property (lessee's right to quiet possession). Lessees are entitled to use the property as they see fit subject to some restrictions such as structural alterations, deliberate damage and some use restrictions based usually on either the nature of the property involved or government restrictions. Certainly some analogies with the corporate context are possible. For example structural alterations to real property may be compared with alterations to the share capital which lessees and directors (respectively) are not entitled to perform (because they require the approval of the lessor and shareholders respectively).[298] However such comparisons strain the fundamental concepts involved and once again it is difficult to squeeze companies into a property analysis.

(5) "Unlike contractual and other personal interests, property may be defined as an interest enforceable against more persons than the contracting parties."[299]

There is no clear application of this concept to the corporate context.

(6) "..property is generally a perpetual right."[300]

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294 LR 8.10 where the ability of companies to refuse to register a share transfer is severely restricted.

295 *Parke v Daily News Ltd* [1962] Ch. 927.

296 *Dodge v Ford Motor Co* 170 N.W. 668.

297 Teh and Dwyer, *Introduction To Property Law* (Butterworths, Sydney, 1992) at paragraph [107].

298 See chapter 8.3 concerning those alterations to the capital structure of the company which require shareholder approval.

299 Teh and Dwyer, *Introduction To Property Law* (Butterworths, Sydney, 1992) at paragraph [108].

300 Above at paragraph [109].

The strongest form of property interest is the estate of fee simple (commonly simply called ownership), which is a perpetual interest. Other forms of property interests are not perpetual, such as life estates and leases for a term. However these lesser property interests derive from stronger property interests which themselves are generally perpetual.

One of the hallmarks of companies is that they enjoy perpetual succession.[301] Shareholders' connection with the company is through their shareholding. This connection is also perpetual[302] regardless of who happens to own the share at any particular time.

Considering all of the indicia of property discussed above, in my opinion a property analysis is inappropriate and not even helpful in trying to understand who shareholders are.[303] There are two primary reasons why I find the property analysis inappropriate. First for insiders to the company, which shareholders clearly are, the company is completely artificial and/or is the shareholders themselves. Therefore a company is simply not a thing capable of being the subject of property rights. Second property is a relationship between a person and a thing characterised by certain hallmarks which comprise the rights to use and enjoy, sell and alienate, and to exclude others from the thing. This analysis is difficult because of the ethereal nature of companies. Also this proprietary bundle of rights is very different from the bundle of rights shareholders have (right to appoint and remove directors/auditors etc). To try to draw an analogy from one to the other strains the fundamental concepts involved. It is simply inappropriate and unhelpful to try to understand one bundle of rights by drawing a comparison with another bundle of very different rights.

Finally even if the company could be regarded as property owned by shareholders this does not necessarily predicate the nature of their relationship with directors. The example of the owner who leases property exemplifies this point. Lessees also enjoy property rights and generally have full rights to use and enjoy the property as they see fit (could this be equated with the right to manage?). The most that could be said is that if the company is the property of the shareholders then they have a very strong connection with the company. This same conclusion can be reached simply by considering the actual rights of shareholders uncomplicated by a property analysis.

The last possibility I mentioned at the beginning of this section is whether shareholders can be regarded as the owners of the underlying assets of the company. The immediate response to this argument is that of course shareholders are not the owners of the underling assets because the company owns them. This arises because of the separate legal entity doctrine[304] and the legal reality that corporations are capable of owning property[305] and do so. But there are three layers of arguments that arise in retort to this evident proposition.

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301 The Corporations Law no longer states that companies enjoy perpetual succession (previously CL s123(2)(c)). However companies continue to exist until they are wound up, which is not inevitable (see CL Part 1.5 "Small Business Guide" s1.1).

302 Subject to limited rights of the company to buy back its shares; CL chapter 2J.1 Division 2.

303 A view shared by Herzel, 'Boards of Directors Versus Institutional Investors' at 165 in Baums, Buxbaum and Hopt (eds), *Institutional Investors and Corporate Governance* (Walter de Gruyter, Berlin 1993).

304 *Salomon v Salomon* [1897] AC 22.

305 Companies have the legal capacity and powers of an individual (CL s124(1)). Individuals can own property therefore companies can as well. The Corporations Law previously stated that companies have the power to own property (previously CL s150(6)(e)) but it no longer does so (although see CL s1362A(1) and Part 1.5 "Small Business Guide" at s1.1).

First, it is possible to think dualistically by regarding the separate entity as owning corporate assets as regards outsiders but *vis-a-vis* insiders to the company to regard the company as effectively being the shareholders. This point is reached by my metaphysical arguments above; that in the context of insiders to the company the concept of the company is completely artificial or is the shareholders.[306] However ownership of property necessarily involves dealings by a person with outsiders (enforceable against the world) and in this context the separate reality of the corporation has meaning and is useful. Therefore this metaphysical argument does not lead to the conclusion that shareholders have property in the underlying assets of the company.

Second, do shareholders possess the indicia of property (discussed above) to the underlying assets so that they should nonetheless also be regarded as owners of them? Clearly shareholders have an interest in the assets which interest is a creature of law. Turning to the bundle of rights, shareholders do not have a right to use and enjoy corporate assets; they have given over management of these assets to the directors. Directors also have the immediate right to sell and alienate the corporation's assets under their broad powers of management. However shareholders must approve the sale of a listed corporation's main undertaking[307] and can cause the sale of the company's assets by instigating a winding up of the company (discussed below). But these indirect powers are not the same as simply having a right to sell and alienate the assets. Neither do shareholders have a right to exclude others from using the underlying assets; the corporation's managers and employees use the assets and can exclude outsiders from using them. The salient point concerning this bundle of rights is that shareholders don't have these rights because they have given them over to the directors. In addition to the bundle of rights indicia, it is clear that shareholders' rights to the underlying assets are not enforceable against all the world. The corporation has this right and as mentioned above when considering outsiders to the company (all the world) the separate entity that is the company makes sense. So the conclusion based on this set of arguments is that shareholders do not have property in the underlying assets of the company.

Third, can shareholders be regarded as having a beneficial property interest in the underlying assets? That is, could the corporation be regarded as the legal owner of the assets and the shareholders the equitable owner? The issue whether people with indirect and non-immediate entitlements to property have an equitable proprietary interest or something lesser in "the hierarchy of equitable estates and interests"[308] is a difficult issue. This necessarily involves whether the property is held on trust for these people.[309] As a matter of general principle I have already rejected such an analysis but it deserves closer examination in this context. The law has reached differing results to the issue raised, depending on the particular set of relationships before them. For example:

- a residual beneficiary of an unadministered estate has no proprietary interest in any particular asset of the estate. The beneficiary's remedy is to compel the personal representative of the estate to administer it properly by order of a court of equity (if

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306 This is the point reached by proponents of an aggregate theory of the corporation, see Tomasic, Jackson and Woellner, *Corporations Law: Principles, Policy and Process* (Butterworths, Australia, 3rd ed, 1996) at 90.

307 Listing Rule 11.2.

308 Meagher, Gummow and Lehane, *Equity: Doctrine and Remedies* (Butterworths, Sydney, 3rd ed, 1992) at [403].

309 Whilst I have already dismissed the categorisation of trustee/beneficiary as a general description of the relationship between directors and shareholders a more particular analysis drawing from trust and property law is also appropriate.

necessary).[310] The principal reason asserted to support the conclusion of no proprietary interest is that there is no specific subject identifiable as the trust fund because it is unclear what assets would have to be realised and ultimately what the residue would consist of;[311]

- a beneficiary of a discretionary trust has no proprietary interest in trust assets.[312] This seems appropriate because the interest of any particular beneficiary is speculative; they may or may not ultimately receive any trust assets or income, depending on the discretion of the trustee;[313]
- a beneficiary of a unit trust has a proprietary interest in the assets of the trust, depending on the terms of the trust deed;[314]
- a partner has a beneficial proprietary interest in every asset of the partnership even though a partner does not have title to specific property but a right to his proportion of the surplus after realisation of assets and the payment of debts and liabilities;[315] and
- shareholders do not have a beneficial proprietary interest in the underlying assets of the company, either while a going concern[316] or in a winding-up.[317] The company retains complete ownership of its assets, without there being a split between legal and beneficial ownership.

The factual position of each of a residual beneficiary of an unadministered estate, a holder of units in a unit trust, a partner and a shareholder is the same in one sense. That is, each has a fixed entitlement that awaits an administrative process before that entitlement can be directed towards any particular asset or ascertained sum of money. Therefore an argument based on the uncertainty of the entitlement (used to deny property rights to the residual beneficiary) is unconvincing when different conclusions are drawn on similar facts. The question becomes, is there a more convincing way to justify these decisions? In my opinion the decision concerning partners is correct, because of their joint property interest in partnership assets. In a partnership there are no other legal actors and of necessity the partners must be the owners. The decision concerning unit trusts also is correct, because a fixed trust is the paradigm example where courts of equity developed and apply the split between legal and beneficial ownership of property. However in my opinion the position of the residual beneficiary and shareholders is less

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310 *Commissioner of Stamp Duties v Livingston* [1965] AC 694; discussed in Meagher, Gummow and Lehane, *Equity: Doctrine and Remedies* (Butterworths, Sydney, 3rd ed, 1992) at [404].

311 *Commissioner of Stamp Duties v Livingston* [1965] AC 694 at 708.

312 *Gartside v IRC* [1968] AC 553; discussed in Meagher, Gummow and Lehane, *Equity: Doctrine and Remedies* (Butterworths, Sydney, 3rd ed, 1992) at [414].

313 *Gartside v IRC* [1968] AC 553 per Lord Reid at 606 and per Lord Wilberforce at 615. Lord Reid also supported this conclusion on the basis that "two or more persons cannot have a single right unless they hold it jointly or in common. But clearly objects of a discretionary trust do not have that: they each have individual rights: they are in competition with each other and what the trustees give to one is his alone".

314 *Charles v Federal Commissioner of Taxation* (1954) 90 CLR 598; discussed in Meagher and Gummow, *Jacobs' Law of Trusts in Australia* (Butterworths, Sydney, 6th ed, 1997) at [315]; McPherson, 'Information as Property in Equity' in Cope (ed), *Equity: Issues and Trends* (The Federation Press, Queensland, 1995) at 240 to 241.

315 *Canny Gabriel Castle Jackson Advertising Pty Ltd v Volume Sales (Finance) Pty Ltd* (1974) 131 CLR 321 at 327; *Partnership Act* 1891 (S.A.) sections 20 and 21; discussed in Meagher, Gummow and Lehane, *Equity: Doctrine and Remedies* (Butterworths, Sydney, 3rd ed, 1992) at [408].

316 *Charles v Federal Commissioner of Taxation* (1954) 90 CLR 598; discussed in Meagher and Gummow, *Jacobs' Law of Trusts in Australia* (Butterworths, Sydney, 6th ed, 1997) at [315].

317 *Re Paul and Gray Ltd* (1932) 32 SR (NSW) 386; *Franklin's Selfserve Pty Ltd v Federal Commissioner of Taxation* (1970) 125 CLR 52 at 69 to 71; discussed in Meagher, Gummow and Lehane, *Equity: Doctrine and Remedies* (Butterworths, Sydney, 3rd ed, 1992) at [410].

clear and neither result (property interest or no property interest) is necessarily correct for the reasons considered so far.[318] In my opinion shareholders resemble holders of units in a trust, but a different legal result is reached. One argument to distinguish them is that outsiders dealing with a unit trust know that ownership of assets is split between the trustees and unit holders and therefore such a result is justifiable. Whilst this has merit after many years of established practice, it does not explain why the different results were first reached. Certainly in a company there is a separate legal entity, but of itself this is unconvincing. Equity is comfortable with splitting ownership, so does it matter if the locus of the legal ownership is in trustees or the company? In my opinion it does not. The critical issue is whether the holders of units or shareholders have beneficial property rights. In my opinion the denial of property rights for shareholders is justifiable for two reasons. First, and to my mind the more persuasive reason, is that in companies shareholders enjoy limited liability[319] and it simply seems inappropriate for them to enjoy this immunity yet retain the advantage of property rights.[320] That is, ownership necessarily carries with it risk and responsibility. Limited liability removes risk and responsibility from shareholders and transfers this to the separate entity that is the company. Therefore whilst shareholders enjoy limited liability they are denied property rights. Under general trust law the trustees have personal liability and they generally have a right of indemnity against the beneficiaries.[321] In turn this division of risks justifies the split in ownership. Second, "for profit" companies are engaged in running a business. Business is inherently dynamic, with the purchase and sale of property occurring on a day to day basis. Business also inherently involves the taking of entrepreneurial risk in the hope of profits.[322] This dynamic and inherently risky context justifies a grant of broad discretionary powers to directors.[323] In turn this context is incompatible with fettering the corporation's property, and the regular and inherently risky transactions involving them, with underlying beneficial property rights owned by a

318 As is evident from the 3:2 split in the High Court decision about residual beneficiaries; see *Commissioner of Stamp Duties v Livingston (Q.)* (1960) 107 CLR 411.

319 CL s516 (see also Part 1.5 "Small Business Guide" at s1.2). However unlimited companies have no limit on the potential liability of its members (CL ss 9), but these companies are rare; Lipton and Herzberg, *Understanding Company Law* (Law Book Company, Australia, 7th ed, 19980 at 68 state there are 600 unlimited companies.

320 Although it must be conceded that the recent hybrid of limited partnerships allows for limited liability and property ownership; see *Partnership Act* 1891 (S.A.) s48. However this hybrid is acceptable since the exception of limited liability is being transposed into a long established legal framework of partnerships where the notion of underlying property interests is accepted and where the general partners do not enjoy limited liability. The reality of limited partnerships can be regarded as a restricted exception to my argument that property carries with it responsibility and risk rather than completely undermining that argument.

321 *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360; *Trustee Act* 1936 (SA) s35(2); Pont and Chalmers, *Equity and Trusts in Australia and New Zealand* (LBC Information Services, Australia, 1996) at 491 to 495; Cassidy, *Concise Corporations Law* (The Federation Press, Sydney, 1995) at 17. The trust deed can provide that the trustees have no right of indemnity against the beneficiaries; Meagher and Gummow, *Jacobs' Law of Trusts in Australia* (Butterworths, Sydney, 6th ed, 1997) at [313]. However if the indemnity is not given then without more it would be very difficult to attract trustees especially if the trust is engaged in commercial activities. Because of this, in commercial trusts unlimited liability for unit holders is usually avoided by interposing a corporation in the structure; see Meagher and Gummow, *Jacobs' Law of Trusts in Australia* (Butterworths, Sydney, 6th ed, 1997) at [313].

322 Partnerships also operate entrepreneurial businesses but in partnerships the partners are the only people with a property claim to partnership assets (with the partnership not being a separate entity). So there is no split of legal and beneficial property interests between different groups of people.

323 Particularly compared with the more limited discretion trustees have; see Sealy, 'The Director As Trustee' [1967] Cambridge Law Journal 83 at 89.

generally passive body of shareholders.[324] If the underlying beneficial ownership of corporate assets remained with shareholders then this would clog the commercial world and introduce unnecessary legal uncertainty (including the possibility of directors having to consult shareholders as owners each time corporate property was to be bought or sold).

The conclusion drawn from all of these strands of arguments is that shareholders do not own the underlying assets of the company. However whilst not enjoying property rights, their rights to the underlying assets are nonetheless high in the hierarchy of rights.

Contracting Parties

Returning to the central question, can shareholders relationship with the company and directors be adequately and fully explained on a contractual basis? The shareholders are in a contractual relationship with the company and each other but not directly with the directors (whose contractual relationship is with the company).[325] This contractual position has been used to support all different sorts of theories and arguments about who shareholders are and what a company is. Those theories include:

- one of the arguments to support the exclusive power of management being vested in the directors (discussed below);
- a version of the aggregate theory, which views the corporation as a free association of individuals drawn together by a contractual consensus, expressed in the company's constitution;[326] and
- an economic analysis, which views the company as a nexus of contracts (called the contractarian theory).[327] The company is an efficient congregation of contracts for the supply of equity, debt, human resources and the sale of end products. The company form avoids the inefficient and repeated renegotiation of these contracts.

These theories are interesting but really illuminate very poorly the issue of who shareholders are and what their appropriate role is. For to describe the relationship as contractual does not explain what the content of that contract is or should be. The description fudges the issue. In theory the contract could say anything, reposing in the shareholder the status of monarch or street cleaner. However putting those theoretical possibilities aside, corporate constitutions almost invariably provide for the division of functions described below. Investigating the functional role of shareholders is a much

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324 Certainly unit trusts often comprise trading trusts, but these trusts usually involve investments in property (usually shares in other companies or in real property) and managing such investments is less dynamic than running a traditional business. This is also how they were used historically; see Meagher and Gummow, *Jacobs' Law of Trusts in Australia* (Butterworths, Sydney, 6th ed, 1997) at [314]. In any event my purpose in this paper is not to try to justify the decision concerning unit trusts (or residual beneficiaries). But I have adequately justified why shareholders are not regarded as the beneficial owners of the underlying assets of the company.

325 CL s140(1). If the argument is accepted that the artificiality of the company renders the company superfluous in analysing relationships between insiders to the company then the company would not be a party to this contract.

326 Tomasic and Bottomley, *Corporations Law In Australia* (The Federation Press, Sydney, 1995) at 49 to 50.

327 Posner, *Economic Analysis Of Law* (Little, Brown And Company, Boston, 3rd ed., 1986) at 367 to 372. A good discussion of contractual theory and its shortcomings is in Bottomley, 'From Contractualism to Constitutionalism: A Framework for Corporate Governance' (1997) 19 Sydney Law Review 277 at 279 to 290. For criticisms of the contractarian theory from a communitarian perspective see Millon, 'Communitarianism in Corporate Law: Foundations and Law Reform Strategies' in Mitchell (ed), *Progressive Corporate Law* (Westview Press, USA, 1995). See also Branson, 'The Death of Contractarianism and the Vindication of Structure and Authority in Corporate Governance and Corporate Law' in Mitchell (ed), *Progressive Corporate Law* (Westview Press, USA, 1995).

more fruitful exercise than merely characterising their rights as contractual. Perhaps the one substantive outcome from the contractual characterisation is that by implication their rights are not proprietary in nature.[328] As stated above this implication does not necessarily arise because a contract is the usual way to confer or deal with property interests. Nonetheless it seems from reading between the lines that this implication is intended in the corporate context. In my opinion, the conclusion that shareholders do not enjoy property rights is sounder if based on an analysis of the fundamental principles of property law, rather than if based on this type of inferential reasoning.

Shareholders as Citizens

It is possible to view shareholders as citizens in a democratic system of governance. That is given the role of shareholders there is a close analogy with a representative form of democratic government that is used in the political arena in Australia and other major countries. This analogy is rich with possibilities, such as the implications in the corporate context of the active role of the media in politics supported by freedom of expression principles. Given the importance of the analogy and that it makes more sense once the role of shareholders and directors has been examined it is explored in a separate chapter (chapter 5).

Shareholders As Bystanders

Shareholders can also be viewed as mere "bystanders".[329] Many laws are consistent with this notion and at least to a certain extent are a self-fulfilling prophecy. Examples of these types of laws are:

- the exclusive management power cases (discussed below) which deny shareholders an active, let alone a persuasive, voice in the management of their companies;
- the rule in *Foss v Harbottle*[330] which as a general proposition, albeit with increasingly liberal exceptions,[331] denies shareholders the right to sue directors for breach of duty or other wrongdoing;
- narrow interpretations of statutory rights of shareholders to convene meetings of themselves;[332]
- courts at general law only allowing shareholders limited rights to inspect corporate books;[333] and
- reluctance of courts to interfere on issues of management policy [334] or to review the quality of management decisions under the duty of care.[335]

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328 The distinction between contract and property is long standing; see Bradbrook, MacCallum and Moore, *Australian Property Law* (Law Book Company, Sydney, 1996) at 1.81 to 1.90.

329 Hill, 'The Shareholder as Cerberus: Redefining the Shareholder's Role in Modern Australian Corporate Law', paper presented at the 1995 Corporate Law Teachers Conference' (copy on file of author) at 11 to 12; Buxbaum, 'The Internal Division of Powers in Corporate Governance' (1985) 73 California Law Review 1671 at 1683.

330 (1843) 67 E.R. 189.

331 Sealy, 'The Rule In Foss v Harbottle: The Australian Experience' (1989) 10 The Company Lawyer 52.

332 *Re Totex-Adon Pty Ltd* [1980] 1 NSWLR 605; *LC O'Neil Enterprises Pty Ltd v Toxic Treatments Ltd* (1986) 10 ACLR 337; *Vision Nominees Pty Ltd v Pangea Resources Ltd* (1988) 6 ACLC 770. Although for meetings held after 1 July 1998, the right of shareholders to convene meetings (CL s249F) has been liberalised; cf s247, the old provision.

333 See chapter 10.3.

334 *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co. N.L.* (1986) 121 CLR 483 per Barwick C.J., McTiernan and Kitto JJ at 493 who stated:

> Directors in whom are vested the right and the duty of deciding where the company's interests lie and how they are to be served may be concerned with a wide range of

This view of shareholders also matches much of their apathetic and disinterested behaviour and the commandeering of their powers by managers setting the agenda at general meetings. However this view is completely out of step with the designated role of shareholders. Not exercising rights does not mean that those rights should not exist. It also becomes a chicken and egg argument. If rights do not exist then shareholders are unable to act, whether apathetic or not. This is how these rules that view shareholders as bystanders are self-reinforcing and a self-fulfilling prophecy. I examine this issue in further detail later in this chapter under the heading 'People Who Are Shareholders'. At this stage to accord the view of shareholders as bystanders legal status is inappropriate and would render shareholders impotent. It is not an appropriate basis from which to consider what their information rights are or should be.[336]

Conclusion

Courts, academic commentators and others have often resorted to existing legal categories to explain the relationship of shareholders to the directors or to the company. This approach is so pervasive that it deserves close legal analysis. Although similarities can be drawn with trustee/beneficiary, principal/agent and from the law of property and contract none of these are sufficiently tailored to fit corporations adequately. This is particularly so when courts attempt to draw such analogies without explaining why the analogy is appropriate, explaining all the consequences of drawing the analogy or addressing opposing arguments. In my opinion drawing these analogies actually obfuscates the analysis and masks the real issues.[337] The analogy approach certainly does not provide a clear conceptual footing from which to base a coherent law, although the attempt to use the analogy points to the fundamental issues at stake. The relationship between shareholders and directors is unique and should be analysed on its own merits,[338] and by reference to the democratic analogy which is appropriate (discussed in chapter 5).

4.3 THE ROLE AND FUNCTIONS OF SHAREHOLDERS AND DIRECTORS

Introduction

When a person acquires shares in a company and is entered on the share register[339] then that person becomes a shareholder in the company. Shareholders have certain rights and a pre-designated role in the governance of the company in which they have invested. Shareholders share governance of the company with their appointed directors and their delegates, the senior executives. Only by examining how power is shared between these

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practical considerations, and their judgement, if exercised in good faith and not for irrelevant purposes, is not open to review in the courts.

335 Eisenberg, 'The Duty Of Care Of Corporate Directors And Officers' (1990) 51 University Of Pittsburg Law Review 945 at 959 to 969. This is also being reinforced in the statutory context with the proposal to introduce a statutory business judgement rule; see *Corporate Law Economic Reform Program Bill* 1998 (Cth) s180 (2).

336 Bottomley, 'From Contractualism to Constitutionalism: A Framework for Corporate Governance' (1997) 19 Sydney Law Review 277 at 305 states that "whilst the pressures towards passivity are understandable, this does not mean that member passivity should become a foundational assumption of our theoretical framework".

337 For a general argument that analogy and metaphor can be a "source of obfuscation" see Posner, *Law and Literature: A Misunderstood Relation* (Harvard University Press, USA, 1988) at 3.

338 Borrowing from Latin, the relationship is sui generis.

339 CL s246A(b); Table A clauses 19 to 22.

three groups can a sound understanding of the proper role of shareholders be attained. I examine what I regard as the key powers of the company and the responsibilities of the shareholders and directors in each area. In my opinion those key powers are:

- Appointment and removal of directors;
- Appointment and removal of auditors;
- Remuneration of directors and auditors;
- Alteration of the Constitution;
- Winding up;
- Management of business and companies;
- Dividends; and
- Share issues.

I also briefly look at the directors' right of access to corporate information, which right is necessary for them to fulfil their role.

The Role of Shareholders

Appointment And Removal Of Directors And Executives

Corporate constitutions almost invariably provide that directors[340] are appointed by shareholders.[341] The directors are charged with managing the affairs of the company (discussed below). However given the complexity of modern business conditions and the size of large listed public companies, the reality is that directors can no longer effectively manage the day to day affairs of their companies.[342] Therefore the directors are entitled to delegate some of their powers to a managing director[343] who is usually charged with the day to day management of the company. The managing director thus occupies the central position in the corporation.[344] Depending on the size and complexity of the company's business, the managing director usually employs a range of executives to assist him or her to discharge those functions effectively.

Generally corporate constitutions provide that directors, other than the managing director, hold office for a maximum period of three years. After those three years the directors must resubmit themselves to shareholders for re-election if they wish to continue.[345] The usual practice is to have staggered elections with one third of the directors retiring each year. The managing director usually holds office for a period of time agreed with the other directors.[346]

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340 The initial directors of a newly formed company are those people named in the application for registration and who consent to act as directors (CL s120).

341 Table A, clause 60(1). This is reinforced by Listing Rule 14.5 which implicitly provides that directors must be elected by shareholders. CL s224C provides, as a replaceable rule, that a "company may appoint a person as a director by resolution passed in general meeting" (for one person companies, see CL s224B(2)).

342 *AWA Ltd v Daniels* (1992) 7 ACSR 759 at 864 to 869; Hilmer, *Strictly Boardroom* (The Business Library, Melbourne, 1993) at 25 to 52.

343 CL s226C - replaceable rule; Table A clause 79(1).

344 Herzel, 'Boards of Directors Versus Institutional Investors' at 165 in Baums, Buxbaum and Hopt (eds), *Institutional Investors and Corporate Governance* (Walter de Gruyter, Berlin, 1993) who describes the CEO/Chairperson of U.S. corporations as an "imperial figure".

345 Table A, clauses 58 to 61.

346 Table A, cl 79(1).

The directors may be removed at any time by the shareholders.[347] This right of removal is subject to certain procedural safeguards in favour of the directors that shareholders propose to remove.[348] However just as shareholders have no power to appoint the managing director or the senior executives they have no power to remove these people.

What I have described above about the power of shareholders to elect directors is the formal position. In practice directors have robbed shareholders of this power's potency. This has arisen by two related factors. First, directors may appoint other directors either to fill casual vacancies or as additions to the Board.[349] The existing directors commonly use this power to select and appoint new directors who they consider suitable. These appointees hold office only until the next annual general meeting ("AGM").[350] However the newly appointed directors then offer themselves for re-election at the next AGM with the endorsement of the incumbents. Second, directors have informally usurped this power because they have the power to call general meetings of shareholders, including the AGM[351] This means that the directors also prepare the notice calling the meeting.[352] The problem is that the managers set the agenda of the meeting, which is a general problem not restricted to the issue of the election of directors.[353] The directors decide what topics shareholders will vote on and the terms of the proposed resolutions (in this case who is nominated for election as a director).[354] Shareholders are presented with a take it or leave it choice on the terms of the directors choosing. The reality is that shareholders usually act merely as a rubber stamp to ratify the choice of the incumbent directors. To counter-balance this perspective the general apathy or passivity of shareholders needs to be acknowledged.[355] However this is a chicken and egg situation; interest and participation is difficult in the face of no choice. There is the possibility of

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347 Public companies CL s227; proprietary companies CL s226E (replaceable rule) and Table A cl 62.

348 CL s227(4) & (5).

349 Table A, cl 61(1). See also CL s224D - replaceable rule.

350 CL s224D(3) (for public companies), Table A, cl 61(2) & LR 14.4.

351 Table A, cl 40. It must be noted that shareholders holding 5% of the issued share capital have the power to call their own meeting (CL s249F), requisition the directors to call a meeting (CL s249D) or including an item on the agenda of the A.G.M. (CL s249N). In addition 100 shareholders can requisition the directors to convene a meeting (CL s249D(1)(b)) or propose a resolution at the A.G.M. (CL s249N(1)(b)). The previous right of shareholders to convene meetings was subject to the proviso "so far as the articles do not make other provision" (previously CL s247(1)). This proviso was narrowly interpreted by the courts: see *Re Totex-Adon Pty Ltd* [1980] 1 NSWLR 605; *LC O'Neil Enterprises Pty Ltd v Toxic Treatments Ltd* (1986) 10 ACLR 337; *Vision Nominees Pty Ltd v Pangea Resources Ltd* (1988) 6 ACLC 770 at 774-6. In practice these powers were rarely used by shareholders, but now the restrictive proviso has been removed the use of these sections may increase.

352 Table A, cl 41.

353 Eisenberg, 'The Structure of Corporation Law' (1989) 89 Columbia Law Review 1461 at 1477 to 1480; Buxbaum, 'The Internal Division of Powers in Corporate Governance' (1985) 73 California Law Review 1671 at 1681 to 1683.

354 The ability to amend resolutions at the meeting is limited because this is prejudicial to shareholders who have read the notice of meeting and either decided not to attend or have already voted by proxy; see *Betts & Co Ltd v MacNuaghten* (1910) 1 Ch 430; *In re The Picturesque Atlas & Publishing Co Ltd* (1892) 13 NSWLR (Eq) 44; *Efstathis v Geek Orthodox Community of St George* (1988) 6 ACLC 706; *Re Moorgate Mercantile Holdings Ltd* (1980) 1 All ER 40. Also shareholders have no right to circulate material before the meeting to urge and attempt to persuade their fellow shareholders to vote against the proposal; *Campbell v Australia Mutual Provident Society* (1908) 24 TLR 623.

355 Ramsay and Blair, 'Ownership Concentration, Institutional Investment And Corporate Governance: An Empirical Investigation Of 100 Australian Companies' (1993) 19 MULR 153 at 178 to 179, discussed further at chapter 4.5.

outsiders nominating for a board position or shareholders nominating their own candidates,[356] but these possibilities are rarely pursued.

It would be fairer if directors were forced to present alternative candidates and to explain their strengths and weaknesses. The incumbent directors should undertake a search for appropriate candidates and present to shareholders a short list of candidates. If alternative candidates were offered for election, this would give shareholders real choice whilst still allowing directors to urge shareholders to appoint the directors' preferred candidate. This is also consistent with my proposals concerning the decision making discipline directors should operate under the duty of care and the information they need to keep and make available to shareholders discussed in chapter 7.4.[357] Without adopting measures to give shareholders real choice then their consent to proposals conceived by management is significantly "impoverished".[358]

The position is not quite as stark as this. In practice there are forces that influence the composition of Boards generally, but not necessarily in firm specific situations. The process by which the existing directors search for new board candidates is becoming more professionalised with the appearance of nomination committees.[359] The influential Bosch committee's report recommended that the role of chairperson be separate from and independent of the CEO, the Board be comprised of a majority of non-executive directors and there be a nomination committee to nominate new members of the Board.[360] In addition the Australian Investment Managers Association (AIMA),[361] then the peak body which represents institutional investors, issued guidelines which endorse those of the Bosch committee but go further by recommending that the non-executive directors and the chairperson be independent.[362] AIMA has an extensive definition of independence.[363] These recommendations are made to counter-balance the power of the

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356 Listing Rule 14.3.

357 Under the sub-heading "Care".

358 Eisenberg, 'The Structure of Corporation Law' (1989) 89 Columbia Law Review 1461 at 1477.

359 Australian Institute of Company Directors, *Corporate Governance Policy Paper: Nomination Procedures* (Australian Institute of Company Directors, Australia, 1993).

360 Australian Institute of Company Directors and others (Bosch Committee), *Corporate Practices and Conduct* (Information Australia, Australia, 2nd ed., 1993) at 11 to 15; Australian Investment Managers Association, *Corporate Governance: A Guide for Investment Managers and Corporations* (AIMA, Australia, 2nd ed., 1997) at 3.5.

361 Now called the Investment and Financial Services Association (IFSA).

362 Australian Investment Managers Association, *Corporate Governance: A Guide for Investment Managers and Corporations* (AIMA, Australia, 2nd ed., 1997) at 3.2 and 3.3.

363 Above at 3.2 define independence as:

> An independent director is a director who is not a member of management (a non-executive director) and who:
>
> * is not a substantial shareholder of the company or an officer of or otherwise associated directly or indirectly with a substantial shareholder of the company;
> * has not within the last three years been employed in an executive capacity by the company or another group member or been a director after ceasing to hold any such employment;
> * is not a principal of a professional adviser to the company or another group member;
> * is not a significant supplier or customer of the company or another group member or an officer of or otherwise associated directly or indirectly with a significant supplier or customer;
> * has no significant contractual relationship with the company or another group member other than as a director of the company; and
> * is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company.

executives,[364] not to address the imbalance of power between directors and shareholders. The empirical evidence is equivocal concerning whether these types of measures enhance firm performance but the measures are a positive influence in conflict of interest situations between executives and shareholders (eg takeovers and poison pills).[365]

Appointment And Removal Of Auditors

The Corporations Law requires shareholders in the normal course to approve the appointment[366] and removal[367] of auditors. An auditor must consent to the appointment[368] otherwise the appointment is of no effect.[369] However directors can appoint the first auditors[370] and to fill any casual vacancy,[371] who hold office only until the next AGM.[372] Hence the same problem of agenda setting occurs. So in practice, the shareholders normally rubber stamp the nominee of the directors, who have already chosen who they consider will be a suitable auditor.[373] Curiously, if the shareholders fail to appoint the auditor nominated by the directors and have not themselves nominated and elected an alternative auditor,[374] then the directors appoint an auditor to fill the vacancy.[375] Appointment by shareholders of auditors is meant to bolster their independence. The need for independence arises because of their critical role as financial watchdog.[376] Clearly agenda setting can effect this independence.

The appointed auditor holds office until death, removal or resignation. The auditor can only be removed by the shareholders and there are certain procedural safeguards for the benefit of auditors.[377] The auditor can only resign with the consent, and at the discretion, of the ASIC.[378] The ASIC in "Policy Statement 26: Resignation of Auditors" has expressed its policy concerning the exercise of its discretion whether or not to consent to an auditor's resignation. ASIC's "overriding concern is to ensure that the independence and integrity of the audit function is preserved".[379] It is the independence of the audit

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364 House of Representatives Standing Committee on Legal and Constitutional Affairs (Lavarch Committee), *Corporate Practices and the Rights of Shareholders* (AGPS, Canberra, 1991) at [5.5.8] to [5.5.10]; Tomasic and Bottomley, *Directing the Top 500: Corporate Governance and Accountability in Australian Companies* (Allen and Unwin, Australia, 1993) at 14.

365 Stapledon and Lawrence, *Corporate Governance in the Top 100: An Empirical Study of the Top 100 Companies' Board of Directors* (Centre for Corporate Law and Securities Regulation, Melbourne, 1996) at 9 to 12.

366 CL s327(3); although c.f. Thomas J in *Re Caysand No 64 Pty Ltd* (1993) 12 ACSR 291 at 294 who was "unable to accede to the submission...that there is a general leaning in favour of appointment in general meetings rather than by directors".

367 CL s329; special notice requirements ss(1);(3) & (4).

368 CL s327(7)&(8).

369 CL s327(9).

370 CL s327(1).

371 CL s327(5).

372 CL ss 327(2) and (14).

373 It is explicitly recognised that one of the roles of an audit committee is to nominate the auditor: see discussion in chapter 6.5.

374 CL s328.

375 CL s327(5); see *Re Caysand No 64 Pty Ltd* (1993) 12 ACSR 291 which suggests that this style of appointment is not an interim appointment. If the auditor has been removed from office and a new auditor has not been appointed then the ASIC appoints the new auditor; CL s327(11) & (12).

376 Which I explore in chapter 8.4.

377 CL s329(1) to (4).

378 CL s329(5) & (6).

379 Policy Statement 26 at paragraph 4.

function which is important, not necessarily a particular auditor. Therefore the ASIC will consent to a resignation when a particular auditor is no longer independent.[380] Notably the ASIC will not consent to the resignation where the directors or management are "opinion shopping" (ie. searching for an auditor willing to support a proposed accounting treatment).[381]

However at a structural level, due to the same forces mentioned previously, audit committees of the Board are common. The role of audit committees is discussed in a later chapter.[382]

Remuneration Of Directors, Executives and Auditors

The remuneration of the directors is set by the shareholders.[383] If the directors want an increase in their fees they must put a resolution to that effect to the shareholders in general meeting.[384] However usually shareholders only vote on the total of the remuneration available to the whole Board who themselves determine how much each will receive.[385] There is the problem of agenda setting which necessarily entails a potential conflict of interest and "mutual backscratching".[386] The directors set the remuneration of the managing director and other senior executives,[387] usually on the recommendation of a remuneration committee of the Board.[388] This also, but to a slightly lesser extent, raises a potential conflict of interest but has the advantage of being a more efficient forum to decide such issues than the general meeting.[389]

Traditionally the law has not endeavoured to limit the amount of remuneration the directors or executives can receive for their services.[390] With one exception, that remains the position. The related party provisions of the Corporations Law provide that the remuneration of an officer of the corporation[391] who is a related party of the corporation[392] (who will most commonly be the directors) must be "reasonable".[393] It is

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380 Above at paragraph 16(b).

381 Above at paragraph 9. See also Statement of Auditing Practice 32 'Audit Independence' at paragraphs 54 to 55.

382 In chapter 6.5 under the sub-heading 'Director's Obligations Concerning Audit'.

383 CL s236A (replaceable rule), Table A cl 63. LR 10.17 regulates the form, but not the amount, of this remuneration.

384 LR 10.17.

385 Hill, *Remuneration Disclosure in Australia* (Australian Investment Managers' Association, Sydney, 1996) at 4.

386 Above at 4.

387 Table A cl 79(1).

388 Stapledon, *Institutional Investors and Corporate Governance* (Clarendon Press, Oxford, 1996) at 171 to 172 who cites a study undertaken in 1993 which found that 73% of the top 150 companies had a remuneration committee. Stapledon and Lawrence, *Corporate Governance in the Top 100: An Empirical Study of the Top 100 Companies' Board of Directors* (Centre for Corporate Law and Securities Regulation, Melbourne, 1996) at iii undertook their own survey in 1995 which found that two thirds of the top 100 companies had a remuneration committee.

389 Hill, *Remuneration Disclosure in Australia* (Australian Investment Managers' Association, Sydney, 1996) at 5.

390 Hill, '"What Reward Have Ye?" Disclosure of Director and Executive Remuneration in Australia' (1996) 14 Company and Securities Law Journal 232 at 233.

391 CL s82A.

392 CL s243F.

393 CL s 243K. If the remuneration is unreasonable, then it ceases to be an exception to the basic prohibition against providing financial benefits to related parties, but could be approved by shareholders in general meeting (CL chapter 2E.5).

difficult to know where the courts will draw the line between reasonable and unreasonable remuneration; perhaps only a totally outrageous remuneration package will be regarded as unreasonable.[394] This restriction does not apply to executives who are not also directors.

Although not of concern to the law, shareholders have a legitimate concern about the size and type of remuneration directors and executives receive. If directors receive an excessive amount then this takes away from the bottom line profit of companies and therefore shareholder wealth. The type and amount of remuneration is seen as an opportunity to align the interests of directors and executives with the shareholders.[395] This is typically done in two ways. First, executive salary can be performance based.[396] In this way executives are motivated by self-interest for the company to perform well. However there are criticisms of the types of performance indicators sometimes used in that they are too generous to directors or do not adequately capture director and executive performance.[397] Second, share option schemes are often put into place for directors and executives.[398] Under these schemes directors and executives are able to acquire shares in the company. The price for the shares under the options is usually set at a slight discount to the then market price and the hope is that the price of the shares will increase by the time the directors and executives are able to exercise the options. As a result directors and executives are also shareholders. As shareholders they want the same results as other shareholders.[399]

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394 See Defina, Harris and Ramsay, 'What is Reasonable Remuneration for Corporate Officers? An Empirical Investigation Into the Relationship Between Pay and Performance in the Largest Australian Companies' (1994) 12 Company and Securities Law Journal 341 who principally draw from overseas cases to suggest criteria that could be used by Australian courts. The authors also note some cases where shareholders have attacked the level of directors remuneration under the oppression remedy in section 246AA of the Corporations Law. This remedy is most suited to and used by minority shareholders in small proprietary companies. However the remedy is not restricted in its terms to small companies and could be utilised in larger ones. See also Australian Institute of Company Directors, *Non-Executive Director Remuneration Guidelines* (AICD, Sydney, 1996).

395 Easterbrook and Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, USA, 1991) at 9; Eisenberg, 'The Structure of Corporate Law' (1989) 89 Columbia Law Review 1461 at 1489 to 1493.

396 Jensen and Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 Journal of Financial Economics 305; Eisenberg, 'The Structure of Corporate Law' (1989) 89 Columbia Law Review 1461 at 1493 to 1495; Ramsay and Blair, 'Ownership Concentration, Institutional Investment And Corporate Governance: An Empirical Investigation Of 100 Australian Companies' (1993) 19 MULR 153 at 156; Hill, *Remuneration Disclosure in Australia* (Australian Investment Managers' Association, Sydney, 1996) at 7 to 8. However a recent empirical study found "little, if any, evidence of a positive relation between Australian CEO pay and [sharemarket performance or accounting earnings]", see Izan, Baljit Sidhu and Taylor, 'Does CEO Pay Reflect Performance? Some Australian Evidence' (1998) 6 Scholarly Research and Theory Papers 39 at 46.

397 Hill, *Remuneration Disclosure in Australia* (Australian Investment Managers' Association, Sydney, 1996) at 8.

398 Jensen and Murphy, 'CEO Incentives-It's Not How Much You Pay, But How' (1990-May/June) Harvard Business Review 138; Hill, *Remuneration Disclosure in Australia* (Australian Investment Managers' Association, Sydney, 1996) at 8 to 9. Note that guidelines have been issued concerning employee and executive share schemes, see Australian Institute of Company Directors and Australian Investment Managers' Association, *Employee Share Scheme Guidelines and Executive Share Option Scheme Guidelines* (AICD, Australia, 1994).

399 Jensen and Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 Journal of Financial Economics 305; Eisenberg, 'The Structure of Corporate Law' (1989) 89 Columbia Law Review 1461 at 1493 to 1495; Ramsay and Blair, 'Ownership Concentration, Institutional Investment And Corporate Governance: An Empirical Investigation Of 100 Australian Companies' (1993) 19 MULR 153 at 156.

No one argues against these measures as a matter of theory. However it is doubtful whether these measures sufficiently or effectively align the interests of shareholders and managers.[400] The controversial issues are:

- how big a percentage of profits the executives get;
- how many shares are issued to them, at what price and whether this excessively dilutes the holdings of existing shareholders;
- who decides on the level of remuneration and in particular that this is not the recipients themselves; and
- to ensure that managers are not rewarded for failure when removed for poor performance.[401]

There is increasing criticism of the size of some remuneration packages and some of this criticism seems justified.[402]

The Corporations Law regulates the amount of retirement benefits that can be paid to directors[403] (whether executive or non-executive).[404] Generally such payments must be approved by shareholders. However there is an exception which allows reasonably significant retirement benefits to be given to directors without shareholder approval.[405] Under this exception directors can receive the total of their last three years remuneration or for full time executive directors who have been employed longer than three years, up to seven years remuneration (depending on their period of service and an averaging formula).

The Corporations Law also expressly states that the auditor's reasonable fees and expenses of an audit are payable by the company.[406] In practice the remuneration of

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400 Stapledon, *Institutional Investors and Corporate Governance* (Clarendon Press, Oxford, 1996) at 17. If direct information on management performance was introduced as I propose in chapter 7.3 then these measures could also be used as a measure for remuneration; see Kaplan and Norton, 'Using the Balanced Scorecard as a Strategic Management System' (1996-Jan-Feb) Harvard Business Review 75 at 81 to 82.

401 Stapledon, *Institutional Investors and Corporate Governance* (Clarendon Press, Oxford, 1996) at 74 and 173 to 174. See also Australian Institute of Company Directors and Australian Investment Managers' Association, *Employee Share Scheme Guidelines and Executive Share Option Scheme Guidelines* (AICD, Australia, 1994).

402 In the UK this criticism lead to the formation of a Study Group to consider the issue of directors remuneration; see Greenbury Committee, *Directors Remuneration* (Gee Publishing, UK, 1995). See also Hill, *Remuneration Disclosure in Australia* (Australian Investment Managers' Association, Sydney, 1996) at 2 to 4. In Australia a response by the business community to these criticisms was the issue of guidelines, see Australian Institute of Company Directors, *Corporate Governance Paper: Non-Executive Director Remuneration Guidelines* (Australian Institute of Company Directors, Australia, 1996).

403 CL s 237.

404 CL s 237(19)-see the definition of "prescribed office", which includes a chief executive officer who is not also a director (which is very rare).

405 CL s 237(6). For example assuming Southcorp Holdings Ltd adopted this type of retirement package the following retirement benefits could be paid under the exception (based on their 1998 annual report). Southcorp's non-executive directors who received between $30,000 to $40,000 would be entitled to between $90,000 to $120,000, for those between $70,000 - $80,000 pa. would be entitled to between $210,000 to $240,000. The Managing Director, Mr Graham Kraehe, is on a base salary of approximately $1,290,000 and has been employed for 5 years and therefore could be paid approximately $6,450,000 when he retires (if he is ultimately employed for 7 years, then he could be entitled to approximately $9 million). Most people could live on that sort of retirement package, especially when they either have other sources of income or go on to a new, highly paid job anyway.

406 CL s331.

auditors is seen as a management decision and therefore the directors agree the audit fee with the auditors. The amount the auditors are paid, both for their audit work and other services to the company, must be separately disclosed in the financial statements.[407]

Alteration of the Corporate Constitution

The constitution of a corporation can only be amended by a special resolution of shareholders.[408] Corporate constitutions almost exclusively allocate functions between the shareholders and the directors.[409] It is therefore theoretically possible for shareholders to change the rules of the game at any time to suit themselves. However the problem of agenda setting also applies in this context. That is, the directors have control of calling general meetings and invariably proposals to alter the constitution originate from them and do not result in more control being given to shareholders.

There are rules which place restrictions on the power of shareholders in exercising their powers. Courts have for a long time stated that shareholders must exercise their powers "bona fide in the best interests of the company".[410] More recently the High Court has recognised that this test is not appropriate in all circumstances. The High Court stated that resolutions passed by shareholders will be valid "unless it is ultra vires, beyond any purpose contemplated by the articles or oppressive as that expression is understood in the law relating to corporations".[411] A similar rule exists in the Corporations Law.[412] It is clear though that these rules are designed to protect minority shareholders from the actions of majority shareholders (whether acting in general meeting or by their elected representatives the directors). These rules are not designed to and do not protect powers traditionally given to directors from modification by the shareholders.

Winding Up

Whilst the company is a viable going concern and its affairs are being conducted regularly, shareholders have the exclusive power by special resolution to wind up their company.[413] Put colloquially, shareholders can kill the separate legal person whom they breathed life into by their initial injection of capital. Directors, creditors, the ASIC and others are only entitled to commence winding up proceedings if the company is insolvent[414] or the company's affairs are otherwise being conducted irregularly.[415] In both these circumstances shareholders may also wind up their company.[416] Both of these situations are justified. If the company is insolvent then almost invariably shareholder

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407 AASB 1034 sections 11.1(a) and (b) and 11.1.1.

408 CL s136(2).

409 Pursuant to the *Company Law Review Act* 1998 (Cth) the division of some functions now are set out as replaceable rules in the Corporations Law. However the replaceable rules do not apply to companies incorporated prior to 1 July 1998 who have not repealed their constitution since that date; *Company Law Review Act* 1998 (Cth) Schedule 1, s135.

410 *Allen v Gold Reefs Of West Africa Ltd* [1900] 1 Ch. 656.

411 *Gambotto v W.P.C. Ltd* (1995) 127 ALR 417 at 425 (although the High Court held that other considerations were also relevant where the property rights of minority shareholders were being expropriated by majority shareholders).

412 CL s246AA.

413 CL s491.

414 CL s459P.

415 See the grounds for which a company may be wound up by the court in CL s461(b) to (k).

416 CL s459P(1)(a) and 461(a).

funds will have been dissipated.[417] If the affairs of the company are being conducted irregularly then the company is no longer entitled to the privileges of incorporation. Therefore it is no longer appropriate for shareholders to exclusively have the power to decide whether the company should continue. Of course there are other types of insolvency procedures that directors,[418] creditors[419] and occasionally others[420] can implement. However all of these are transitory and either the company returns to normal trading or proceeds to a winding up. Shareholders can avoid any other people taking such action, or satisfying their claims if they arise, by injecting sufficient fresh capital into the company.

In a winding up, once creditors and others have received their money,[421] the shareholders are entitled to the remainder of the company's assets.[422]

It is very significant that shareholders have the principal right to decide whether the company continues in existence and if they decide that it should not then they receive the surplus wealth of the company. The ability to kill a legal person, albeit an artificial one, is the ultimate power one can have. The power to wind up companies and to receive the surplus wealth is a very significant power.

Role of Directors

Business Management

There is a vast body of literature on management and "master of business administration" degrees are offered at leading universities around the world. Whilst the business literature is replete with definitions of management and conflicting theories on how to do it well there is also a legal definition of management. Ormiston J. in *CCA (Vic) v Bracht* [423] sought to explain the management function, in the context of the prohibition on disqualified people taking part in management, in the following terms:

> activities which involve policy and decision making, related to the business affairs of a corporation, affecting the corporation as a whole or a substantial part of that corporation, to the extent that the consequences of the formation of those policies or the making of those decisions may have some significant bearing on the financial standing of the corporation or the conduct of its affairs.[424]

The nature of management power is very broad. It enables those reposed with the power to do on behalf of the company anything the company could do unless a particular power

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417 The test of insolvency is defined as an inability to pay debts as and when they fall due (CL s95A). It is possible for a company to have a surplus of assets over liabilities but nonetheless still be insolvent. If this is the case then shareholder funds will not have been dissipated. However in such circumstances it would be rare for the company to proceed to liquidation. Certainly the most common situation is for an insolvent company to have a significant deficiency of assets over liabilities.

418 Directors are exclusively entitled to commence a voluntary administration; CL s436A.

419 Secured creditors are the ones who usually appoint Receivers; see Ford, Austin and Ramsay, *Ford's Principles Of Corporations Law* (Butterworths, Sydney, 9th ed., 1999) at paragraph [25.060].

420 For example liquidators can commence a voluntary administration (CL s436B) and a court can appoint a receiver on the application of the ASIC during an investigation into a company; see CL s1323(1)(h).

421 CL s471C and 555 to 562A.

422 CL s501, 553A and 563A.

423 (1988) 14 ACLR 728.

424 Above at 734.

is expressly reserved to shareholders.[425] In particular management power embraces the right to:

- commence litigation in the company's name;[426]
- to buy, hold and sell property;[427]
- to buy and sell products ie. conduct the business;
- to borrow money and grant security over the company's property;[428]
- to employ people; and
- even to sell the company's business[429] (although for listed public companies directors must get shareholder approval to sell the company's main business undertaking).[430]

Corporate constitutions almost always provide that the "business of the company shall be managed by the directors".[431] The same type of provision is now also a replaceable rule in the Corporations Law.[432] However as mentioned previously given the complexity of modern business conditions and the size of large listed public companies the reality is that directors can no longer effectively manage the day to day affairs of their companies. Therefore the directors are entitled to delegate some of their powers to a managing director who is usually charged with the day to day management of the company. Depending on the size and complexity of the company's business the managing director usually employs a range of executives to assist him or her to acquit those functions effectively.

Concerning the division of responsibilities between the directors and the managers Ford, Austin and Ramsay in their textbook consider the role of directors is:

- to appoint and reward the company's chief executive (the managing director);
- to set goals, formulate strategy and approve business plans for the company;
- to approve annual budgets and key management decisions (such as decisions on major capital expenditure, business acquisitions, restructuring and refinancing);
- to monitor management performance and business results;
- to set and review policies for shareholder communication and approve reports to shareholders; and
- to set and review budgetary control and conformance strategies.[433]

This view of the role of directors has been judicially endorsed.[434] A recent report in this area, the Hilmer Report,[435] probably goes even further in limiting the role of directors.

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425 *Campbell v Rofe* [1933] A.C. 91 at 99.

426 That this power resides with directors is the necessary foundation to the rule in *Foss v Harbottle* (1843) 67 E.R. 189.

427 *Queensland Press Ltd v Academy Instruments No 3 Pty Ltd and Anor* (1987) 11 ACLR 419.

428 *Gibbs and Webb's Case* (1870) L.R. 10 Eq. 312.

429 *Strong v J. Brough & Sons (Strathfield) Pty Ltd* (1991) 5 ACSR 296.

430 LR 11.2. See generally Redmond, *Companies and Security Law: Commentary And Materials* (Law Book Company, Sydney, 2nd ed., 1992). Discussed later in this chapter.

431 Table A cl 66.

432 CL s226A.

433 Ford, Austin and Ramsay, *Ford's Principles of Corporations Law* (Butterworths, Sydney, 9th ed., 1999) at [7.060]. See also Australian Institute of Company Directors, *Measuring Board Performance*(AICD, Sydney, 1993) at 2.

434 *AWA Ltd v Daniels trading as Deloitte Haskins & Sells* (1992) 7 ACSR 759 at 865 to 866 where Rogers J accepted a version of this from a previous edition of this textbook. This portion of the judgement was not overturned on appeal, see *Daniels v Anderson* (1995) 13 ACLR 614.

Hilmer expands on the traditional analysis and the main difference he advocates is that directors should not formulate strategy. Managers should formulate and directors should criticise and approve or not approve the policy. Whilst Hilmer's position probably reflects what normally occurs in practice, Boards still formulate policy and they certainly should not be restricted from doing this.

Note that in the functions of directors described above there is no mention of actually managing the company and its businesses on a day to day basis. That job is left to managers. In the context of the *AWA Ltd v Daniels* [436] Rogers J stated that the role of managers is:

(a) to carry out the day to day control of the corporation's business affairs;
(b) to establish proper internal controls, management information systems and accounting records;
(c) reduce to writing if appropriate and communicate policies and strategies adopted by the Board;
(d) implement the policies and strategies adopted by the Board;
(e) have a knowledge of and review detailed figures, contracts and other information about the corporations affairs and financial position and summarise such information for the Board where appropriate;
(f) prepare proposals and submissions for consideration by the Board;
(g)prepare a budget; and
(h) attend to personnel matters including hiring and firing staff and their terms of employment.[437]

As between shareholders and managers the critical issue is whether that delegation of management power was to the exclusion of shareholders. Alternatively do shareholders have the right to overrule the decision of directors and force them to take a particular business decision?[438] If the delegation is exclusive, so that shareholders cannot force a management decision upon the directors, then shareholders' only remedies are either to quit their investment or exercise other powers. Those other powers include endeavouring to remove those directors and appoint new directors who will carry out their wishes or altering the constitution to give them this type of ultimate directorial power. As the issue is a matter for the corporate constitution then the constitution could quite clearly state whether exclusive power was delegated or not. Unfortunately, generally corporate constitutions have not explicitly and unambiguously addressed this issue. Therefore the matter has often come before the courts.

Numerous cases have considered this issue and give a great insight into the courts attitude concerning the nature of the relationship between shareholders and directors. The courts in these cases have espoused two competing theories:

1. shareholders are the primary and ultimate organ of the company. Therefore directors are subject to the supervisory control of the shareholders; or
2. Directors are not necessarily subordinate to shareholders. If the directors are delegated a certain authority then their authority is not subject to the supervisory control of shareholders unless the corporate constitution clearly provides for that control. They are one of the primary organs of the company.

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435 Hilmer, *Strictly Boardroom* (The Business Library, Melbourne, 1993) at 3.26.

436 *AWA Ltd v Daniels trading as Deloitte Haskins & Sells* (1992) 7 ACSR 759.

437 Above at 867.

438 In the political context this issue involves the tension between representative and participatory democracy; see Arblaster, *Democracy* (University of Minnesota Press, Minneapolis, 1987) in chapter 8, discussed in chapter 5.2 of this thesis.

Historically the first theory prevailed[439] but has now been superseded by the second theory.[440] All the modern cases support the second theory except for *Marshalls Valve* which can be regarded as a throwback to the first theory, and is now itself nearly 100 years old.

It is instructive to consider the reasoning[441] used to support these two very different theories. Some of this reasoning involves broad categorisations about the nature of the relationship between shareholders and directors, some of which I have already dealt with in the previous section of this chapter.

There seems to be two lines of reasoning in the cases which support the first theory.[442] One case reasoned that "the company is a trustee for the shareholders, and the shareholders are cestuis que trust of the company."[443] I have already argued above that this characterisation is not helpful. However even if this characterisation is correct, under trust law the beneficiaries of a trust are generally not entitled to direct the trustee how to exercise the trustees' discretionary powers.[444] Therefore drawing this analogy does not support the conclusion (shareholders have supervisory power over directors) which the judges seek to make.

Another case spoke in terms of shareholders having and exercising "rights of property".[445] However I argued above that although shareholders enjoy property in their shares, it is not useful or appropriate to regard them as the owner of the company or of its underlying assets.

Turning to the second theory, although it currently enjoys widespread support it is not necessarily correct, as I will seek to establish. Two preliminary reasons can be advanced to show this. First, the first theory prevailed for a time. Second, the New Zealand *Companies Act* 1993 entitles shareholders to "pass a resolution relating to the management of a company."[446] These resolutions are not binding on the board unless the Act or the company's constitution provides otherwise.[447] Although non-binding the New Zealand legislation makes it clear that this can be regarded as a legitimate topic for shareholder involvement.

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439 *Pender v Lushington* (1877) 6 Ch. D. 70; *Duckett v Gover* (1877) 6 Ch. D. 82; *Harben v Phillips* (1882) 23 Ch. D. 14; *Marshall's Valve Gear Co Ltd v Manning Wardle & Co Ltd* (1909) 1 Ch 267.

440 *Clifton v Mount Morgan Ltd* (1940) 40 SR (NSW) 31 at 44 to 45; *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* (1906) 2 Ch 34; *John Shaw & Sons (Salford) Ltd v Shaw* (1935) 2 K.B. 113; *NRMA v Parker* (1986) 11 ACLR 1;*Queensland Press Ltd v Academy Instruments No 3 Pty Ltd and Anor* (1987) 11 ACLR 419.

441 It is perhaps misleading to speak of the "reasoning" used in these cases. Usually there is a mere assertion that the relationship between shareholders and directors is of a certain type with no reasons given to justify the classification.

442 Some cases do not offer any reasoning in support of their conclusions, *Harben v Phillips* (1882) 23 Ch. D. 14 at 35 per Cotton L.J. ("leave to shareholders their undoubted right of settling in their own way what is to be their policy, and how their business is to be carried on"). The application of this reasoning to the facts of that case was subsequently criticised by Jordan C.J. in *Clifton v Mount Morgan Ltd* (1940) 40 S.R(N.S.W) 31 at 47 to 50.

443 *Duckett v Gover* (1877) 6 Ch. D. 82 at 85.

444 *re Brockbank* [1984] Ch 206; *Stephenson v Barclays Bank Trust Co Ltd* [1975] 1 All E R 625 per Walton J at 627. See Heydon, Gummow and Austin, *Cases And Materials on Equity And Trusts* (Butterworths, Sydney, 4th ed., 1993) at 869 to 872; Meagher and Gummow, *Jacobs' Law Of Trusts In Australia* (Butterworths, Sydney, 5th ed., 1986) at 648 to 649.

445 *Pender v Lushington* (1877) 6 Ch. D. 70 at 75.

446 *Companies Act* 1955 (N.Z.) section 79(a).

447 As above.

The following reasoning, drawn from the decided cases supports the second theory:
(1) rejecting a view of directors as "mere agents of the company";[448]
(2) viewing the directors as not subject to a direction on a management issue passed by ordinary resolution since the constitution provided for removal of directors and alteration of the corporate constitution by special resolution;
(3) regarding the corporate constitution as "a contract between the members of the company inter se";[449] and
(4) avoiding the danger of allowing a majority of shareholders to dictate business policy to the directors which "might lead to an interference by a bare majority very inimical to the interests of the minority [shareholders]".[450]

All four aspects of this reasoning can be criticised. The first reason given is that directors are not mere agents of shareholders. I have already analysed this and concluded that the principal/agent analogy is not very helpful although I agree with the conclusion that directors are not the mere agents of shareholders.

The second reason given attempts to address the balance of power between shareholders and directors. The reasoning is that if shareholders can only sack the directors and can only change the rules which govern their relationship with the directors by a special majority then that same majority is needed to tell the directors what or how to do their job. There is merit in this argument. Essentially it is an argument about majorities and hence their (legitimate) powers, not about the nature of the relationship between shareholders and directors. Noticeably this argument seems to concede that directors are under the ultimate supervisory control of shareholders, albeit by the requisite majority proscribed in the constitution.[451] In addition this argument is now significantly weakened since directors can be removed by a simple majority of shareholders.[452] Removal is the most potent sanction that can be used in any relationship.[453] It certainly is more potent and final than changing the terms of the appointment during the course of the relationship. Arguably the requirement of a special majority in order to change the constitution should be regarded as a safeguard to protect minority shareholders from prejudicial action from the majority shareholders. The special majority requirement should not be seen as protecting incumbent directors from action by a majority of shareholders. This is particularly so given directors do not have any right to vote to

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448 *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* (1906) 2 Ch 34 per Cozens-Hardy L.J. at 45; see also Ryan J in *Queensland Press Ltd v Academy Instruments No 3 Pty Ltd and Anor* (1987) 11 ACLR 419 at 421.

449 *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* (1906) 2 Ch 34 per Cozens-Hardy L.J. at 44.

450 *Queensland Press Ltd v Academy Instruments No 3 Pty Ltd and Anor* (1987) 11 ACLR 419 at 421 quoting Farwell L.J. in *Salmon v Quin & Axtens Ltd* [1909] 22 K.B. 89.

451 *Clifton v Mount Morgan Ltd* (1940) 40 S.R(N.S.W) 31 is traditionally seen as a case which supports this proposition. However in that case Jordan C.J. considered article 120 whereby management power was delegated to the directors "subject to directions given by the company in general meeting". Jordan C.J. said at 51 to 52:

> As regards the shareholders in general meeting, if they feel any diffidence about the probable policy of the Board of Directors as constituted by the last election there is nothing to prevent them from clipping their wings by ordinary resolution to any extent which might be thought desirable pursuant to Article 120.' [Emphasis added]. Of course the result for any particular company will depend on the terms of their articles.

452 Public companies CL s 227; proprietary companies CL s226E (replaceable rule) and Table A cl 62.

453 Other examples include divorce in marriage and removal of a government or judge from office.

amend the constitution anyway. For these reasons I do not view this argument as persuasive.

The third reason given, that the constitution is a contract, is a correct statement of the legal status of that document. Certainly the constitution is a contract[454] but this does not of itself address the issue of the nature of the relationship between shareholders and directors. For contracts usually create an agency relationship and govern the creation or transfer of most proprietary interests. Therefore a contractual analysis could support the first theory. The argument is particularly dubious when the court is endeavouring to interpret constitutions (contracts) which are ambiguous about this very issue.

However a contractual analysis could support the second reason (discussed above). The parties to the contract (the shareholders and the directors) have agreed to the terms of their contract. In true laissez-faire style the parties are strictly bound by the terms of their contact which they are taken to have freely negotiated and agreed to. The terms of their contract include requirements for special majorities and therefore those requirements must be complied with. There is no room to modify this either because of some overarching theory of what the appropriate relationship should be or because of the inappropriateness of the freedom of contract theory. However there is no reason why a strict contractual theory should prevail over other theories. Also the freedom of contract theory has been trenchantly criticised[455] and subjected to statutory reform.[456] The contractual theory seems particularly unsuited to companies because their constitutions are usually in a standard format drafted by promoters/directors with their interests in mind.

The fourth argument is about majorities oppressing minorities. This argument also does not withstand analysis for two reasons. First, it is speculative; equally the management decision or policy of the directors may be against the interests of all shareholders (both the majority and minority). Conversely the majority shareholders may be acting in the best interests of the minority shareholders. Second, the argument predates and does not take account of those laws which apply if majority shareholders act against the interests of the minority.[457] Arguably the majority shareholders should be allowed to act but if they do so in a way inimical to the interests of minority shareholders then the minority shareholders have grounds for a remedy using these laws.

Therefore the conclusion that shareholders cannot tell directors how to exercise their power does not necessarily follow from the reasoning used. It seems that lurking behind the decision is an unexpressed view about the nature of the relationship between shareholders and directors whereby it is considered inappropriate for shareholders to exercise supervisory control over directors. The real justifications for this are those I explained above for not regarding directors as the "mere agents", however I have questioned whether this should result in a blanket denial of a supervisory role for shareholders. Nonetheless this is the state of the current law and this enables directors to act with almost complete autonomy.[458]

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454 CL s140(1).

455 Carter and Harland, *Contract Law in Australia* (Butterworths, Australia, 6th ed., 1996) at paragraph 113.

456 *The Contracts Review Act 1980 (NSW)*; *The Trade Practices Act 1974 (Cth)* s51AB.

457 These laws were discussed above under the sub-heading "Alteration of the Corporate Constitution".

458 Eisenberg, 'The Structure of Corporate Law' (1989) 89 Columbia Law Review 1461 at 1471.

It is useful to consider the types of direction shareholders could give directors. Shareholders could give directions on a range of topics including:

- to take, or not to take, a particular business decision, such as buying or selling assets or a business.[459] As mentioned earlier, the only requirement in Australia like this is Listing Rule 11.2 which requires shareholders to approve a sale or disposal of the company's main undertaking.[460] In comparison in New Zealand a major transaction (assets representing the greater part of the company's assets) must be approved by a special resolution of shareholders;[461]
- to cancel a business decision taken by the directors;[462]
- to ensure the proper procedures for the conduct of shareholders' meeting are followed;[463]
- to institute or discontinue legal proceedings on behalf of and in the interests of the company;[464]
- to conduct the business within certain policy constraints. For example shareholders could require the company to solely operate one business, within one industry, or to diversify over a range of businesses. Or shareholders could require companies not to exceed a certain debt to equity ratio. Other people who provide money to the company as debt capital often insist on such requirements.[465] There seems no reason in principle why shareholders could not also impose such restrictions; or
- to adopt a certain dividend policy. For example that a fixed percentage of profits are to be paid as dividends (perhaps unless the directors persuade the shareholders that the company needs to retain the profits for a certain reason).

An important caveat to directors having exclusive management power is that shareholders have residual control in two situations. First, shareholders can act in the place of directors if the directors are unable to act. Directors may be unable to act for a variety of reasons, for example:

- the number of directors falls below the number required for a quorum. For example in a proprietary company with 2 directors, if one dies then one director generally does not constitute a quorum;
- the directors are deadlocked. They just cannot agree on a matter; or
- directors are disqualified from acting because of a conflict of interest. [466]

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459 *Queensland Press Ltd v Academy Instruments No 3 Pty Ltd and Anor* (1987) 11 ACLR 419-sale of shares in another company; *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* (1906) 2 Ch 34-sale of company's assets and undertaking.

460 Pursuant to Listing Rule 11.1 shareholders may also get to vote where a company proposes "a significant change, either directly or indirectly, to the nature or scale of its activities". However the need for approval is not mandatory but only "if ASX requires".

461 *Companies Act* 1993 (N.Z.) ss 106 & 129.

462 *Duckett v Gover* (1877) 6 Ch. D. 82-an allegedly fraudulent contract for the purchase of a colliery.

463 *NRMA v Parker* (1986) 11 ACLR 1.

464 *Marshall's Valve Gear Co Ltd v Manning Wardle & Co Ltd* (1909) 1 Ch 267-legal proceedings to protect the company's patent; *John Shaw & Sons (Salford) Ltd v Shaw* (1935) 2 K.B. 113-discontinue proceedings for the recovery of a debt.

465 Requirements about debt to equity ratios are often found in debenture trust deeds/negative pledges: Bruce, McKern, Pollard and Skully, *Handbook of Australian Corporate Finance* (Butterworths, Sydney, 5th ed, 1997) at 243, 255 and 408; Austin and Vann, *The Law of Public Company Finance* (Law Book Company, Sydney, 1986) at 16 and 267 to 268; Sykes, *The Bold Riders* (Allen & Unwin, New South Wales, 1994) at 7 to 11.

466 *Re Express Engineering Works Ltd* [1920] 1 Ch. 466 is an example of this. See generally Ford, Austin and Ramsay, *Ford's Principles Of Corporations Law* (Butterworths, Sydney, 9th ed., 1999) at paragraph [7.130].

Second, shareholders can act in the place of directors if the shareholders act unanimously.[467] The conceptual underpinning to this doctrine is not made clear in the decided cases.[468] Putting aside sophisticated academic arguments, the doctrine is simply a recognition of power. This doctrine is the logical conclusion to the broad powers shareholders have, which at the most require a special resolution to be effective.

Dividends

Final dividends usually involve a two-stage process. Directors must recommend final dividends, then they are declared by shareholders in general meeting.[469] At one level then it could be argued that the dividend payment power is shared between shareholders and directors. However given that shareholders cannot initiate the payment of a dividend and that shareholders never refuse to declare a recommended dividend the reality is that directors effectively control this decision. The constitutions of some companies take it one step further and totally exclude shareholders from the decision making process; that is directors are authorised to declare the dividend.[470] This is the common position for interim dividends.[471]

Dividends are payable only from "profits".[472] Profits are quantified in the annual financial statements. The quality of these financial statements is therefore crucial, particularly given the premise that companies are all about making money for the shareholders.

Share Issues

Directors are usually explicitly given the power to issue shares.[473] In the usual course this is perfectly appropriate. Given that directors are delegated management power they are the ones who can assess whether the company requires additional capital. However while the share issue power can be used legitimately, to raise more money it can be and has been used illegitimately to dilute a certain persons share holding and therefore upset the balance of power between shareholders.[474] It is a common defensive takeover tactic to structure a significant transaction that has this effect. These types of issues are motivated by a desire to keep the current directors in power.

It is not clear from standard constitutions whether this delegation of power is to the exclusion of shareholders. Pidgin J of the Supreme Court of Victoria recently decided that a clause in a constitution similar to Table A clause 2 did not confer exclusive power

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467 *Re Express Engineering Works Ltd* [1920] 1 Ch 466; *Parker & Cooper Ltd v Reading* [1926] Ch 975 9; *Re Duomatic Ltd* [1969] 2 Ch 365; *Re Compaction Systems Pty Ltd* (1976) 2 ACLR 135; *Ho Tung v Man of Insurance Co Ltd* [1902] AC 232; *Herrman v Simon* (1990) 4 ACSR 819; *Brick & Pipe Industries Ltd v Accidental Life Nominees Pty Ltd* (1991) 9 ACLC 324 at 351 to 356.

468 Ford, Austin and Ramsay, *Ford's Principles Of Corporations Law* (Butterworths, Sydney, 9th ed., 1999) at paragraph [7.590].

469 Table A cl 86.

470 See the constitution of Southcorp Ltd. This is also the position under the default provisions in the Corporations Law; see CL s254U - replaceable rule.

471 Table A cl 87.

472 CL s254T.

473 Table A cl 2.

474 *Ngurli v McCann* (1953) 90 CLR 425; *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285.

on directors.[475] However usually shareholders will not be in a position to decide whether the company requires additional capital.

Directors Access to Information

In order properly to fulfil their responsibilities, particularly concerning the broad power of management, directors must have unrestricted access to corporate information.[476] Sometimes the majority of directors freeze out a minority faction of directors by denying them access to corporate information. When this occurs, the minority directors usually seek a declaratory order from a court to enforce their rights to information. Generally the courts, when called upon, have fully embraced the principle of unrestricted access by directors to corporate information.[477] The courts have stated that the right is virtually unqualified, so that :

- it is not a matter of the court's discretion whether to allow inspection;
- the directors do not have to justify the desire to inspect;[478] and
- the court may decline to enforce the right of inspection only if satisfied the director intends to abuse the confidence reposed in him or her. However, the court will not assume this in the absence of clear proof.[479]

This general law right of access to corporate information is reinforced by the right of directors to inspect the company's financial records under the Corporations Law.[480] Whilst "financial records" are broadly defined,[481] it certainly does not include many of the documents of a non-financial nature, such as consultants reports or legal advice. For these types of documents, the general law continues to apply.

Rights of access are less clear for former directors.[482]

Conclusion

From the preceding analysis of the role of shareholders and directors it is clear that the directors possess significant powers, particularly the extremely broad and autonomous power of management. Even those powers which are formally vested in and used by shareholders have been effectively commandeered by directors due to their control of the agenda at shareholder meetings and information advantages. Directors occupy a very powerful position in the company and act with almost complete autonomy.

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475 *Donocon v Donocon* (1990) 2 ACSR 385 at 394 to 397.

476 See generally Australian Institute of Company Directors, *Directors' Right of Access to Company Documents* (AICD, Sydney, 1996).

477 *Burn v The London & South Wales Coal Company* (1890) 7 TLR 118; *Edman v Ross* (1922) SR (NSW) 351.

478 *Molomby v Whitehead* (1985) 63 ALR 282.

479 *Edmann v Ross* (1922) SR (NSW) 351. See Norman, 'Access to Corporate Information' (1986) 4 C&SLJ 149 at 150-157. Also an application for inspection may be adjourned if at the time of the court hearing a general meeting of members has been called for the removal of the directors who are seeking inspection because the right of inspection ceases after a person ceases to be a director: *Conway v Petronius Clothing Co Ltd* [1978] WLR 72.

480 CL s290(1) (previously CL s289(9)). Overseas cases on similar sections are not uniform but the better view is that a similar broad approach to their interpretation is appropriate: see *Berlie Hestia (NZ) Ltd v Fernyhough* [1980] 2 NZLR 150; cf *Conway v Petronius Clothing Co. Ltd* [1978] 1 All ER 185.

481 CL s9.

482 *The State of South Australia and State Bank of South Australia v Barrett* (1995) 13 ACLC 1,368; *Kriewaldt v Independent Direction Ltd* (1996) 14 ACLC 73. See Australian Institute of Company Directors, *Directors' Right of Access to Company Documents* (AICD, Sydney, 1996).

However shareholders possess a formidable array of powers. Even where in practice directors hold sway over these powers they remain formally vested in shareholders. Shareholders sometimes aggressively use these powers[483] and there is no guarantee the current practice will continue in the future. In particular, the power to hire and fire the directors and to wind up the company means that shareholders hold powers of last resort to determine how the company is run and to decide its ultimate fate. These powers cast shareholders as the ultimate power brokers in the company.

This division of power leads to two conclusions. First, whenever there is a division of functions the issue of accountability arises. Since shareholders appoint directors and delegate to them their powers the directors are meant to exercise these powers in the interests of shareholders.[484] That is, since shareholders possess the ultimate powers of the company the directors should be accountable to them. Given the extraordinary breadth of the powers directors enjoy and therefore the position of reliance and relative weakness of shareholders, the directors should be accountable for all of their functions. Looked at from shareholders' perspective they have an interest in and responsibility to monitor all that the directors and the company do. To put the point succinctly, shareholders are comprehensive monitors.

Second, given this division of functions, the directors and shareholders have divergent interests.[485] Putting aside the rare altruistic individual, most people ensure they look after their own interests; people have a tendency to selfishness. Shareholders are interested in directors maximising the profit and value of the company's businesses and declaring the maximum amount of dividends as possible.[486] Directors obviously hold their positions to endeavour to achieve this but they will also be motivated by self-interested factors. Directors are interested in maximising their salary, their power and prestige (usually by maximising the size of their corporations) and entrenching their positions. Also directors and executives may simply not work as hard as they should.[487] As a result, the early and well-respected economist Adam Smith questioned the viability of the corporate form. Smith stated:

> The directors of such companies being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own....Negligence and profusion, therefore must

483 As is evident from the recent manouverings at Westpac and Coles Myer Ltd; see Tricker, 'Corporate Governance-Australian Experience in the '90s' paper presented at a conference 'Corporate Governance: Critical Board Issues' organised by the Australian Institute of Company Directors in Sydney on 24 May 1993 (author on file).

484 The law recognises this reality by imposing on directors fiduciary duties, the most stringent form of duties known to the law. It is clear under these fiduciary duties that directors must act in the interests of shareholders (*Ngurli Ltd v McCann* (1953) 90 CLR 425 at 438; *Mills v Mills* ((1938) 60 CLR 150 at 164) except when the company is insolvent or is approaching insolvency (*Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 3 ACLC 215 at 222; *Grove v Flavel* (1986) 4 ACLC 654); see Blanchard, 'Honesty in Corporations' (1996)14 C&SLJ 4 at 10.

485 Stokes, 'Company Law and Legal Theory' in Twining (ed.), *Legal Theory and Common Law* (Basil Blackwell, U.K., 1986) at 158; Easterbrook and Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, USA, 1991) at 1 to 2; Eisenberg, 'The Structure of Corporate Law' (1989) 89 Columbia Law Review 1461 at 1471.

486 This desire for large dividends can be affected by each shareholders individual tax position, whether the company has a dividend reinvestment plan and other factors.

487 In the economic literature called shirking; see Eisenberg, 'The Structure of Corporate Law' (1989) 89 Columbia Law Review 1461 at 1471.

> always prevail, more or less, in the management of the affairs of such a company.[488]

The corporate form has flourished,[489] but the dangers Smith pointed to remain. As already discussed,[490] this leads some to seek to better align the interests of directors and executives with shareholders by such devices as a shareholding in the company and performance based remuneration. For the purposes of this discussion though, it is sufficient to note the divergence of interest and consider its ramifications for the role of shareholders. Given the divergence of interest, shareholders cannot just blindly trust directors and executives to perform as well as they are able. This divergence itself points to the need for shareholders to actively monitor all the actions of the directors, executives and the company.

4.4 WHAT IS THE COMPANY?

It is not possible to gain an appropriate understanding of who shareholders are in the abstract. To properly understand who shareholders are, requires an appreciation of what the company is and what are its purposes. That is, any analysis must be context based, and any analysis that loses sight of this is necessarily flawed and myopic. The analysis in this part is different from the one used in the previous part when considering whether shareholders enjoyed rights of property.

As I have already discussed,[491] a company is a separate legal entity[492] and has the legal capacity and powers of an individual (and some powers peculiar to corporations (eg the power to issue shares)).[493] In many ways this is trite and not very informative. I adopt two different, but in some ways similar, approaches to what the company is. Those approaches are a more theoretical evaluation of what the purposes of the company are followed by a visit to the public/private debate.

Clark provides an excellent theoretical framework within which to consider what the purposes of companies are.[494] He considers five views of the proper role of companies in society and particularly in relation to governmental tasks. I quote him at length on those five views;

> Dualism: the Norm of Strict Profit Maximisation
>
> *Statement*. The dualist, who is also the traditionalist, regards the private and public spheres as having distinct functions that ought to be kept distinct. Accordingly, from the traditional legal viewpoint, a corporation's directors and officers have a fiduciary duty to maximise shareholder wealth, subject to numerous duties to meet specific obligations to other groups affected by the corporation....

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488 Smith, *The Wealth of Nations* (Everymans Library, U.S.A., 1776) Volume II at 229.

489 Bottomley, 'From Contractualism to Constitutionalism: A Framework for Corporate Governance' (1997) 19 Sydney Law Review 277 at 277 states that "the corporation has become one of the dominant - if not *the* dominant - organisational forms in the late 20th century".

490 At chapter 4.3 under the heading 'Remuneration of Directors, Executives and Auditors'.

491 Above at chapter 4.2.

492 *Salomon v Salomon & Co. Ltd* [1897] A.C. 22; CL s119.

493 CL s124.

494 Clark, *Corporate Law* (Little Brown & Co, New York, 1986) in chapter 16.

Corporations owe many contractual, common law and statutory duties to their customers, suppliers, creditors, employees, and to the environment, the general public, and numerous governmental agencies.

If the legal system as a whole imposes so many duties to so many constituencies and thus mandates a wide ranging (though perhaps inadequate and not ultimately coherent) accommodation of diverse interests, what, if anything, is the real meaning of the profit maximisation norm? The answer is that it tells corporate managers what their *residual* goal is-or, in economic jargon, what the company's "objective function" is. The duties to all other groups need simply be satisfied-they function as constraints-but the duty to shareholders is open-ended: Profits should be made as large as possible, within the constraints.[495]

Monism: Long -Run Identity Between Public and Private Interest

Statement. The monist viewpoint is that many types of corporate activities that appear to be profit-reducing voluntary expenditures for the public good are really conducive to profit maximisation in the long run. Virtually no one is a strict or absolute monist, that is, one who believes that all public-spirited tasks a corporation may engage in will conduce to long run profits. The typical monist believes rather that there is some set of "socially responsible" corporate activities that it is good for corporations to foster, because doing so will eventually create a better climate or culture in which business can operate. The set of socially responsible activities is usually understood (not defined) in an extremely conventional sense to include contributions to recognised charities and non profit organisations, modest investments in urban areas, employment of minority or handicapped workers and the like.[496]

Modest Idealism: Voluntary Compliance with the Law

Statement. The essence of modest idealism is that corporate managers should cause their corporations to comply with applicable laws and regulations even when non-compliance would increase the corporation's net present value.[497]

High Idealism: Interest Group Accommodation and the Public Interest as Residual Goals

Statement. High Idealism holds that the business corporation's residual goal, and not just its specific, externally imposed legal obligations, should be defined to include a much wider set of interests than those of the shareholders. One variation is that the purpose of the corporation, and the general residual duty of those who hold decision making power over its activities, is to achieve a reasonable accommodation of the interests of all groups affected by the corporation. Another version is that the basic purpose of a corporation include not only the objective of making profits but also that of furthering the public interest, as conceived by its decision makers.[498]

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495 Above at 677 to 678. See also Easterbrook and Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, USA, 1991) at 36.

496 Clark, *Corporate Law* (Little Brown & Co, New York, 1986) at 681.

497 Above at 684 to 685.

498 Above at 688. See also Stokes, 'Company Law and Legal Theory' in Twining (ed.), *Legal Theory and Common Law* (Basil Blackwell, U.K., 1986) at 176 to 177 where she outlines a "corporatist model of the company" which is similar to high idealism.

Pragmatism: Contracting to Provide Public Services

> *Statement*. Pragmatism holds that governmental units should make greater use of business corporations to implement public policies, and that business corporations should design, develop, and seize opportunities to perform public services on a profit-making basis. For example, the typical pragmatist wants the realm of government contracting to expand well beyond traditional activities like making weapons for the Defence Department and office buildings for other governmental units. He envisages more contracting by business corporations to provide job training for members of minority groups, to redevelop urban areas, to educate children, and to run municipal hospitals.[499]

Monism[500], modest idealism[501] and pragmatism[502] are all logically consistent with dualism although their emphasis is slightly different. On the other hand high idealism is radically different from the other four.

Clark examines the legal status, in the U.S., of his theories. He concludes that dualism,[503] monism[504] and modest idealism[505] all find legal acceptance in the U.S. As for pragmatism he concludes that the law is neutral; it neither "encourages or restrains" the pragmatist viewpoint.[506] In contrast Clark concludes that high idealism "is not embodied in current statutes and case law; its various formulations are to be found in the writings of reform-oriented commentators".[507]

The legal status of these theories is the same in Australia. Although surprisingly there is not one word in the Corporations Law, Listing Rules or standard constitutions stating that

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499 Clark, *Corporate Law* (Little Brown & Co, New York, 1986) at 694.

500 Above at 683.

501 Above at 685.

502 Above at 695.

503 Above at 678 to 679. Clark cites the case of *Dodge v Ford Motor Co.* 170 N.W. 668 (Mich. 1919) to support his conclusion. Clark states that in that case "the Michigan Supreme Court viewed as 'bad faith' and a breach of fiduciary duty Henry Ford's use of his power to withhold corporate dividends, over the objection of minority shareholders, in order to be able to sell cars more cheaply and benefit the American public at the expense of corporate profits".

504 Above at 681 to 682.

505 Above at 686. Acceptance of all three views, with slight modification (monism has been divorced from the maximisation of shareholder wealth justification), has also been endorsed in the influential ALI project. The American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (St. Paul Minn, USA, 1994) in analysis and recommendation 2.01 provides:

> The Objective and Conduct of the Corporation
>
> (a) Subject to the provisions of Subsection (b) and 6.02 (Action of Directors That Has the Foreseeable Effect of Blocking Unsolicited Tender Offers), a corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.
>
> (b) Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business:
>
> > (1)Is obliged, to the same extent as a natural person, to act within the boundaries set by law;
> >
> > (2)May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and
> >
> > (3)May devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.

506 Clark, *Corporate Law* (Little Brown & Co, New York, 1986) at 695.

507 Above at 690.

the residual goal of corporations is to maximise profit for shareholders,[508] this clearly is the accepted position in Australia. This can principally be seen in the cases where courts have acknowledged that directors owe their fiduciary duties to the company but have consistently said that in that context the company means the shareholders (and if the company is approaching insolvency also creditors).[509] There is also no doubt that shareholders are principally concerned to make a profit. That is why they have chosen to invest in for profit organisations rather than other types of organisations such as incorporated associations, one defining feature of which is that they are prohibited from passing on any profit to their members.[510] Therefore at the least dualism is an accepted theory in Australian law.

Monism has not been explicitly endorsed in Australia but monist behaviour is commonplace in Australia. Australian companies are patrons to the arts, make charitable contributions, support universities and engage in other seemingly altruistic behaviour. This behaviour has never been challenged in the courts and is entrenched behaviour. Therefore it must be concluded that a monist theory of the company is part of Australian law.

Modest idealism also has not been explicitly endorsed but must be taken to be part of the law of Australia. Legislatures pass laws with the expectation that they be complied with (even if they know that compliance may be sub-optimal). Legislatures usually back this expectation up with penalties for non-compliance and establish agencies to monitor compliance (although often the funding of these agencies leaves a lot to be desired). It would be anathema for a court to say that a company is entitled to disobey the law.[511] For the courts espouse and are the keepers of the Rule of Law.

A pragmatist view is clearly utilised in Australia, although its popularity fluctuates depending on the times and political party then in power. With the recent sell-off of traditionally government owned corporations, including the Commonwealth Bank, State Bank of South Australia, Qantas and most recently the partial sale of Telstra, the current popularity of pragmatism is waning.

High idealism is not accepted in Australian law.[512] This is best seen as the reverse side of the cases which decided that directors owe their fiduciary duties to the company, meaning the shareholders. So for example there is clear authority that the directors duties do not encompass the interests of employees.[513] The interests of these other

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508 The same silence exists in the U.S.; see above at 678.

509 Discussed above in chapter 4.2. See also Blanchard, 'Honesty in Corporations' (1996)14 C&SLJ 4 at 9 to 11. There is an argument that directors owe their duty to the company and this means the commercial entity; see McPherson, 'Duties of Directors to Shareholders and Creditors' paper presented in Company & Security Law After the Market Crash (Legal Research Foundation, Australia, 1989). This view is not part of Australian law; see *Ngurli Ltd v McCann* (1953) 90 CLR 425 at 438.

510 *Associations Incorporation Act* (S.A.) 1985.

511 Clark, *Corporate Law* (Little Brown & Co, New York, 1986) at 686 raises the same argument.

512 Sealy, 'Directors "Wider" Responsibilities-Problems Conceptual, Practical and Procedural' (1987) 13 Monash University Law Review 164. See also Senate Standing Committee on Legal and Constitutional Affairs, *Company Directors Duties: Report on the Social and Fiduciary Duties and Obligations of Company Directors* (AGPS, Canberra, 1989) at [6.25 to 6.56] where the committee concluded that high idealism should not be adopted in Australia. Rather the social impacts companies have should be dealt with in legislation directed specifically at those issues.

513 *Parke v Daily News Ltd* [1962] Ch 927. See however the *Companies Act* 1985 (U.K.) which provides in section 309(1):

stakeholders can not be the purpose of director's actions. However their interests must be weighed in the running of any successful commercial enterprise so long as maximising shareholder wealth remains the residual goal of the company.[514]

In conclusion, the residual goal of companies is to maximise shareholder wealth within the constraints of the law, although there is room for some seemingly altruistic behaviour so long as this can be tied to promoting the long-term profitability of the company. Also these companies can be utilised to operate governmental activities. However the residual goal of companies is not to benefit employees, consumers, the environment or the general public. These people can, and must be, taken into account in any company operating a business, but only insofar as shareholders benefit as a result (ie. maximising shareholder wealth must remain as the corporation's residual goal).[515]

The second issue is whether companies are essentially a private or a public institution. In some ways this is precisely what Clark was addressing as well, so this discussion can be viewed as a different way to consider the same issue. There is debate in the legal and other literature about whether companies are by their nature public or private institutions. One way to contrast public and private institutions is to compare public power which resides in the state with more private types of power. Stokes talks of the distinction between this type of public and private power in the following way:

> This distinction reflects the separation of the state from the individual in a liberal society. Liberal democracy has been concerned most explicitly with legitimating the power of the state, or public power. This is because the assumption is made that all-important power in society is concentrated in the hands of the state. The arguments used to justify public power are very familiar. They are that the system of representative democracy gives authority to the legislature to make law, and that the power conferred upon all administrative or public bodies is legitimate as it is derived from the legislature.[516]

It is clear that traditionally companies were regarded as private institutions as they certainly were not part of the state.[517] However the rise in power of corporate groups[518] and multi-national corporations in an increasingly globalised economy[519] is a feature of the 20th century that has disrupted this simplistic dichotomy of public and private.

> The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its members.

514 This has been explicitly recognised in New Zealand. *Companies Act* 1993 (N.Z.) provides in section 103:

> A director of a company may, when exercising powers or performing duties as a director, have regard to the interests of creditors and employees of the company, but nothing in this section limits the duties or obligations of directors set out in this Act [principally to act in good faith and in a manner that he or she believes on reasonable grounds is in the best interests of the company].

515 Sealy, 'Directors "Wider" Responsibilities-Problems Conceptual, Practical and Procedural' (1987) 13 Monash University Law Review 164 at 187.

516 Stokes, 'Company Law and Legal Theory' in Twining (ed.), *Legal Theory and Common Law* (Basil Blackwell, U.K., 1986) at 156.

517 Above at 156 to 159 where Stokes talks of companies as an aspect of private property and subject to market mechanisms which are features of private institutions.

518 See Gillooly (ed.), *The Law Relating to Corporate Groups* (Federation Press, Sydney, 1993); Tolmie, 'Corporate Social Responsibility' (1992) UNSW Law Journal 268 at 275.

519 Blumberg, *The Megacorporation in American Society* (prentice Hall, New Jersey, 1975); Nader, *Taming the Giant Corporation* (Norton and Co., New York, 1976); and Anderson, 'Corporations, Democracy and the Implied Freedom of Political Communication: Towards a Pluralistic Analysis of Constitutional Law' (1998) 22 Melbourne University Law Review 1 at 3 to 5.

Stokes, and a growing number of other commentators,[520] has talked of this phenomenon as follows:

> ...the modern public company has become an organisation whose significance almost rivals that of the state. It is the primary institution for organising and employing much of our capital and labour resources and the primary supplier of goods and services in our community. The rise of the corporate economy is said to lead to a 'gradual approximation of the state and society, of the public and private sphere'. Society comes to resemble 'a constellation of governments, rather than an association of individuals held together by a single government'.[521]

At this theoretical level it is no longer appropriate to either have a rigid dichotomy between public and private spheres or to regard large public companies as purely part of the private domain.[522] Certainly they are not <u>the</u> state, but arguably they are so significant they can be likened to <u>a</u> state.[523]

The distinction between public and private power is also blurred with the recognition that large public corporations wield significant political power.[524] The heads of such companies, such as Kerry Packer[525] and Rupert Murdoch,[526] often have the ear of the Prime Minister or the Premier of States.[527] As these people can influence, if not dominate,[528] the political process then they have a de facto role in the state.

Another distinction between public and private power is based on a comparison between public life and family and other private interactions between individuals.[529] If this style of analysis is correct then companies are very definitely part of the public domain.

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520 Unger, *Law in Modern Society* (The Free Press, New York, 1976) at 193 and 200 to 203; Nader, *Taming the Giant Corporation* (Norton and Co., New York, 1976) at 17; Bratton, 'The New Economic Theory of the Firm: Critical Perspectives From History' (1988-89) 41 Stanford Law Review 1471 at 1497 to 1498; and Corcoran, 'The Corporation as Citizen and as Government: Social Responsibility and Corporate Morality' (1997) 2 Flinders Journal of Law Reform 53 at 60 to 62.

521 Stokes, 'Company Law and Legal Theory' in Twining (ed.), *Legal Theory and Common Law* (Basil Blackwell, U.K., 1986) at 176 (footnote references omitted).

522 Tolmie, 'Corporate Social Responsibility' (1992) UNSW Law Journal 268 at 272 to 273 and 289 to 291; Edgeworth, 'Post-Property?: A Postmodern Conception Of Private Property' (1988) 11 UNSW Law Journal 87 at 94 to 95; Bottomley, 'From Contractualism to Constitutionalism: A Framework for Corporate Governance' (1997) 19 Sydney Law Review 277 at 278, 291 and 297 to 298.

523 Similarly while countries enjoy sovereignty within their borders (and are thus the state) outside of their borders they are part of a community of nations (they remain a state, but on a global view cannot be regarded as the state).

524 Nader, *Taming the Giant Corporation* (Norton and Co., New York, 1976) at 20 to 22; Tolmie, 'Corporate Social Responsibility' (1992) UNSW Law Journal 268 at 273; and Parkinson, *Corporate Power and Responsibility*, Clarendon Press, Oxford, 1993, at 19 to 21.

525 Barry, *The Rise and Rise of Kerry Packer* (Bantam, Australia, 1993) at chapters 10 and 16.

526 Pilger, *Hidden Agendas* (Vintage, Great Britain, 1998) at 466 to 470.

527 Sykes, *The Bold Riders* (Allen and Unwin, Sydney, 1994) at 70 to 78 which describes the WA Inc saga which is a tale of links being too close between big business in Western Australia and the then state government. See also Ryan and Burge, *Corporate Cannibals: The Taking of Fairfax* (William Heinemann Australia, Victoria, 1992) at chapter 12 'Courting Canberra'; and McEachern, *Business Mates* (Prentice Hall, Australia, 1991).

528 Some commentators talk of "capture" of the government by large dominant corporations-see Tolmie, 'Corporate Social Responsibility' (1992) UNSW Law Journal 268 at 277 who herself quotes from Glasbeek, 'The Corporate Social Responsibility Movement-the Latest in Maginot Lines to Save Capitalism' (1988) 11 Dallhousie LJ 363 at 398.

529 Graycar and Morgan, *The Hidden Gender Of Law* (The Federation Press, Sydney, 1990) at 30 to 40; Collier, *Masculinity, Law and the Family* (Routledge, London, 1995) at 59 to 63.

This issue can also be considered at a more grass roots level. At one level companies are distinctly private institutions. Membership is voluntary and is attained by purchasing shares in a company. Also many of the rules regulating the relationships between members and the company, namely the corporate constitution, are contractual which legal rules are of a private nature. On the other hand there is a vast quantity of mandatory rules imposed on the company by Parliament which suggests they are public institutions.[530] This is so even though some of these mandatory rules are subject to each company's constitution.[531]

However it must be borne in mind that there is the distinction between proprietary and public companies. The hallmarks of proprietary companies are that they must not have more than 50 non-employee shareholders and must not engage in any activity that would require the lodgement of a prospectus (essentially raise money from the public).[532] Proprietary companies are by their nature more private institutions and this is reflected in normal circumstances by less disclosure to the public.[533] In contrast, public companies and particularly those listed on the stock exchange, are by their own description and by their nature much more of a public institution. Public companies have no limit on the number of people who can be shareholders and they are able to raise money from the public.[534] There is a concomitant increase in the disclosures a public company must make[535] and their financial statements must be audited.[536]

Taking all of these factors into account it must be recognised that companies are not the state (which also accords with high idealism not being accepted as part of Australian law). However large public companies are so significant in our society that it is meaningless to try to down play that significance by trying to cast them as a purely private institution (which classification is no longer appropriate). In my opinion corporations reside in that grey area between the extremes of a rigid public or private dichotomy. Either /or thinking is inappropriate; companies display both public and private characteristics.

Conclusion

Clark's framework leads to two conclusions about the information shareholders should receive. First, since monism is embraced, then voluntary, seemingly altruistic expenditures are acceptable so long as they can be justified according to the long-term profitability of the company. Arguably if directors choose to depart from a strict profit maximising position they should report this information to shareholders and justify the expenditure, for such expenditure comprises funds taken from the bottom line profit which shareholders would otherwise be entitled to. I explore this issue in chapter 9.

530 The Corporations Law comprises approximately 2,000 sections.

531 As is evident by the regime of "replaceable rules" located in the Corporations Law; see CL ss 135 & 141.

532 CL s113.

533 CL s292(2) exempts small proprietary companies from much of the reporting requirements set out in chapter 2M of the Corporations Law. Small proprietary companies in normal circumstances do not have to audit their financial statements (CL s301(2) & 327(1A)).

534 Subject to the requirements of Part 7.12 of the Corporations Law.

535 That is the exemptions provided by CL s292(2) to the reporting requirements of chapter 2M of the Corporations Law do not apply to public companies.

536 CL 301(1) discussed at chapter 6.5.

Second, Australian law embraces a modestly idealistic view of the corporation under which companies are compelled to comply with the law even if corporate profits are thereby reduced. Therefore arguably this justifies disclosure to the shareholders of a corporation's compliance with the law. This justification arises for two reasons, one positing shareholders as antagonistic to modest idealism and the other that they are sympathetic to it. Compliance with the law has costs and the incursion of such costs takes away from the profits which are otherwise available for shareholders (ie it moves from a Dualist position). On the other hand shareholders may wholly support modest idealism and are therefore concerned that their company's behaviour matches this viewpoint. Therefore on either basis shareholders are interested in receiving information about the company's compliance with all of the laws which affect it.

Also, since the corporation is not viewed as a wholly private institution, then directors should not be able to argue for non-disclosure on privacy grounds, except for that category of confidential information which the law protects.[537] Even if companies were regarded as private institutions this would not affect the claim of shareholders to information, since they are insiders to the company, not an intrusive public with no interest in the corporations affairs.[538] This rejection of classifying companies as wholly private institutions also has ramifications for the discussion in chapter 5 about the analogy with democracies and in chapter 9.3 about whether the disclosure of social information is warranted.

4.5 PEOPLE WHO ARE SHAREHOLDERS

So who actually owns shares in Australian companies and does this have any impact on the nature of the information they should receive? Investors are a heterogeneous group ranging from the very sophisticated financial analysts to institutional investors to individual investors.[539] In this part of the thesis I principally examine the increasing prominence of institutional investors.

The identity of those registered as shareholders of Australian public listed companies and the extent of their holdings is evolving. The trend is to more concentrated[540] holdings by institutional investors.[541] As at March 1996 Australian institutional investors[542] held 34% of the shares listed on the Australian Stock Exchange and foreign investors (some of who would be institutional investors) held 32.5%.[543] As at March 1997 the corresponding figures are 34.6% and 31.7%.[544] Similar figures held for 1998.[545] This is

537 Discussed in chapter 3.

538 Bottomley, 'From Contractualism to Constitutionalism: A Framework for Corporate Governance' (1997) 19 Sydney Law Review 277 at 283 supports the view of shareholders as insiders to the company.

539 Baker and Haslam, 'Information Needs of Individual Investors' in Courtis (ed), *Corporate Annual Report Analysis* (Dept of Accounting and Financial Management, Armidale, 1978) 105 at 106.

540 That is, ownership of a significant number of shares or even a controlling interest by a few shareholders. This may be compared with diffuse ownership where the share capital of the company is spread amongst many people with no clearly identifiable group of shareholders having a significant or controlling shareholding.

541 Ramsay and Blair, 'Ownership Concentration, Institutional Investment And Corporate Governance: An Empirical Investigation Of 100 Australian Companies' (1993) 19 MULR 153.

542 Categorised by the ASX as Life Offices, Superannuation Funds and other Financial Institutions.

543 Australian Stock Exchange Limited, *1996 Market Report* at 7.

544 Australian Stock Exchange Limited, *1997 Market Report* at 6 to 7.

a significant parcel of shares which potentially enables their holders to control the company. The trend to more concentrated holdings by institutional investors is also evident in other industrial countries such as the U.S.,[546] U.K.,[547] Japan[548] and New Zealand.[549]

Institutional investors are a diverse group comprising superannuation funds, life insurance companies, investment trusts, unit trusts and other similar bodies. These institutions are diverse in various ways, including their:

> legal structures, regulatory and prudential constraints and management styles, all of which have an important bearing on the degree to which each type of institution will be inclined (or indeed permitted) to become engaged in corporate governance activities.[550]

However there is also significant homogeneity amongst institutional investors, with them being collectively defined as:

> Institutions which have as their primary role the professional investment and management of any fund established for the purpose of pooling monies paid by individual investors and invested in financial and non-financial assets.[551]

The cohesiveness of this group is demonstrated by the existence of the Investment and Financial Services Association Ltd[552] which is the peak body representing the investment and financial services industry. The Association members manage in excess of $400 billion of assets.[553]

There is considerable debate about the appropriate role for institutional investors in corporate governance.[554] Some see the rise of the institutional investor as the necessary

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545 Ford, Austin and Ramsay, *Ford's Principles of Corporations Law* (Butterworths, Sydney, 9th ed., 1999) at [17.090].

546 Ferrara and Zirlin, 'The Institutional Investor and Corporate Ownership' (1991) 19 Securities Regulation Journal 341 at 351; Coffee, 'Liquidity Versus Control: The Institutional Investor as Corporate Monitor' (1991) 91 Columbia Law Review 1277 at 1291 to 1294.

547 Davies, 'Institutional Investors: A U.K. View' (1991) 57 Brooklyn Law Review 129 at 131.

548 Coffee, 'Liquidity Versus Control: The Institutional Investor as Corporate Monitor' (1991) 91 Columbia Law Review 1277 at 1294 to 1302.

549 Ramsay and Blair, 'Ownership Concentration, Institutional Investment And Corporate Governance: An Empirical Investigation Of 100 Australian Companies' (1993) 19 MULR 153 at 176.

550 Griffin, 'Institutional Investors In Australia: A Shareholders Perspective' (paper presented at a conference 'Corporate Governance & Australian Competitiveness: The Role Of Institutional Investors' organised by the Australian Investment Managers Group, Sydney, 11 November 1993) at 3. See also Farrar and Russell, 'The Impact of Institutional Investment on Company Law' 5 The Company Lawyer 107 at 108.

551 Definition used by the Australian Bureau of Statistics and quoted in Griffin, 'Institutional Investors In Australia: A Shareholders Perspective' (paper presented at a conference Corporate Governance & Australian Competitiveness: The Role Of Institutional Investors organised by the Australian Investment Managers Group, Sydney, 11 November 1993) at 2.

552 Formerly called The Australian Investment Managers Association and prior to that The Australian Investment Managers Group.

553 Investment and Financial Services Association, *Providing Investment and Financial Security for all Australians* (IFSA, Australia, 1998).

554 Hill, 'Institutional Investors and Corporate Governance in Australia' at 597 in Baums, Buxbaum and Hopt (eds), *Institutional Investors and Corporate Governance* (Walter de Gruyter, Berlin 1993).

and effective check and balance against almost unbridled management power.[555] Others question this by noting the general passivity of institutional investors.[556] There are notable exceptions[557] and there have been for some time well founded suspicions that institutional investors participate in a reasonable amount of action behind the scenes.[558] There is some recent empirical research about the role played by institutions in modern corporate governance which supports this. The evidence is that there is routine dialogue between institutions and management on various topics, but usually on common structural matters (eg separation of role of chairperson and CEO) rather than firm specific issues.[559] Institutions are rarely proactive in firm specific matters and only will be if shareholder rights are at stake or there is an acute financial crisis.[560] A plethora of reasons explain this continuing relative passivity, namely coordination costs,[561] conflicting interests,[562] "race to the exit" scenarios,[563] small shareholdings and traditional

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555 Monks and Minnow, *Power and Accountability* (Harper Collins, Great Britain, 1991) at Chapters 6 and 7; Koppes, 'Corporate Governance As A Key To Global Competitiveness' (paper presented at a conference 'Corporate Governance & Australian Competitiveness: The Role Of Institutional Investors' organised by the Australian Investment Managers Group, Sydney, 11 November 1993); Stewart, 'The King is Dead' (1993) 64 Charter 10.

556 Tomasic and Bottomley, *Directing The Top 500* (Allen & Unwin, New South Wales, 1993) at 155; Coffee, 'Liquidity Versus Control: The Institutional Investor as Corporate Monitor' (1991) 91 Columbia Law Review 1277 at 1281 to 1290; Rock, 'The Logic and (Uncertain) Influence of Institutional Shareholder Activism' (1991) 79 The Georgetown Law Journal 445 at 452 and 505 to 506.

557 The push by institutional investors for a change to the composition of the Board of Coles Myer being a recent example: see Westfield and Gluyas, 'Clark To Lead Coles Revamp' *The Australian*, 25 October 1995 at 25. Farrar and Russell, 'The Impact of Institutional Investment on Company Law' 5 The Company Lawyer 107 at 109 document the pressure put by institutional investors on the manufacturers of thalidomide to significantly increase (from £3.25 million to £21.75 million) the settlement paid to victims of that drug. For other examples see Hill, 'Institutional Investors and Corporate Governance in Australia' at 601 to 602 in Baums, Buxbaum and Hopt (eds), *Institutional Investors and Corporate Governance* (Walter de Gruyter, Berlin 1993).

558 Farrar and Russell, 'The Impact of Institutional Investment on Company Law' 5 The Company Lawyer 107 at 109; Griffin, 'Institutional Investors In Australia: A Shareholders Perspective' (paper presented at a conference 'Corporate Governance & Australian Competitiveness: The Role Of Institutional Investors' organised by the Australian Investment Managers Group, Sydney, 11 November 1993) at 6; Brancato, 'Creating Relationships Between Institutional Investors and Corporations: the U.S. Experience' (paper presented at a conference 'Corporate Governance & Australian Competitiveness: The Role Of Institutional Investors' organised by the Australian Investment Managers Group, Sydney, 11 November 1993) at 10; Davies, 'Institutional Investors: A U.K. View' (1991) 57 Brooklyn Law Review 129 at 130.

559 Stapledon, *Institutional Investors and Corporate Governance* (Clarendon Press, Oxford, 1996) at 100 to 106 and 184 to 185; and Holland, 'Self Regulation and the Financial Aspects of Corporate Governance' [1996] Journal of Business Law 127, at 136 to 138.

560 Black and Coffee, 'Hail Britannia?: Institutional Investor Behaviour Under Limited Regulation' (1994) 92 Michigan Law Review 1997 at 2041 and 2053 to 2055; and Stapledon, *Institutional Investors and Corporate Governance* (Clarendon Press, Oxford, 1996) at 121 to 129 and 147 to 149.

561 Black and Coffee, 'Hail Britannia?: Institutional Investor Behaviour Under Limited Regulation' (1994) 92 Michigan Law Review 1997 at 2055 to 2059; Stapledon, *Institutional Investors and Corporate Governance* (Clarendon Press, Oxford, 1996) at 268.

562 Black and Coffee, 'Hail Britannia?: Institutional Investor Behaviour Under Limited Regulation' (1994) 92 Michigan Law Review 1997 at 2059 to 2061; Stapledon, *Institutional Investors and Corporate Governance* (Clarendon Press, Oxford, 1996) at 264 to 266 and 269 to 270; Holland, 'Self Regulation and the Financial Aspects of Corporate Governance' [1996] Journal of Business Law 127 at 154 to 155; and Eisenberg, *The Structure of Corporate Law* (1989) 89 Columbia Law Review 1461 at 1476.

free rider problems,[564] the difficulty of forming coalitions amongst competitors,[565] legal barriers,[566] the role of political history and the fear of political intervention,[567] organisational capability,[568] fund manager performance measurement,[569] the increased level of index investments,[570] information constraints,[571] lack of homogeneity amongst institutional investors,[572] problems associated with multinational companies,[573] presence of a non-institutional controlling shareholder,[574] cronyism and convergence of interests between the senior personnel of institutions and companies,[575] capture of institutional investors by management because of other business relationships with the company,[576] and the ability of companies to discriminate between their treatment of investors (particularly by selectively withholding voluntary information).[577] Although the evidence indicates that the level of active monitoring of institutional investors is rising, the bottom line remains that they have not yet shown the will or ability to consistently

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563 Black and Coffee, 'Hail Britannia?: Institutional Investor Behaviour Under Limited Regulation' (1994) 92 Michigan Law Review 1997, at 2061 to 2063; Stapledon, *Institutional Investors and Corporate Governance* (Clarendon Press, Oxford, 1996) at 253 to 255.

564 Black and Coffee, 'Hail Britannia?: Institutional Investor Behaviour Under Limited Regulation' (1994) 92 Michigan Law Review 1997, at 2063 to 2064; Stapledon, *Institutional Investors and Corporate Governance* (Clarendon Press, Oxford, 1996) at 255 to 258.

565 Black and Coffee, 'Hail Britannia?: Institutional Investor Behaviour Under Limited Regulation' (1994) 92 Michigan Law Review 1997 at 2064.

566 Hill, 'Institutional Investors and Corporate Governance in Australia' at 603 to 607 in Baums, Buxbaum and Hopt (eds), *Institutional Investors and Corporate Governance* (Walter de Gruyter, Berlin 1993); Black and Coffee, 'Hail Britannia?: Institutional Investor Behaviour Under Limited Regulation' (1994) 92 Michigan Law Review 1997 at 2064 to 2066; Stapledon, *Institutional Investors and Corporate Governance* (Clarendon Press, Oxford, 1996) at 271 to 275; and Farrar, 'Legal Restraints On Institutional Investor Involvement In Corporate Governance', paper prepared for the Australian Investment Managers Group, December 1993.

567 Black and Coffee, 'Hail Britannia?: Institutional Investor Behaviour Under Limited Regulation' (1994) 92 Michigan Law Review 1997 at 2066 to 2068; Stapledon, *Institutional Investors and Corporate Governance* (Clarendon Press, Oxford, 1996) at 270 to 271; Holland, 'Self Regulation and the Financial Aspects of Corporate Governance' [1996] Journal of Business Law 127 at 152 to 153.

568 Black and Coffee, 'Hail Britannia?: Institutional Investor Behaviour Under Limited Regulation' (1994) 92 Michigan Law Review 1997 at 2068 to 2073; Stapledon, *Institutional Investors and Corporate Governance* (Clarendon Press, Oxford, 1996) at 261 to 263.

569 Hadden, 'Corporate Governance By Institutional Investors? Some Problems From an International Perspective' at 93 to 95 in Baums, Buxbaum and Hopt (eds), *Institutional Investors and Corporate Governance* (Walter de Gruyter, Berlin 1993); Stapledon, *Institutional Investors and Corporate Governance* (Clarendon Press, Oxford, 1996) at 258 to 260.

570 Stapledon, *Institutional Investors and Corporate Governance* (Clarendon Press, Oxford, 1996) at 263 to 264.

571 Above at 266 to 267; and Black and Coffee, 'Hail Britannia?: Institutional Investor Behaviour Under Limited Regulation' (1994) 92 Michigan Law Review 1997 at 2048.

572 Stapledon, *Institutional Investors and Corporate Governance* (Clarendon Press, Oxford, 1996) at 267 to 268.

573 Hadden, 'Corporate Governance By Institutional Investors? Some Problems From an International Perspective' at 98 to 100 in Baums, Buxbaum and Hopt (eds), *Institutional Investors and Corporate Governance* (Walter de Gruyter, Berlin 1993).

574 Stapledon, *Institutional Investors and Corporate Governance* (Clarendon Press, Oxford, 1996) at 268 to 269.

575 Holland, 'Self Regulation and the Financial Aspects of Corporate Governance' [1996] Journal of Business Law 127 at 155.

576 Jensen and Warner, 'The Distribution of Power Among Corporate Managers, Shareholders and Directors' (1988) 20 Journal Of Financial Economics 3 at 11 to 12.

577 Holland, 'Self Regulation and the Financial Aspects of Corporate Governance' [1996] Journal of Business Law 127 at 155 to 156.

and proactively monitor all the companies in which they invest.[578] However nobody doubts that institutional investors potentially can play a significant if not dominant role in the governance of the companies in which they invest.[579]

One key to this potential being realised is the quality of the information which institutional shareholders receive. Notably institutional shareholders are in a unique position to understand, interpret and analyse this information (and to accordingly take appropriate action). This is because the investing role has become professionalised.[580] Institutional investors either have qualified professionals in-house to digest this information or have access to professional advisers to assist them. In addition it has been recognised that institutions are not only able to fully appreciate the information they receive but they also receive superior information. This view has been expressed in the following terms:

> First, institutions generally have greater resources than do individual investors to allocate towards gathering and analysing firm-related information. Second, economies of scale and professional expertise give institutional investors lower marginal costs in acquiring information, resulting in the acquisition of more information of higher quality. Third, some institutional investors (such as insurance companies, commercial banks, and non-bank trusts) may have business relations with the firm that give them access to information not available to individual investors.[581]

(This is beneficial for institutional investors but is problematic in the context of insider trading laws[582] designed to ensure equality of information amongst all investors).

The increasing prominence of institutional investors is particularly pertinent in assessing the understandability of information. This is also tied to the Efficient Capital Markets Hypothesis, which I discuss under the next heading.

The other significant but different group of investors are individual investors. Individual investors are a diverse group with a range of educational backgrounds.[583] There is a

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578 Parkinson, *Corporate Power and Responsibility* (Clarendon Press, Oxford, 1993) at 166 to 177. See also Stapledon, *Institutional Investors and Corporate Governance* (Clarendon Press, Oxford, 1996) particularly his conclusions at 78; 153 to 154, 176 and 203.

579 Farrar and Russell, 'The Impact of Institutional Investment on Company Law' 5 The Company Lawyer 107 at 108. Coffee argues that this potential will only come about if there are structural changes to the environment in which institutional investors operate; Coffee, 'Liquidity Versus Control: The Institutional Investor as Corporate Monitor' (1991) 91 Columbia Law Review 1277 particularly at 1338. See also Johnson, 'An Insiders Call for Outside Direction' (1990) Harvard Business Review 46 at 52.

580 Historically documented in Clark, 'The Four Stages of Capitalism: Reflections on Investment Management Treatises' (1981) 94 Harvard Law Review 561 at 564. See also Johnson, 'An Insiders Call for Outside Direction' (1990) Harvard Business Review 46 at 48.

581 Szewczyk, Tsetsekos and Varma, 'Institutional Ownership and the Liquidity of Common Stock Offerings' (1992) 27 The Financial Review 211 at 214. See also Coffee, 'Liquidity Versus Control: The Institutional Investor as Corporate Monitor' (1991) 91 Columbia Law Review 1277 at 1323 to 1324. In the U.K. the Institutional Shareholders Committee encourages regular and systematic communication between institutional investors and the senior executives of a company; see Cadbury Committee, *The Financial Aspects of Corporate Governance* (Gee, Great Britain, 1992) at paragraph 6.11.

582 CL Pt 7.11 Division 2A. See Farrar and Russell, 'The Impact of Institutional Investment on Company Law' 5 The Company Lawyer 107 at 111.

583 Baker and Haslam, 'Information Needs of Individual Investors' in Courtis (ed), *Corporate Annual Report Analysis* (Dept of Accounting and Financial Management, Armidale, 1978) 105 at 106 to 107.

current trend to increased share ownership by individual investors.[584] As at March 1996 individual shareholders held 13.2% of the market[585] but a year later they held 18.5%.[586] This rose to 20.2% in 1998.[587] This seems to have arisen by increased participation by individual investors in some the large offerings in what were previously government owned organisations such as the Commonwealth Bank and Telstra.[588] Most of these recent acquisitions were made via, or are managed by, a financial intermediary.[589] However this does not detract from the increasing prominence of institutional investors whose percentage holding of the overall market is still slightly increasing. Individual investors shareholding is increasing but government holdings are falling due to the sell off of the above mentioned government owned organisations and holdings by other companies has also decreased.[590]

4.6 SHAREHOLDERS AS INVESTORS

Introduction

Investors are people and institutions with sufficient funds so that they are seeking to place those funds with someone else with the expectation of making a profit. Investors become shareholders when they choose to invest in company shares rather than placing their money in other types of investments such as bank deposit, mortgage finance, government bonds or real estate.[591] A particular investment decision is not irrevocable. One of the hallmarks of shares is that they are private property and generally freely transferable.[592] Shareholders therefore have a fluid investment. They are vitally concerned whether to hold, increase or reduce (or quit altogether) their investment in a particular company.[593] What decision shareholders make will be based on the same types of factors that influenced their initial decision. Some of those factors relate to the value of the shares including their current market value compared with their initial purchase price and their expected rate of return (anticipated dividend stream)[594] minus the relevant

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584 Australian Stock Exchange, *1997 Australian Share Ownership Survey* (Australian Stock Exchange, Australia, 1997).

585 Australian Stock Exchange Limited, *1996 Market Report* at 7.

586 Australian Stock Exchange Limited, *1997 Market Report* at 6.

587 Ford, Austin and Ramsay, *Ford's Principles of Corporations Law* (Butterworths, Sydney, 9th ed., 1999) at [17.090].

588 Hill, 'Institutional Investors and Corporate Governance in Australia' at 590 in Baums, Buxbaum and Hopt (eds), *Institutional Investors and Corporate Governance* (Walter de Gruyter, Berlin 1993).

589 Australian Stock Exchange, *1997 Australian Share Ownership Survey* (Australian Stock Exchange, Australia, 1997) at 8 to 9; Australian Stock Exchange Limited, *1997 Market Report* at 7.

590 See the comparison between Australian Stock Exchange Limited, *1996 Market Report* at 7 and Australian Stock Exchange Limited, *1997 Market Report* at 6 to 7.

591 Easterbrook and Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, USA, 1991) at 4.

592 Clark, *Corporate Law* (Little, Brown and Company, U.S.A., 1986) at 13 to 15. The *First Corporate Law Simplification Act* 1995 (Cth) removed the requirement on proprietary companies to restrict the right to transfer its shares (previously set out in CL s116(a)).

593 The ability of shareholders to quit their investment is commonly used by institutional investors who are dissatisfied with the performance of a company. This is commonly called the Wall Street Rule; see Rock, 'The Logic and (Uncertain) Influence of Institutional Shareholder Activism' (1991) 79 The Georgetown Law Journal 445 at 462 to 463.

594 Information about future earnings is the most predominant method of valuing/pricing shares even though other methods exist (such as the capital value of the corporations underlying assets);

transaction costs.[595] Other factors include the shareholders current financial position, the then rate of return of other investments, taxation implications and the state of the economy generally.[596] As discussed earlier in this chapter, companies incorporated under the Corporations Law are appropriate vehicles for such investments because that is their very purpose; they exist to make money for shareholders. Shareholders are principally concerned to make a profit and that is why they have chosen to invest in "for profit" organisations rather than other types of organisations.[597] In order to make rational investment decisions shareholders must have access to reliable information concerning the value of their investment. This will primarily be, but not limited to, the financial statements.

This reality of shareholders as investors[598] and the nature of "for profit" companies is almost a dirty word in corporate law circles. There is not one word in the Corporations Law, Listing Rules or standard constitutions that explicitly recognises this reality.[599] This silence is absurd. However the reality that shareholders are investors and are able to quit their investment at any time should always be kept in mind. The ability of shareholders to quit their investment should be recognised as a useful self-help remedy but the importance of this option should not be overstated. Quitting is a useful option to have but it can also operate oppressively and turned against those who have this option (if you don't like the situation, get out).[600] Certainly it should not be viewed as the only option open to shareholders.

From the relatively simple proposition of shareholders as investors two broader and related issues require examination. The first is the efficient capital markets hypothesis (ECMH) and the argument that the capital and takeover markets are one of the mechanisms which constrain managers tendency to act in their own interests rather than in the interests of the company. These require examination because otherwise the notion of shareholders as investors suggests individuals operating independently and in isolation. This is far from the truth; shareholders act within dynamic markets and are influenced by the actions of their fellow shareholders. These arguments also inform the policy behind some mandatory disclosure rules and impact on the issue of the understandability of information.

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see Gilson and Kraakmann, 'The Mechanisms of Market Efficiency' (1984) 70 Virginia Law Review 549 at 561.

595 The transactions costs in the sale and purchase of shares include brokers fees, stamp duty, capital gains taxes and the value of the shareholders own time in completing the transaction.

596 It probably is not possible to list all the factors which motivates people to make particular investment decisions. Noise theory, which I discuss below posits that investors also often make irrational investment decisions. This seems at least partially correct but is not pervasive. In my opinion noise theory does not undercut the need to provide relevant information for those investors who wish to make rational decisions (or who elect to make irrational decisions with their eyes open).

597 For example one defining feature of incorporated associations is that they are prohibited from passing on any profit to their members; see *Associations Incorporation Act* (S.A.) 1985 ss 18(5) and(6) and 55. Corporations are not the only type of "for profit" organisation; others include partnerships and joint ventures. But other key features of corporations, such as limited liability, perpetual succession and centralised management, make them a very suitable and common vehicle for business enterprises.

598 Hill, 'The Shareholder as Cerberus: Redefining the Shareholder's Role in Modern Australian Corporate Law', paper presented at the 1995 Corporate Law Teachers Conference' (copy on file of author) at 13 to 15.

599 The same silence exists in the US; see Clark, *Corporate Law* (Little, Brown and Company, U.S.A., 1986) at 678.

600 As it can in the employment context.

The Efficient Capital Markets Hypothesis

The ECMH moves away from looking at how individual investors make investment decisions. The ECMH posits that investors as a group of buyers and sellers efficiently price shares by using information. The sharemarket is efficient if the market in pricing shares comes to rational and unbiased decisions on the perceived value of shares and reacts spontaneously to new and relevant information; the result being that share prices fully reflect all information.[601] The ECMH is at least plausible because of the spreadable nature of information.[602] Several assumptions underpin the ECMH which are linked to the notion of a market. Those assumptions are that "there are a large number of participants such that the actions of any individual participant cannot materially affect the market; participants are fully informed, have equal access to the market, and act rationally; the commodity is homogenous; and there are no transaction costs".[603] The champions of the ECMH point to a significant amount of empirical research in support of it.[604] The ECMH dates from the mid-1960's[605] but quickly gained widespread acceptance culminating in a well-known economist stating that "there is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Market Hypothesis".[606]

The emphasis of the ECMH is the efficiency of the market, supported by the underlying assumptions. It is important to recognise that the ECMH involves much more than the simple and undeniable notion that investors use information in making their investment decisions.[607] There are three forms of efficiency under the ECMH; weak, semi-strong and strong.[608] The three forms of the ECMH have been defined as:

- weak-form efficiency - the information contained in the past sequence of prices of a security is fully reflected in the current market price of that security;
- semi- strong-form efficiency - all publicly available information is fully reflected in a security's current market price; and

601 For a slightly different definition see Blair and Ramsay, 'Mandatory Corporate Disclosure Rules and Securities Regulation' in Walker and Fisse (eds.), *Securities Regulation in Australia and New Zealand* (Oxford University Press, Auckland, 1994) at 275; see also Gilson and Kraakmann, 'The Mechanisms of Market Efficiency' (1984) 70 Virginia Law Review 549 at 554 to 557; Cunningham, 'From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Markets Hypothesis' (1994) 62 The George Washington Law Review 546 at 559.

602 See chapter 2.3.

603 Cunningham, 'From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Markets Hypothesis' (1994) 62 The George Washington Law Review 546 at 559.

604 For example see the empirical studies listed in Keane, *The Efficient Market Hypothesis: and the Implications for Financial Reporting* (Gee and Co., Great Britain, 1980) at 9 to 12; Blair and Ramsay, 'Mandatory Corporate Disclosure Rules and Securities Regulation' in Walker and Fisse (eds.), *Securities Regulation in Australia and New Zealand* (Oxford University Press, Auckland, 1994) at 276.

605 Cunningham, 'From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Markets Hypothesis' (1994) 62 The George Washington Law Review 546 at 558 to 559.

606 Jensen, 'Some Anomalous Evidence Regarding Market Efficiency' (1978) 6 Journal of Financial Economics 95 at 95. This statement is often quoted in the literature see for example Langevoort, 'Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited' (1992) 140 University of Pennsylvania Law Review 851 at 853.

607 Langevoort, 'Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited' (1992) 140 University of Pennsylvania Law Review 851 at 898 ("The efficient market hypothesis cannot take credit for the insight that information affects prices.").

608 This three tier classification is traced to the seminal article Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 J. Fin 383.

- strong- form efficiency - all information, whether public or private, is fully reflected in a security's current market price.[609]

The ECMH has been subjected to a range of criticisms, including:

- a rejection of the strong form of the ECMH largely on the basis of empirical research that insiders who have access to non-public information about the company outperform the market in trading in the company's shares.[610] This position finds reality in laws which prohibit insider trading;
- that the ECMH is just a theory and should not necessarily be treated as accurately reflecting reality;[611]
- stock markets are not uniformly efficient because efficiency depends on a certain volume of trading and most trading occurs in the biggest listed companies. Thus the market for smaller companies whose shares are thinly traded are not as price efficient;[612]
- noise theorists who argue that investors do not always act rationally;[613] rather they sometimes act based on broader psychological considerations such as their emotions, intuition and by peer/group pressure (resulting in rumours and fads).[614] As a result information unrelated to the fundamental value of a security is incorporated into its price; the net effect is that share prices do not necessarily reflect underlying values. Noise theorists draw support from psychological studies,[615] empirical research of capital markets[616] and anecdotal evidence from participants in the market

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609 Blair and Ramsay, 'Mandatory Corporate Disclosure Rules and Securities Regulation' in Walker and Fisse (eds.), *Securities Regulation in Australia and New Zealand* (Oxford University Press, Auckland, 1994) at 276. See also Cunningham, 'From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Markets Hypothesis' (1994) 62 The George Washington Law Review 546 at 560; Keane, *The Efficient Market Hypothesis: and the Implications for Financial Reporting* (Gee and Co., Great Britain, 1980) at 6 to 7.

610 Seligman, 'The Historical Need for a Mandatory Corporate Disclosure System' (1983) 9 J. Corp. L. 1 at fn 22; Cunningham, 'From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Markets Hypothesis' (1994) 62 The George Washington Law Review 546 at 562; Langevoort, 'Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited' (1992) 140 University of Pennsylvania Law Review 851 at fn 7.

611 This was essentially the position taken by Justices White and O'Connor in *Basic Inc v Levinson* (1988) 485 U.S. 224.

612 Blair and Ramsay, 'Mandatory Corporate Disclosure Rules and Securities Regulation' in Walker and Fisse (eds.), *Securities Regulation in Australia and New Zealand* (Oxford University Press, Auckland, 1994) at 276; Headrick, 'The A to B of Our Two Stockmarkets: How Regulation Affects Big and Small' (1992-March) JASSA 2; Cox, 'Institutional Ownership in a Changing World: Is There a Need for a Segmented Market?' paper presented at a conference "Corporate Governance & Australian Competitiveness: The Role of Institutional Investors" conducted by the Business Council of Australia and the Australian Investment Managers Group on 11 November 1993; for similar evidence from Canada see Daniels and MacIntosh, 'Toward a Distinctive Canadian Corporate Law Regime' (1991) 29 Osgoode Hall Law Journal 863 at 877 to 879.

613 The original noise theorist is Black, 'Noise' (1986) 41 The Journal of Finance 529.

614 Langevoort, 'Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited' (1992) 140 University of Pennsylvania Law Review 851 at 866 to 872; Cunningham, 'From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Markets Hypothesis' (1994) 62 The George Washington Law Review 546 at 563 to 566; Shleifer and Summers, 'The Noise Trader Approach to Finance' (1990) 4 J. Econ. Perspectives 19.

615 Langevoort, 'Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited' (1992) 140 University of Pennsylvania Law Review 851 at 858 to 861.

616 Above at 869; Cunningham, 'From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Markets Hypothesis' (1994) 62 The George Washington Law Review 546 at 565.

acknowledging their partial irrationality.[617] Noise theorist have been seriously questioning the accuracy of the ECMH from the mid-1980's;[618] and

- chaos theory which arguably renders the ECMH invalid.[619] The argument is that the ECMH was drawn from research which showed that successive changes to the price of securities were random (described as the random walk model).[620] These price changes were statistically random; the studies did not look to ascertain reasons for the changes. This randomness was drawn from linear statistical tests that compared prices over certain time periods.[621] The ECMH developed in response to this research to provide the reason for these seemingly random price changes.[622] Chaos theory challenges the ECMH because it challenges linear mathematical models. Under chaos theory "there is a pattern to the seeming randomness of physical events occurring in the universe".[623] The authors drew from empirical research that established that capital markets did not operate on a linear basis.[624] From this and other research the authors concluded that capital markets conformed to chaos theory.[625] They particularly drew from the share market crash of October 1987 which defies any rational explanation based on either the ECMH or noise theory.[626] They argued that the ECMH was invalid because it was an oversimplification; the ECMH was not a complete explanation of sharemarket behaviour. The authors believed that investors still require relevant information and act on it, but that changes to share prices were determined by "deeper structural forces".[627]

Despite these criticisms[628] the weak and semi-strong forms of the ECMH, which originated in the US, enjoys continued widespread acceptance in that country.[629] The chief corporate regulatory body in that country, the Securities and Exchange Commission, utilises the doctrine in formulating corporate laws[630] and it has also been

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617 Langevoort, 'Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited' (1992) 140 University of Pennsylvania Law Review 851 at 852 and 868. Adherents to the ECMH explain away irrational trading as anomalous and to ultimately cancel each other out in the market; see Langevoort at 862; Manne, 'Mergers and the Market for Corporate Control' (1965) 73 J. Pol. Econ. 110 at fn 10.

618 Langevoort, 'Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited' (1992) 140 University of Pennsylvania Law Review 851 at 866 to 868.

619 Cunningham, 'From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Markets Hypothesis' (1994) 62 The George Washington Law Review 546.

620 Above at 551 to 553.

621 Above at 553 to 558.

622 Above at 558 to 563.

623 Above at 547 and 582.

624 Above at 571 to 581.

625 Above at 589 to 592.

626 Above at 593 to 594.

627 Above at 608. The authors do not identify these deeper structural forces, seeing its identification as "a new chapter".

628 The last two criticisms are themselves theories and are therefore subject to the criticism that they are just theories and do not necessarily reflect reality. See Langevoort, 'Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited' (1992) 140 University of Pennsylvania Law Review 851 at 855 to 856.

629 Twenty years after his original article Fama revisited the ECMH and concluded that it still had merit: see Fama, 'Efficient Capital Markets: II' (1991) 46 The Journal of Finance 1575; see also Gilson and Kraakmann, 'The Mechanisms of Market Efficiency' (1984) 70 Virginia Law Review 549 at 549 to 550. See also Epstein and Pava, *The Shareholder's Use of Corporate Annual Reports* (JAI Press, Connecticut, 1993) at 52 to 58.

630 Gilson and Kraakmann, 'The Mechanisms of Market Efficiency' (1984) 70 Virginia Law Review 549 at 550; Cunningham, 'From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Markets Hypothesis' (1994) 62 The George Washington Law Review 546 at

explicitly endorsed by the US Supreme Court.[631] In Australia the ECMH also seems to form the policy basis of several laws including the continuous disclosure rules[632] and the truncated prospectus requirements for corporations subject to the continuous disclosure regime.[633] These laws only make sense with a background understanding of the ECMH. To some extent this continued acceptance of the ECMH is attributable to the joint hypothesis problem. Whether securities are properly priced depends upon somebody being able to arrive at a correct price for the securities. A correct price depends on there being an objective asset-pricing model for corporations. So far such a model has not been developed. Therefore it is not possible to unambiguously say from empirical evidence whether or not the market properly prices assets.[634]

The ECMH also informs the understandability of information. In particular it illuminates the extent to which complex and sophisticated information, particularly the financial statements, should be understandable to less sophisticated investors. I examine this issue a little later in this chapter.

As stated above, the ECMH still enjoys widespread acceptance. The ECMH is posited on shareholders receiving relevant information concerning the value of their investments.

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548. Both of these articles cite the integrated disclosure system adopted by the SEC, whereby information already in the public domain does not have to be repeated in a subsequent prospectus, as support for ECMH. But compare with Langevoort, 'Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited' (1992) 140 University of Pennsylvania Law Review 851 at 873 to 889 who argues that reliance on ECMH was not a necessary justification for integrated disclosure.

631 *Basic Inc v Levinson* (1988) 485 U.S. 224 where the US Supreme Court adopted the fraud on the market theory. The US Supreme Court defined this theory, quoting from a previous case, in the following terms:

> The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business....Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements....The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.

See also Gilson and Kraakmann, 'The Mechanisms of Market Efficiency' (1984) 70 Virginia Law Review 549 at 550; Cunningham, 'From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Markets Hypothesis' (1994) 62 The George Washington Law Review 546 at 548; Langevoort, 'Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited' (1992) 140 University of Pennsylvania Law Review 851 at 889 to 912.

632 LR 3.1 and CL s1001A, discussed at chapter 10.2.

633 CL s1022AA. See Blair and Ramsay, 'Mandatory Corporate Disclosure Rules and Securities Regulation' in Walker and Fisse (eds.), *Securities Regulation in Australia and New Zealand* (Oxford University Press, Auckland, 1994) at 277 to 280. The ECMH has been explicitly endorsed in support of amending the Corporations Law in the following terms:

> The government considers it essential that there be timely disclosure of relevant information about the financial position and prospects of entities in which Australians invest. It is essential to enable informed judgments on investment decisions, whether made by individual Australians or by large institutional investors. In every case the principle is the same-disclosure of relevant information about an investment and access to such information, either directly or through advisers, is necessary to ensure an equitable and efficient investment system.

See the second reading speech for the *Corporate Law Reform Bill (No. 2)* 1992, quoted in Blair and Ramsay, 'Mandatory Corporate Disclosure Rules and Securities Regulation' in Walker and Fisse (eds.), *Securities Regulation in Australia and New Zealand* (Oxford University Press, Auckland, 1994) at 264.

634 Fama, 'Efficient Capital Markets: II' (1991) 46 The Journal of Finance 1575 at 1575 to 1576; Cunningham, 'From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Markets Hypothesis' (1994) 62 The George Washington Law Review 546 at 569.

The hypothesis therefore strongly supports the view of shareholders as investors and who must receive timely and relevant information. Therefore the law should ensure that shareholders receive all relevant information so they can make rational investment decisions.

Market Discipline

The second major argument concerning the capital and takeover markets (and other markets) is that they have a disciplining effect on directors and therefore hold them accountable. The capital market is the relevant market when companies makes an issue of new shares (often described as the primary market). The argument is that if the company is performing poorly then potential purchasers of the shares price the new shares accordingly (ie at a lower price). This will make the task of raising more capital more difficult (including the ability to locate underwriters) and more expensive.[635] That shareholders as investors require information when new shares are issued is recognised by the law which requires a prospectus to be issued. I discuss prospectuses in chapter 8.3.

However most attention focuses on the takeover market. The argument is that less efficiently managed companies or companies where managers are acting in their own interests[636] will experience a net exodus of investors and hence the share price will decline.[637] Declining prices represents an opportunity for those who consider they can manage the company more efficiently and increase the worth of the company and therefore the value of the shares. Such people may well consider a takeover of the company. This dynamic has been described in the following terms:

> Share price, or that portion reflecting managerial inefficiency, also measures the potential capital gain inherent in the corporate stock. The lower the stock price, relative to what it could be with more efficient management, the more attractive the take-over becomes to those who believe they can mange the company more efficiently. And the potential return from the successful takeover and revitalisation of a poorly run company can be enormous.[638]

There are limitations to, and criticisms of, this understanding of the takeovers market, including:

- there being other explanations for takeovers including the benefits of synergy, the desire of bidders to empire build and exploitation of temporary depressions in price.[639] These and other reasons for takeovers[640] should not be regarded as mutually

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635 Jensen, 'Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers' (1986) 76 The American Economic Review 323 at 323 and 324.

636 Dodd and Officer, *Corporate Control, Economic Efficiency and Shareholder Justice* (Centre for Independent Studies, Australia, 1986) at 2 to 3.

637 Manne, 'Mergers and the Market for Corporate Control' (1965) 73 J. Pol. Econ. 110 at 112 where Manne states that "A fundamental premise underlying the market for corporate control is the existence of a high positive correlation between corporate managerial efficiency and the market price of shares of that company".

638 Manne, 'Mergers and the Market for Corporate Control' (1965) 73 J. Pol. Econ. 110 at 113. See also Coffee, 'Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance" (1984) 84 Columbia Law Review 1145 at 1152 and 1163 to 1166; Lavarch Committee, Corporate Practices and the Rights of Shareholders, (AGPS, Canberra, 1991) at paragraph 3.3.2; Dodd and Officer, *Corporate Control, Economic Efficiency and Shareholder Justice* (Centre for Independent Studies, Australia, 1986) at 2 and 9 to 11 who speak in terms of assets being transferred to those who can more effectively use them.

639 Coffee, 'Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance' (1984) 84 Columbia Law Review 1145 at 1166 to 1173.

exclusive but rather all "have a partial validity and may accurately describe the motivations underlying some (but not all) takeovers".[641] The inconclusive empirical and other evidence which both contradicts and affirms the justification for takeovers being the removal of inefficient management supports this conclusion;[642]

- takeovers occur within a limited range. Given the high costs of a takeover, so long as the cost of a relatively poor managerial performance is less than these costs there will not be a takeover.[643] Also companies whose management is grossly inefficient so that the company is financially distressed are "relatively immune to takeovers, either because no turnaround seems likely or because the level of risk associated with these companies makes them unattractive candidates for acquisition";[644]
- the frequency of takeovers fluctuates and therefore the reality of takeover and its disciplining effects also varies.[645] A reading of recent annual reports of the ASIC/ASC reveals the following number of takeovers in the past few years:

Year	**Number of Takeovers**
1992/93	69
1993/94	75
1994/95	64
1995/96	96
1996/97	75
1997/98	76

Even greater fluctuations are evident from previous years.[646] The force of these fluctuations is dampened when it is appreciated that the threat or risk of a takeover itself operates to energise managers to greater efficiency;[647]

- does not deal with one off defalcations by managers;[648] and

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640 Lavarch Committee, *Corporate Practices and the Rights of Shareholders* (AGPS, Canberra, 1991) at paragraphs 3.3.3 and 3.3.4. Jensen, 'Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers' (1986) 76 The American Economic Review 323 at 323 and 324 argues that bidders with free cash flow they refuse to pay to shareholders undertake sub-optimal takeovers and such companies are also potential targets (because they are a cash box).

641 Coffee, 'Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance' (1984) 84 Columbia Law Review 1145 at 1173.

642 Above at 1206 to 1215.

643 Above at 1200 to 1204; Manne, 'Mergers and the Market for Corporate Control' (1965) 73 J. Pol. Econ. 110 at 117.

644 Coffee, 'Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance' (1984) 84 Columbia Law Review 1145 at 1204.

645 Ramsay, 'Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) UNSW Law Journal 149 at 154; Coffee, 'Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance' (1984) 84 Columbia Law Review 1145 at 1215; and Stapledon, *Institutional Investors and Corporate Governance* (Clarendon Press, Oxford, 1996) at 15 to 16.

646 Ramsay, 'Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) UNSW Law Journal 149 at 154 where the following statistics appear:

Year	Number of Takeovers
1988	289
1989	179
1990	97
1991	86

647 Coffee, 'Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance' (1984) 84 Columbia Law Review 1145 at 1192 to 1195 (which Coffee describes as "the general deterrent effect of the hostile takeover").

648 Easterbrook and Fischel, 'Corporate Control Transactions' (1982) 91 Yale Law Journal 698 at 701; Ramsay, 'Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) UNSW Law Journal 149 at 155.

- defensive tactics adopted by incumbent managers which stifle if not thwart takeovers.[649]

Despite these criticisms and limitations the takeovers market clearly has a role in disciplining inefficient managers. Although given these limitations and criticisms it is inappropriate to champion takeovers to the extent of regarding them as the "only potentially serious force for limiting managerial discretion".[650]

The legitimate role of takeovers is recognised by their substantive regulation in chapter 6 of the Corporations Law. In particular the need of shareholders in the target corporation to make a rational decision based on relevant information is recognised by the specific information requirements in chapter 6.[651] These laws also recognise shareholders as investors and their need for pertinent information.

In some senses the decision to launch a takeover is a normal investment decision, but on a grand scale. A person decides to buy shares in the company but not just a small stake in the company. The takeover bidder wants at least sufficient shares to obtain control of the company.[652] Since the traditional justification for takeovers includes the removal of inefficient management then investment decisions are linked with monitoring management. This link is true even in the absence of a takeover. If shareholders monitor managers and are dissatisfied with their performance then they will want to take some form of action. Often the easiest and cheapest action is to sell their shares. In fact it is this very dynamic that leads to depressed share prices and makes the company a potential takeover target. Exit from the corporation by one shareholder relies on entry by another. The new entrant is necessarily drawn by the right to vote attached to the shares (assuming the validity of the market for corporate control).[653] But clearly for the takeover market to operate effectively investors must be provided with information concerning the efficiency of management.

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649 Ramsay, 'Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) UNSW Law Journal 149 at 154: Dodd and Officer, *Corporate Control, Economic Efficiency and Shareholder Justice* (Centre for Independent Studies, Australia, 1986) at 31 to 33; Pound, 'The Effects of Anti-takeover Amendments on Takeover Activity: Some Direct Evidence' (1987) 30 Journal of Law and Economics 353 (Pound concludes at 367 that "the evidence tends to support the view that [anti-takeover] amendments increase the bargaining power of management in the event of a control bid, to the detriment of shareholder wealth. The amendments appear to reduce the frequency of takeover bids significantly while not improving the expected value of shareholder gains in those takeover contests that do occur").

650 Gilson, 'A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers' (1981) 33 Stanford Law Review 819 at 841 (quoted in Coffee, 'Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance' (1984) 84 Columbia Law Review 1145 at fn 15). See also Stapledon, *Institutional Investors and Corporate Governance* (Clarendon Press, Oxford, 1996) at 14 who states that "contractarians place excessive reliance on market forces-especially the market for corporate control-as a means of monitoring corporate management". Similarly see Hill, 'Institutional Investors and Corporate Governance in Australia' at 598 in Baums, Buxbaum and Hopt (eds), *Institutional Investors and Corporate Governance* (Walter de Gruyter, Berlin 1993).

651 See chapter 8.3.

652 Bidders usually have as a condition to their takeover that they obtain 50.1% of the company's shares. However effective control can be obtained at less than 50%: see Dodd and Officer, *Corporate Control, Economic Efficiency and Shareholder Justice* (Centre for Independent Studies, Australia, 1986) at 4.

653 Buxbaum, 'The Internal Division of Powers in Corporate Governance' (1985) 73 California Law Review 1671 at 1672 states that the market for corporate control "is predicated on the existence of shareholder voting".

Understandability

I foreshadowed earlier that the ECMH and the rise of institutional investors raises the issue of the understandability of information. This is because the critical issue concerning understandability of information is understandable to whom (ie identifying audience). Institutional investors and also those who are potential takeover bidders are professionals. They have the education and skills to understand sophisticated information, the most sophisticated in the corporate context being the financial statements. This information is inherently complex and difficult to simplify.[654] So can information be pitched just at these people without any attempt to make it understandable to normal investors who are not professional investors? I think this is best analysed considering shareholders separately as investors and monitors.

As investors it is clear that institutional investors' superior professional skills enable them to analyse information and set the market price of shares. It is the professional investors who react quickly to new information and are the traders that underpin the ECMH. This is also a reflection of the world we all live in. We all live in a world of high and increasing complexity and sophistication where people can no longer be jack of all trades but are forced into increasingly narrow spheres of expertise.[655] Translated into the corporate context the decision to invest in shares has been professionalised.[656] Arguably the law should reflect this increased professionalism and not endeavour to force (if possible?) sophisticated corporate information, particularly the financial statements, to be understandable by the financially illiterate.[657] The reflects the reality that small investors can only hope to be followers of the more sophisticated investor, and thus carried on the tide of the larger market.[658] Although they are not leaders of the market they nonetheless participate in the market, the significance of which becomes apparent below.

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654 Ramsay, 'Models of Corporate Regulation: Command and Control Versus Facilitation' paper presented at the centenary celebration conference of *Salomon v Salomon*, University of Auckland, July 1997 (author on file) at 39.

655 For a general account of this see Mishima, *On Hagakure: The Samurai Ethic and Modern Japan* (Penguin, Great Britain, 1977) at 27.

656 Clark, 'The Four Stages of Capitalism: Reflections on Investment Management Treaties' (1981) 94 Harvard Law Review 561.

657 Keane, *The Efficient Market Hypothesis: and the Implications for Financial Reporting* (Gee and Co., Great Britain, 1980). However a contrary position was argued by Professor Baxt some 20 years ago: see Baxt, *The Rae Report — Quo Vadis?* (Butterworths, Melbourne, 1974) at 174. He argued that financial statements should be understandable by the average investor, not just the sophisticated institutional investor. However Professor Baxt questioned whether unsophisticated investors should be allowed to invest, or invest only at their risk, if the law (or the accounting profession) were not to insist on this degree of understandability. Baxt however conceded (at 175) that "in many situations investors will continue to spend their monies unthinkingly and uncritically, hoping to make a fast dollar even though the information that is contained includes information which they do not fully comprehend". In my opinion given that since this was written the ECMH has gained widespread acceptance and institutional investors have come to predominate. Therefore in my opinion Professor Baxt's opinion is outdated (although his concession may not be).

658 Cox, 'Institutional Ownership in a Changing World: Is There a Need for a Segmented Market?' paper presented at a conference 'Corporate Governance & Australian Competitiveness: The Role Of Institutional Investors' conducted by the Business Council Of Australia and the Australian Investment Managers Group on 11 November 1993; Ramsay, 'Models of Corporate Regulation: Command and Control Versus Facilitation' paper presented at the centenary celebration conference of *Salomon v Salomon*, University of Auckland, July 1997 (author on file) at 37.

As monitors[659] there is a strong argument that all shareholders have an interest in monitoring the affairs of the company.[660] As a matter of principle this is correct. It is lessened in practice to a significant extent by the reality that for small investors it is simply not economically viable for them to take costly monitoring activities. Given their small stake in the company then monitoring action such as a proxy contest to oust the directors or commencing legal proceedings is very expensive. The individual shareholder must bear the expense of this monitoring action yet if he or she is successful the benefits are shared by all shareholders. Therefore it is rational for small shareholders to remain apathetic.[661] In the economics literature this is the problem of free rider.[662] This argument however ignores the reality that the cheapest and easiest response of small shareholders who are dissatisfied with the performance of their directors and the company is to sell their shares. This, coupled with the discipline of the takeover market, provides some redress (perhaps not for the selling shareholders but overall). Although these small shareholders may not be on the cutting edge of the market they are nonetheless participants who can have an influence.

The arguments in the last paragraph point to the necessity to make this information understandable to small, unsophisticated investors. This conclusion is justified because shareholders should have power over their investments (ie. to make independent decisions based on their own assessment of the information presented to them). That is, providing understandable information enhances their personal autonomy.[663] This is a powerful argument in a traditionally liberal country which prizes personal autonomy. Also these types of investors arguably need more help than others, not only because of their unsophistication but because they often do not have a diversified portfolio.[664]

There is one general counter argument. The argument is that it is not the role of the company to educate their shareholders so they can understand particularly sophisticated information. Certainly in a political democracy there is a strong argument that the government has a responsibility to provide a general education to its citizens so they can

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659 There is an argument that shareholders are just investors who have no interest in monitoring; see Hill, 'The Shareholder as Cerberus: Redefining the Shareholder's Role in Modern Australian Corporate Law', paper presented at the 1995 Corporate Law Teachers Conference' (copy on file of author) at 13 to 15. However in my opinion this reasoning suffers from narrow either/or thinking, unacceptably divorces rights from responsibilities and ignores the designated role of shareholders in the company. In particular it ignores the reality that shares have voting rights (LR 6.9); i.e. that non-voting shares, which would turn shares simply into a dividend stream, and therefore legitimise the view of shareholders just as investors, are not permissible in Australia (c.f. the position in the U.S.; see Buxbaum, 'The Internal Division of Powers in Corporate Governance' (1985) 73 California Law Review 1671 at 1713 to 1719 who is critical of non-voting shares).

660 Keane, *The Efficient Market Hypothesis: and the Implications for Financial Reporting* (Gee and Co., Great Britain, 1980) at 24.

661 Ramsay, 'Models of Corporate Regulation: Command and Control Versus Facilitation' paper presented at the centenary celebration conference of *Salomon v Salomon*, University of Auckland, July 1997 (author on file) at 39.

662 Levmore, 'Monitors and Freeriders in Commercial and Corporate Settings' (1982) 92 The Yale Law Journal 49; Easterbrook and Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, USA, 1991) at 78. For an Australian summary of this literature see Ramsay and Blair, 'Ownership Concentration, Institutional Investment And Corporate Governance: An Empirical Investigation Of 100 Australian Companies' (1993) 19 MULR 153 at 158 to 159.

663 Personal autonomy is a traditional justification for freeedom of speech and the press, which is discussed in chapter 5.4 under the sub-heading "Role of the Media".

664 Henderson & Peirson, *Issues In Financial Accounting* (Longman Cheshire, Melbourne, 5th ed., 1992) at 11; Australian Stock Exchange, *1997 Australian Share Ownership Survey* (Australian Stock Exchange, Australia, 1997) at 20 to 21 (although the average holding has increased over the previous three years from 3 stocks to 5 stocks).

meaningfully participate in their representative form of government.[665] I establish in chapter 5 that there is a strong analogy between the governance of companies and a democratic style of government. But it is only an analogy and I do not consider it should extend to requiring companies to have an educative role. I hold this view since companies are not sovereigns and shareholders may invest in many companies. In addition the type of education required could well extend to an accountancy degree which requires several years of full time, tertiary study, which is clearly inappropriate.

So there are arguments and counter arguments. In my opinion the solution is a very pragmatic one. Wherever possible, information should be understandable to the unsophisticated investor. In most categories of information this should be achievable. However it must be recognised that certain information, particularly the financial statements, is by its nature complex and sophisticated. This information should be made as simple as possible, but if it nonetheless is difficult to understand by the unsophisticated investor then this lack of comprehension simply can not be realistically avoided. This is of less concern given the consequences of the ECMH and the problem of free rider.

Conclusion

The ECMH has credibility and reinforces the view of shareholders as investors. Indeed the ECMH is founded on needs of investors for information concerning the value of their investments. The reality of the capital and takeover markets is also self-evident and point to the need of shareholders and potential shareholders for pertinent information at these times. This need is recognised by the law requiring special information be provided to investors in each of these situations (which are both examined in chapter 8.3). All such information should be as understandable as is pragmatically possible to all investors, but the above analysis has recognised there are limits to this for particularly complex information in the hands of unsophisticated investors. However an understanding of markets, with sophisticated market participants necessarily taking the lead, lessens the concern with this otherwise unsatisfactory conclusion.

4.7 CONCLUSION

Shareholders have dual roles; they are both investors and comprehensive monitors. Accordingly shareholders require relevant information in order to rationally and effectively to acquit their roles. These two shareholder roles are both separate and interdependent.

As investors, shareholders are almost exclusively concerned with the financial performance of the company.[666] Based on this view of shareholders their information requirements would be satisfied principally by the financial statements.

As monitors, shareholders are concerned with all the activities of the directors, executives and the company. Monitoring certainly is concerned with the financial performance of the company but also with broader matters, such as the performance of the managers. The financial performance of the company can be and is linked with the

665 Dyson and Lovelock (eds.), *Education and Democracy* (Routledge and Kegan Paul, London, 1975); Peck, *A World Waiting to be Born: Civility Rediscovered* (Bantam Books, USA, 1993) at 4.

666 However see chapter 9 for arguments that shareholders as investors are concerned with broader issues than just financial performance.

performance of management. When companies are trading profitably then shareholders are satisfied and have little reason to question the performance of management. Management often indirectly but sometimes overtly links the two performances together. In many cases this is justified. In others it is not. For a poor management performance may result in an adequate performance by the company.[667] This may occur for a variety of reasons such as a company that operates in a monopoly market (or otherwise being able to dominate that market) or other competitors suffer from similar management deficiencies. Therefore the question becomes whether there are other more direct measures of management performance and whether shareholders receive information concerning this?[668] From a view of the corporation from a monist perspective, then information about any voluntary altruistic behaviour should be disclosed. Also given a modestly idealistic view of the company then shareholders as monitors are interested in directors' compliance with laws which affect them (primarily fiduciary duties) and the corporation's compliance with laws which affect it.

From this broad framework I assess the information shareholders currently receive and should receive. Given that pertinent information is the linchpin of accountability then shareholders should receive information on all of the directors, their delegates and the company's activities unless there are compelling reasons to the contrary. This should be brought about by mandatory disclosure rules. There is doubt by some commentators whether mandatory disclosure rules are appropriate.[669] The prime concern is whether mandatory disclosure rules actually enhance shareholder monitoring.[670] However whilst the evidence to support this as a positive statement is doubtful, mandatory disclosure rules at least makes such monitoring possible. The reality is that parliaments are not persuaded by such arguments because there are extensive mandatory disclosure rules in place (as will be seen in subsequent chapters). Such an approach also ignores the empirical evidence that establishes that unless forced to do so managers will distort information and report principally good news[671] and are reluctant to report new types of information out of concern this may assist their competitors.[672]

Before looking at the information shareholders receive, the next chapter looks at the corporation as a democracy and the lessons that can be learned from it about our understanding of the role of shareholders and others and in turn the type and quality of information they should be entitled to.

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667 In fact that performance may be perceived as good if shareholders have never known different.

668 I explore this issue in chapter 7.3.

669 Ramsay, 'Models of Corporate Regulation: Command and Control Versus Facilitation' paper presented at the centenary celebration conference of *Salomon v Salomon*, University of Auckland, July 1997 (author on file) at 41 to 46.

670 Above at 42.

671 See chapters 6.5 and 9.5.

672 McQueen, 'The Corporate Image-The Evolution of the Annual Report in Australia 1950-1990' (Paper delivered at the Corporate Law Teachers Conference, The University of Melbourne Law School, February 1997, author on file).

CHAPTER 5

SHAREHOLDING AS CITIZENSHIP

5.1 INTRODUCTION

Shareholding can be regarded as a class of citizenship. Citizenship is not a hollow concept. It operates within a political tradition and culture and carries with it certain responsibilities and rights, including legal rights and rights to information. It is of course a democratic political tradition that is relevant in Australia. The political arena has a rich experience on matters democratic which is useful to draw from.[673] In particular it is useful to consider the mechanisms utilised in the political arena to ensure open government, the accountability of elected representatives and to support the peoples right to know. The question then becomes how to best adapt these principles to the corporate context.

It is relevant to draw from the political arena since the internal governance of companies is patterned from the democratic model.[674] Broadly speaking the constituents (shareholders/citizens) elect their representatives (directors/parliamentarians) who thereafter wield very broad discretionary powers. Under this democratic style of governance there is a clear difference between the select few who are reposed with power and the more populous constituents for whom the representatives are elected to act. Buxbaum has eloquently described this division of roles as follows:

> The concept of shareholder participation in the governance of the publicly held corporation presumes the need for representative government. A large organisation, whatever its mission, cannot achieve its goals by constituting its members into an ongoing committee of the whole. Even participatory democracies, worker-owned enterprises, and cultural revolutions accept the distinction between mass and cadre, wherever they may at times draw the line between the two.[675]

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673 Bottomley, 'From Contractualism to Constitutionalism: A Framework for Corporate Governance' (1997) 19 Sydney Law Review 277 at 278 considers that "a political perspective" gives a "richer analytical basis for studying and responding to [issues of corporate governance]".

674 Many commentators consider that an analogy can be drawn between the governance structures of corporations and political democracies; for example see Buxbaum, 'Comparative Aspects of Institutional Investment and Corporate Governance' at 4 in Baums, Buxbaum and Hopt (eds), *Institutional Investors and Corporate Governance* (Walter de Gruyter, Berlin 1993) calls it the "direct political analogy". Bottomley, 'From Contractualism to Constitutionalism: A Framework for Corporate Governance' (1997) 19 Sydney Law Review 277 at 296 thinks there is "no strict analogy" although he regards the comparison as useful with democratic notions suitable to be "adapted", but not "adopted", to the corporate context. See also Fraser, *Reinventing Aristocracy: The Constitutional Reformation of Corporate Governance* (Dartmouth, England, 1998) who accepts the political analogy and uses this as the launching pad to argue in favour of imbuing civic virtues into corporations and their participants.

675 Buxbaum, 'The Internal Division of Powers in Corporate Governance' (1985) 73 California Law Review 1671 at 1671.

This division between the people and their elected representatives[676] introduces the problem of keeping the representatives accountable to those who elect them and for whom they act. One of the keys to accountability is the electorate receiving information about the activities and decisions of their representatives. For the power of information has long been recognised in both the political[677] and corporate contexts.[678] However the governing elite have, at least at the outset, monopoly knowledge (and hence information) of their own activities. But there is a flow of information from Australian governments to their electorates. However as mentioned previously,[679] there is clearly the inherent risk that in reporting on their own performance they will at the least be biased and at the worst deliberately manipulative (either by withholding information or by issuing inaccurate information). In the political arena there is a recognised strong danger of abuse of the communication process.[680] Therefore it is important to consider the structural mechanisms in place in a political democracy to curb this danger and endeavour to ensure the quality of the information citizens receive. These mechanisms, principally an active opposition and effective media coverage, are either generally absent from or less effective in the corporate context. This difference highlights the need for other mechanisms in the corporate context to ensure the quality of corporate information, which I develop in later chapters. For as I established in chapter 2, assessing the quality of information is critical.

Modern political democracy in Australia involves the idea of open government.[681] Citizenship in this type of political environment carries with it two legal rights which support and bolster open government. The two legal mechanisms citizens enjoy are freedom of information legislation and the right to reasons for decisions in administrative law. These two mechanisms are reasonably recent developments in the political context which have matured our concept of democracy. This maturation has not flowed into the corporate context. Therefore this chapter also explores whether shareholders as citizens in the corporate democracy should have access to similar mechanisms.

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676 In corporate law commonly referred to as the separation of ownership and control; see Berle and Means, *The Modern Corporation and Private Property* (Macmillan, New York, 1940).

677 Jones, *Sleepers, Wake! Technology and the Future of Work* (Oxford University Press, Melbourne, 2nd ed, 1990) at 178 who states "Knowledge is power and access to information is analogous to access to power". See also the Senate Standing Committee on Constitutional and Legal Affairs, *Freedom of Information* (AGPS, Canberra, 1979) at [3.4] and [3.7] to [3.14].

678 "Sunlight is the best disinfectant, electric light the best policeman", Brandeis, *Other Peoples Money* (Frederick A Stokes Company, USA, 1914) at 92; Loss, 'Disclosure as Preventive Enforcement' which is in chapter IV of Hopt and Teubner (eds), *Corporate Governance and Directors' Liabilities* (Walter de Gruyter, Berlin, 1984); Lavarch Committee, *Corporate Practices & The Rights of Shareholders* (Australian Government Printing Service, Canberra, 1991) at paragraph 4.1.2: "The examination of information released by a company is a principal means by which shareholders determine the performance of directors and hence ascertain if the directors are acting in the best interests of the Company. The availability of accurate and timely information on the financial position of companies is fundamental to informed judgement by shareholders about their investments".

679 In chapter 2.4 under the heading 'Credibility'.

680 Campbell, 'Rationales for Freedom of Communication' in Campbell and Sadurski, *Freedom of Communication* (Dartmouth, England, 1994) at 18 and 37; see also the quote from the Fitzgerald inquiry into corruption in Queensland later in this chapter.

681 *Commonwealth of Australia v John Fairfax & Sons Ltd* (1980) 32 ALR 485 per Mason J at 492 to 493; Australian Law Reform Commission and Administrative Law Council, *Open Government: A Review of the Federal Freedom of Information Act 1982* (AGPS, Australia, 1995) at 11 to 13.

5.2 HOW COMPANIES ARE LIKE DEMOCRATIC GOVERNMENTS

The governance of Anglo-corporations are styled as mini-democracies.[682] As demonstrated in the previous chapter, shareholders vote for the election of their directors and a broad range of other matters.[683] These elections occur on a regular basis. The usual position is for one third of the incumbent directors (other than the managing director) to retire each year, but they can immediately offer themselves for re-election.[684] Also directors are granted broad discretionary powers of management[685] the exercise of which is generally not subject to review by the shareholders.[686] Although directors are granted the power to manage, the modern reality is that the executives manage on a day to day basis.[687] At a shareholders meeting the shareholders usually have one vote for each issued share they hold.[688] The company's constitution is the primary document which governs the internal relationship between shareholders and their directors. This document can be amended by shareholders but only by a special resolution.[689]

The parallels with the style of representative democratic governments we enjoy in Australia are obvious.[690] Using the Federal Government as an example, politicians are elected on a regular basis.[691] The elected government then has broadly defined discretionary powers[692] with no provision for formal review of their decisions by the electorate. Once again although Ministers have overall responsibility for their portfolios it is departments staffed by bureaucrats which do the day to day work.[693] However under the principle of responsible government Ministers remain politically accountable to Parliament for the actions of the departments in their portfolio.[694] Also the relationship

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682 Latham, 'The Body Politic of the Corporation' in Mason (ed), *The Corporation in Modern Society* (Harvard University Press, Cambridge, 1960). Latham argues (at 220) that the corporation exhibits the characteristics common to all bodies politic, namely:
(1) an authoritative allocation of principal functions; (2) a symbolic system for the ratification of collective decisions; (3) an operating system of command; (4) a system of rewards and punishments; and (5) institutions for the enforcement of the common rules'.
See also Stokes, 'Company Law and Legal Theory' in Twining (ed.), *Legal Theory and Common Law* (Basil Blackwell, U.K., 1986) at 166 and 180.

683 Discussed in chapter 4.3.

684 Table A, clauses 58 to 61; LR 14.4.

685 CL s226A - replaceable rule; Table A, cl 66.

686 Chapter 7.4 under the heading 'Reasonable Decisions'; also Easterbrook and Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, USA, 1991) at 2. See also the discussion of the exclusive management power cases in chapter 4.3 under the heading 'Role of the Directors'.

687 *AWA Ltd v Daniels* (1992) 7 ACSR 759 at 832–833; Hilmer, *Strictly Boardroom* (The Business Library, Sydney, 1994) at 26 to 31.

688 CL s250E(1)(b) - replaceable rule; LR 6.9 - at least where a poll has been demanded.

689 CL s136(2).

690 The similarities are made by Bottomley, 'From Contractualism to Constitutionalism: A Framework for Corporate Governance' (1997) 19 Sydney Law Review 277 at 296 and fn 119.

691 *Commonwealth of Australia Constitution Act* 1901 ss 13 and 28.

692 Above s51, although in the case of the Federal Government these are tied to specific heads of power.

693 Jones, *Sleepers, Wake! Technology and the Future of Work* (Oxford University Press, Melbourne, 2nd ed, 1990) at 174 to 177.

694 de Smith, *Constitutional and Administrative Law* (Pelican, United Kingdom, 5th ed., 1985) at 199 to 200. This is the way, in the political context, that the problem of entropy (see chapter 2.2) is tackled. For the way it should be tackled in corporate law see chapter 7.4 under the sub-heading 'Delegation-Monitoring the Delegate'.

between citizens and their elected representatives is governed by a written constitution[695] which can only be amended by a special majority vote of the electors.[696]

Clearly there is a strong analogy at this level between companies and governments.

Beyond simply drawing the analogy it is important to consider the nature of the democratic process,[697] although democracy is an ambiguous and malleable concept.[698] Broadly speaking at either end of the spectrum of possibilities for democracy is just an election of representatives or a participatory style of democracy.[699] If democracy is just about an election of representatives then democracy is simply about majority power with little if no regard for minorities.[700] Concomitantly the information needs of the electorate "will be more focused on...information about candidates than about the minutiae of government business".[701] At the very end of the other side of the spectrum is direct participation, in terms of taking part in the processes of the state.[702] However direct participation is not feasible in large and complex societies.[703] Nonetheless indirect participation is still feasible in representative forms of democracy,[704] although there is inherent tension between participation and representation.[705] In a participatory style of democracy the pursuit of consensus and the recognition and tolerance of diversity are important.[706] Consensus is simply more democratic than pursuit of a bare majority.[707] It

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695 In Australia our constitution is written; *Commonwealth of Australia Constitution Act* 1901. A written constitution also exists in the U.S.A. but not in the U.K.

696 Above s128.

697 Campbell, 'Rationales for Freedom of Communication' in Campbell and Sadurski, *Freedom of Communication* (Dartmouth, England, 1994) at 37.

698 Lucas, *Democracy and Participation* (Penguin, Great Britain, 1976) at 9 notes that many different forms of government claim to be democratic. There are also many different theoretical models of democracy. For example Held, *Models of Democracy* (Polity Press, United Kingdom, 1987) at 4 and subsequently develops four classic and four contemporary models of democracy. Arblaster, *Democracy* (University of Minnesota Press, Minneapolis, 1987) at 8 simply regards democracy as the idea of popular power-"people as the ultimate political authority". See also Mayo, *An Introduction to Democratic Theory* (Oxford University Press, New York, 1960) in chapter 2.

699 Gaze and Jones, *Law, Liberty and Australian Democracy* (Law Book Company, Sydney, 1990) at 18 to 21.

700 Above at 18 to 19; and see footnote 3 to this chapter.

701 Campbell, 'Rationales for Freedom of Communication' in Campbell and Sadurski, *Freedom of Communication* (Dartmouth, England, 1994) at 38.

702 For an example of direct democracy see the description of the meetings of the Thembu people in Mandela, *Long Walk to Freedom* (Little Brown & Co, USA, 1994) at 18 to 19.

703 Gaze and Jones, *Law, Liberty and Australian Democracy* (Law Book Company, Sydney, 1990) at 18 to 20; Arblaster, *Democracy* (University of Minnesota Press, Minneapolis, 1987) at 82; Bottomley, 'From Contractualism to Constitutionalism: A Framework for Corporate Governance' (1997) 19 Sydney Law Review 277 at 293 and 305.

704 Gaze and Jones, *Law, Liberty and Australian Democracy* (Law Book Company, Sydney, 1990) at 20 to 21 who discuss two models of such a democracy; Maddox, *Australian Democracy in Theory and Practice* (Longman, Melbourne, 3rd ed, 1996) at 96 acknowledges that whilst this is the theory there is the problem of citizen apathy (noting some empirical studies).

705 Held, *Models of Democracy* (Polity Press, United Kingdom, 1987) at 4 to 5; Arblaster, *Democracy* (University of Minnesota Press, Minneapolis, 1987) in chapter 8; Cook and Morgan, *Participatory Democracy* (Canfield Press, San Francisco, 1971) at 2.

706 Campbell, 'Rationales for Freedom of Communication' in Campbell and Sadurski, *Freedom of Communication* (Dartmouth, England, 1994) at 37 to 39.

707 Lucas, *Democracy and Participation* (Penguin, Great Britain, 1976) at 10 who states:

> The word 'democracy' and its derivatives apply to decision procedures. In its original Greek sense a decision is democratically taken if the answer to the question *Who takes it?* is 'More or less everybody'.

must be recognised that consensus will not always be possible; on some issues people will legitimately disagree.[708] But the very pursuit of consensus, of listening to others, is important in itself. Under this model clearly the electorate is not simply viewed as a passive recipient of information (and ticker of a ballot box) but need an opportunity for dialogue and the possibility for persuasion.[709] Nonetheless as a starting point for that dialogue the electorate will need information not just about candidates but "the maximum flow of information about the details of governmental activity and its effects".[710] In my opinion a consensus style of democracy is preferable.[711] Also in Australia in the political arena there is clear evidence of a more participatory style of democracy. As developed later in this chapter, the media actively reports on politics which presupposes an interested market, there are lobby groups and Freedom of Information legislation which allows public participation in decision making. Of course not all electors are interested in such participation and that should be respected as their political right.[712] However this apathy does not detract from the preference as a model of a more participatory style of democracy, otherwise those who are interested are effectively disenfranchised. Also in my opinion a more participatory notion of democracy is appropriate for corporations for the same reasons it is appropriate in the political context.[713] I acknowledge that to some extent this represents a policy choice but it is the choice I make and will inform the thesis.

5.3 INFORMATION FLOW FROM GOVERNMENTS

Nothing in the Federal Constitution obliges Parliament to report any information to the electorate. So electors have no enforceable rights to information.[714] The position is not

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See also Arblaster, *Democracy* (University of Minnesota Press, Minneapolis, 1987) at 4.

708 Held, *Models of Democracy* (Polity Press, United Kingdom, 1987) at 198 argues that class significantly impedes consensus.

709 Campbell, 'Rationales for Freedom of Communication' in Campbell and Sadurski, *Freedom of Communication* (Dartmouth, England, 1994) at 38; Lucas, *Democracy and Participation* (Penguin, Great Britain, 1976) at 10 who states that a "decision is taken democratically if it is reached by discussion, criticism and compromise". See also chapter 8 of Lucas where he analyses participation. Bottomley, 'From Contractualism to Constitutionalism: A Framework for Corporate Governance' (1997) 19 Sydney Law Review 277 at 304 to 307 regards a key element of a democratic system to involve a deliberative process.

710 Campbell, 'Rationales for Freedom of Communication' in Campbell and Sadurski, *Freedom of Communication* (Dartmouth, England, 1994) at 38.

711 Others agree, see Bottomley, 'From Contractualism to Constitutionalism: A Framework for Corporate Governance' (1997) 19 Sydney Law Review 277 at 302 to 304; Campbell, 'Rationales for Freedom of Communication' in Campbell and Sadurski, *Freedom of Communication* (Dartmouth, England, 1994) at 40.

712 Although in Australia every adult citizen is at least compelled to vote; *Commonwealth Electoral Act* 1918 (Cth), sections 101 and 93; *Douglass v Ninnes* (1976) 14 S.A.S.R. 377. This compulsion is not the case in other countries, such as the U.S. See Mayo, *An Introduction to Democratic Theory* (Oxford University Press, New York, 1960) at 121 to 125.

713 Interestingly if this argument is accepted then one implication is that the need for dialogue renders manifestly wrong those cases which deny shareholders the right to convene meeting of themselves on the basis that what they propose to consider is beyond their power; see *NRMA v Parker* (1986) 11 ACLR 1; *Queensland Press Ltd v Academy Instruments No 3 Pty Ltd and Anor* (1987) 11 ACLR 419. These cases are also suspect if the political right to assembly is appropriate for corporations; see Mayo, *An Introduction to Democratic Theory* (Oxford University Press, New York, 1960) at 142; Gaze and Jones, *Law, Liberty and Australian Democracy* (Law Book Company, Sydney, 1990) in chapter 4.

714 At this level the position may be sharply contrasted with companies where in subsequent chapters I demonstrate a significant range of information that the law obliges directors to provide to shareholders.

this straightforward though. First, the proceedings of Parliament are open to the public, recorded in Hansard and, some portions at least, broadcast by the electronic media. So Parliament is a very public forum. But two factors affect this. First, a lot of the real debate on issues of policy, at least so far as the incumbent government is concerned, occurs behind the closed doors of Cabinet. This impoverishes open government but it reflects a long-standing political convention and there is no guarantee of open government in any event. Arguably the board of directors is analogous to cabinet, which analogy I pursue in considering the freedom of information legislation and is affected by the information I recommend be disclosed by the board under the duty of care in chapter 7.4. Second, the bureaucracy has usually already prepared issue papers on policy matters and made recommendations which often are not matters of public record. However governments are concerned about winning regular elections so they go about the process of explaining and "selling" their policies to the general population. Also most of their decisions ultimately find their expression in legislation and therefore will be a matter of public record.

Second, there is an active opposition. The role of the opposition is to criticise government policy and to suggest viable alternatives.[715] This goes a long way to ensure close scrutiny of the incumbent government's policy and public debate of the issues. Once again, unfortunately, this may be sharply contrasted with companies. There are no established and permanent[716] groups of directors standing in opposition to the incumbent directors. Very occasionally there is a proxy contest for board positions[717] or a faction on a board that sharply disagrees with the majority.[718] These two situations remain a rare exception to the rule. This paucity of a self-interested opposing voice leads to a significantly impoverished public debate on and evaluation of directors decisions compared with the political arena. This creates the need for other mechanisms in the corporate context to serve a similar purpose as an active opposition, the most obvious of which is the role of auditors (explored later, particularly in chapter 6.5).

Can market forces be equated with an active opposition? The takeover, capital, product and management markets have long been recognised as a constraining force on the behaviour of directors.[719] But this would be like arguing that the citizens should be the active opposition to the incumbent government. Also this is a chicken and egg argument. For these markets to a large extent rely on the information released by managers to effectively operate (ie information is the lifeblood of these markets). This is certainly the case of the capital and takeover markets which are generally seen as the most potent of these markets. Also these markets are no more than the people that comprise them; in the case of the capital and takeover markets they are existing shareholders and potential shareholders. It is difficult for shareholders to be this kind of antagonistic force where

715 Maddox, *The Hawke Government and Labour Tradition* (Penguin, Victoria, 1989) at 101; Mayo, *An Introduction to Democratic Theory* (Oxford University Press, New York, 1960) at 147 to 150; Maddox, *Australian Democracy in Theory and Practice* (Longman, Melbourne, 3rd ed, 1996) in chapter 8.

716 Latham, 'The Body Politic of the Corporation' in Mason (ed), *The Corporation in Modern Society* (Harvard University Press, Cambridge, 1960) at 225.

717 For example see *Advance Bank of Australia Ltd v FAI Insurance* (1987) 5 ACLC 725. See also the proxy contest in Brierly Investments Ltd during November 1998; Gluyas, 'Shamrock Keeps Heat on Brierley' *The Australian* Wednesday 4 November 1998 at 27.

718 A division in the board of NRMA Ltd occurred in late 1993. The minority directors (including Dawn Fraser) successfully obtained an injunction preventing the issue of shares pursuant to a prospectus (which the court held was false and misleading) which had been approved by a majority of the directors; *Fraser v NRMA* (1995) 15 ACSR 590.

719 Eisenberg, 'The Structure of Corporation Law' (1989) 89 Columbia Law Review 1461 at 1488 to 1505. I have discussed the capital and takeover markets at chapter 4.6.

the outstanding shares are widely dispersed because shareholders lack the cohesion, sophistication and self-interest to be effective. Certainly there is the role of institutional investors but as noted above[720] the bottom line remains that they have not yet shown the will or ability to consistently and proactively monitor all the companies in which they invest. Certainly for the purposes of my argument these market forces are not a force equivalent to an active opposition who are able to test the credibility and appropriateness of the information prepared by those in power and offer viable alternatives.

Third, and in a similar vein to the last argument, there are lobby groups which operate in the political arena. These self-interested groups actively lobby the government and supporting bureaucracy in order to influence government policy.[721] Lobby groups try to obtain information that is not generally available in order to more effectively and intelligently go about their business.[722] Such groups are often successful in obtaining this information particularly if they are an established group with a cooperative relationship with the government. By this mechanism, and other more formal channels of discourse,[723] governments are in touch with and influenced by the views of at least some of their constituents. In the corporate context established lobbying mechanisms that represent the interests of shareholders[724] are only just beginning to emerge.[725] However corporate executives go on "road shows" where they provide up to date information to institutional and other significant investors.[726] In these forums and by unilateral contact[727] these investors can make their views known and seek to influence management policy. Indeed if they feel particularly strongly on a particular issue and hold the required number of shares (5%) they can call a meeting of the company to consider the matter or include a resolution at the next AGM.[728] The empirical research concerning this issue (mentioned above) supports the view that the activities of institutional investors and their representative bodies are beginning to resemble political lobbying. Also care must be taken in this type of situation to ensure the participants do not breach the insider

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720 Chapter 4.5.

721 Galnoor, 'The Information Marketplace' in Galnoor (ed), *Government Secrecy In Democracies* (Harper & Row, New York, 1977); Maddox, *Australian Democracy in Theory and Practice* (Longman, Melbourne, 3rd ed, 1996) at 412 to 417.

722 Above at 80 and following.

723 Such as discussion papers and other consultative procedures often adopted when a change of policy is being considered

724 Unions are an established and effective lobby to protect the interests of employees. Green groups are an organised lobby but they seem more effective at the government rather than the corporate level.

725 The Australian Investment Managers Association was formed in the early 1990's to represent the interests of institutional investors. There is also the Australian Shareholders Association which purports to represent the interests of small investors. There is also some evidence from the US of large investors lobbying management with alternative management proposals and policies; see Pound, 'Beyond Takeovers: Politics Comes to Corporate Control' (1992-March/April) Harvard Business Review 83; Berenbeim, *Company Relations with Institutional Investors* (The Conference Board, U.S.A., 1994).

726 Hill, 'Institutional Investors and Corporate Governance in Australia' in Baums, Buxbaum and Hopt (eds), *Institutional Investors and Corporate Governance* (Walter de Gruyter, Berlin, 1993) at 605.

727 See Tomasic and Bottomley, *Directing the Top 500* (Allen and Unwin, New South Wales, 1993) at 154. See also Blue, 'Directors Push for Investor Briefings' *The Australian*, 27 February 1996 at 59. During my time as a legal practitioner I certainly experienced instances of this type of unilateral contact.

728 CL ss 249D, F, N & O.

trading provisions or are associates and by reason of the entitlement provisions of the Corporations Law breach the takeover provisions.[729]

Fourth, the Federal Parliament has voluntarily bound itself to provide financial reports of its financial position on a monthly and an annual basis.[730] The annual reports are audited by the Auditor General.[731] These reports are necessarily different from company financial statements because the financial affairs of a government are very different from those of a for-profit business enterprise. For example a government derives income from taxation (not trading), acts according to a budget and has no equivalent to the notion of shareholder funds or goodwill.

Fifth, a myriad of government departments and statutory authorities have to report annually pursuant to the legislation which regulates their activities. For example the ASIC is obliged to publish an annual report on their activities, has to report on its operations and also provide audited financial statements.[732] Given the number of annual reports published by a myriad of government bodies the flow of published information to the public is overwhelmingly voluminous.

Six, the media plays a significant role in political life. Their role I examine in the next part.

5.4 ROLE OF THE MEDIA & FREEDOM OF POLITICAL COMMENT

Any Australian who has any contact with the media, whether newspapers, magazines, radio, television or some other format, would be aware of their reporting of political events. In fact for most of us it is exclusively through the media that we are informed of current political debates and decisions. Most Australians would not pursue the information which has been described in the previous part of this chapter. Some with specialty interests may pursue information published in their specialty areas but probably not in any others.

The role of the media is so critical in the political context that they are sometimes described as the Fourth Estate (ie the fourth branch of government after Parliament, the Executive and the Judiciary).[733] The role of the media is inextricably linked to the much-vaunted concepts of freedom of expression and freedom of the press. The Australian High Court has recognised and highlighted the importance of these freedoms for a representative, democratic society by recently implying into the Federal Constitution these freedoms.[734]

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729 Stapledon, 'Disincentives to Activism by Institutional Investors in Listed Australian Companies' paper presented at the 6th National Corporate Law Teachers Conference 1996.

730 See the following documents which are published each financial year: *Budget Statement*, issued by the Treasurer and Minister for Finance; *The Commonwealth Public Account*, issued by the Minister for Finance; *Aggregate Financial Statement*, prepared by the Minister for Finance and the Auditor General.

731 *Audit Act* 1901 (Cth), sections 40, 41A-C and 51. For improvements being implemented to the financial reporting by the government and for suggested improvements to the Auditor-General's role see Howard, 'Report Card on Open Government: A Good Start, But...' (1997-July) Australian Accountant 18.

732 *Australian Securities Commission Act* 1989 (Cth) s138.

733 Graber, *Mass Media And American Politics* (Congressional Quarterly Press, Washington, 1980) at 18; Schultz, *Reviving the Fourth Estate: Democracy, Accountability and the Media* (Cambridge University Press, Australia, 1998).

734 The High Court did this in a series of cases including *Australian Capital Television v Commonwealth* (1992) 177 CLR 106, *Theophanous v Herald and Weekly Times Ltd* (1994) 182

In the USA the framers of their constitution thought these freedoms were too fundamental to be left to implication. The First Amendment to the USA Constitution provides that "Congress shall make no law ... abridging the freedom of speech, or of the press". The USA therefore has a rich and long history concerning these freedoms. It is instructive to look at the various justifications given for the First Amendment.

Lichtenberg has offered five traditional justifications for the twin freedoms of expression and of the press.[735] There is significant overlap between some of the different categories. The five justifications are:

1. Individual Self Realisation
   "The end of man ... is the highest and most harmonious development of his powers to a complete and consistent whole."[736] Further "a persons ability to communicate ideas to the public at large, is essential to human enlightenment."[737] This justification is linked more to freedom of expression than freedom of the press.

2. A Precondition to Personal Autonomy
   The philosophical underpinning to this justification is the "overriding importance that a person be able to think for themselves, that whatever his 'outer' condition he not be intellectually or psychologically subjugated to another's will."[738] This justification is closely linked to, if not a sub-set of, the previous one.

3. Attaining Truth
   "[Freedom of speech and the press] promotes the free flow of information, open and robust debate, a multiplicity of voices. These conditions are necessary in turn for winnowing truth from error and for democracy to function."[739]

CLR 104 and *Stephens v West Australian Newspapers Ltd* (1994) 182 CLR 211 culminating in their joint, unanimous decision in *Lange v Australian Broadcasting Corporation* (1997) 145 ALR 96. The strength of this implied freedom seems to be waning; see Anderson, 'Corporations, Democracy and the Implied Freedom of Political Communication: Towards a Pluralistic Analysis of Constitutional Law' (1998) 22 Melbourne University Law Review 1 at 2 to 3. Note that in this paper Anderson argues that in the hands of powerful corporations who in a pluralist world wield significant normative power, this implied freedom of speech is actually undemocratic!

735 Lichtenberg, *Democracy and the Mass Media* (Cambridge University Press, USA, 1990). Others authors support these justifications and offer other justifications, for example Campbell, 'Rationales for Freedom of Communication' in Campbell and Sadurski, *Freedom of Communication* (Dartmouth, England, 1994) at 17 add the following justifications, namely "the stimulus of tolerance...the flourishing of plurality...the efficient allocation of resources...[and] the intrinsic worth of the communicative experience".

736 Lichtenberg, *Democracy and the Mass Media* (Cambridge University Press, USA, 1990) at page 112, quoting Wilhelm von Humboldt.

737 Above at 112.

738 Above at 108. I have also used this justification in considering the understandability of corporate information: see chapters 4.5 and 4.6. See also Campbell, 'Rationales for Freedom of Communication' in Campbell and Sadurski, *Freedom of Communication* (Dartmouth, England, 1994) at 33 to 37 who discusses both of these first two categories under his heading "self-determination".

739 Lichtenberg, *Democracy and the Mass Media* (Cambridge University Press, USA, 1990) at 81. Note that this view rests on an objective view of truth, which many philosophers would disagree with, however a modified version of this justification would support those philosophers who believe knowledge is based on rational certainty obtainable by conversation with our fellows (also discussed in chapter 2.2). See Campbell, 'Rationales for Freedom of Communication' in Campbell and Sadurski, *Freedom of Communication* (Dartmouth, England, 1994) at 23 to 28

4. Necessary Element In a Democracy

"Because democracy means popular sovereignty ... the citizens in a democracy, as the ultimate decision makers, need full (or at least a lot of) information to make intelligent political choices."[740] "Freedom of speech ensures that opponents of the government can make their views known to the public, and thus provide the voters with a genuine choice in elections. The free flow of information and opinion from diverse and antagonistic sources is the best way to ensure that voters will learn what they need to know about the candidates and about government policies and public issues."[741]

5. Watchdog

"A press that is free to publicise the actions of government can perform the watchdog function of protecting against the tendency of the state to aggrandise its powers and abuse the rights of its citizens."[742] The press must go further than relaying information, they also have a critical function. The press "serves as the people's watchdog, ensuring independent criticism and evaluation of the established power of government and other institutions that may usurp democratic power".[743] Although not explicitly mentioned in these passages it is part of the watchdog function for the press to undertake its own independent investigations in an endeavour to uncover governmental malpractice. Sometimes the press is spectacularly successful in doing this, even at the highest level of government, "Watergate" being the watershed example from the USA.[744]

The last three arguments are closely linked; they all point to the pivotal role of the media in democracies.[745] The five justifications reflect different philosophical and political dispositions. Commentators differ as to which is the most important justification; some

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who suggests several versions of a modified justification such as "necessary conditions of intellectual progress", "authenticated ways of promoting the discovery of truth" and "discussion can make an important and distinctive contribution to knowledge". See also Gaze and Jones, *Law, Liberty and Australian Democracy* (Law Book Company, Sydney, 1990) at 285 to 286.

740 Lichtenberg, *Democracy and the Mass Media* (Cambridge University Press, USA, 1990) at 110. See also Department Of Science, *A National Information Policy For Australia* (Canberra Publishing & Printing Co., A.C.T., 1985) at 27; MacPhee, 'Freedom of Speech' (1988) 4 Civil Liberty 5.

741 Lichtenberg, *Democracy and the Mass Media* (Cambridge University Press, USA, 1990) at 91. c.f. the role of the media under authoritarian regimes where the role of the media is to support, rather than criticise, the regimes policy: Graber, *Mass Media And American Politics* (Congressional Quarterly Press, Washington, 1980) at 17. See also Campbell, 'Rationales for Freedom of Communication' in Campbell and Sadurski, *Freedom of Communication* (Dartmouth, England, 1994) at 37 to 41.

742 Lichtenberg, *Democracy and the Mass Media* (Cambridge University Press, USA, 1990) at 70.

743 Above at 110.

744 Bernstein and Woodward, *All The Presidents Men* (Simon and Schuster, New York, 1974). It was a Four Corners program, 'The Moonlight State', which prompted the Fitzgerald Inquiry which in turn led to the downfall of the Bjelke-Peterson government in Queensland; see Schultz, *Reviving the Fourth Estate: Democracy, Accountability and the Media* (Cambridge University Press, Australia, 1998) at 220 to 224.

745 The High Court in *Lange v Australian Broadcasting Corporation* (1997) 145 ALR 96 clearly justified the implied freedom of speech by use of the fourth justification. At 106 the members of the court stated "Freedom of communication on matters of government and politics is an indispensable incident of that system of representative government which the Constitution creates...". The court did not explicitly endorse the third or fifth justification. They dealt with the issue more generally and their judgment can not be taken as a denial of these other justifications. Indeed at 115 they recognised not just the need for information but also "opinions and arguments" which arguably implicitly supports the fifth justification.

even argue that one of the categories is the justification. I prefer the view that freedom of expression is a multi-faceted concept supported by all of the justifications.[746] However in any given context the justifications must be evaluated to see whether any government regulation, either to support or derogate from the freedoms, is appropriate.[747] However it must be recognised that the freedom of speech is very strong and that any restrictions on it must be specially justified by competing and stronger justifications and closely constrained. The need to restrict any exception is reinforced by the "tendency to abuse" any exceptions by those who may have a "vested interest in suppressing hostile speech".[748]

Of course these are the theories, in practice the media has shortcomings and detractors. The media have been accused of and criticised for agenda setting,[749] bias[750] and even spreading inherent propaganda.[751] Also and perhaps even more poignantly, the media are accused by some of not winnowing truth or supporting democracy but rather creating "confusion and resigned disinterest".[752] In addition the media are not omniscient. They are comprised of fallible human beings with finite energies and with finite resources to work with. The coverage of political affairs must necessarily be not as comprehensive as it could be.[753] Also the extent to which the media undertake the watchdog role fluctuates over time.[754] These accusations, criticisms and shortcomings do not destroy the valuable role of the media but means that they should be treated with a modicum of scepticism and a realistic acknowledgment of their limited scope.

All five justifications also support the case for media scrutiny of company directors and managers. So how effectively do the media report and scrutinise corporate behaviour?

There is an established financial press in Australia. There is the Financial Review, a daily newspaper with a national circulation, which is substantially devoted to business and financial issues. Also all of the major newspapers such as the Australian, the Sydney Morning Herald, the Age and the Advertiser have a business section. Also on television there are also some business style programs, usually on a Sunday morning. This reporting provides a certain flow of information to shareholders. However given the vast array of listed public companies in Australia the coverage of their behaviour must of necessity be limited. Of course sometimes there will be considerable coverage of

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746 This is also the opinion of Campbell, 'Rationales for Freedom of Communication' in Campbell and Sadurski, *Freedom of Communication* (Dartmouth, England, 1994) at 22.

747 This is the approach taken by the High Court in *Lange v Australian Broadcasting Corporation* (1997) 145 ALR 96 at 107 to 108.

748 Above at 28 to 29.

749 Graber, *Mass Media And American Politics* (Congressional Quarterly Press, Washington, 1980) at 4 to 5.

750 Above at 5. See also Western and Hughes, *The Mass Media In Australia* (University Of Queensland Press, Queensland, 1983) at 59 to 83; Barry, *The Rise and Rise of Kerry Packer* (Bantam, Australia, 1993) particularly in chapter 3.

751 Pilger, *Hidden Agendas* (Vintage, Great Britain, 1998) at Part VIII (particularly at 524).

752 Graber, *Mass Media And American Politics* (Congressional Quarterly Press, Washington, 1980) at 22.

753 Schultz, *Reviving the Fourth Estate: Democracy, Accountability and the Media* (Cambridge University Press, Australia, 1998) at 4 and 235 speaks of the media operating in "a random fashion" and being "a flawed watchdog".

754 Above at chapters 8 to 10 argues that investigative journalism in Australia reached its highpoint in the 1980's and has waned since then.

notorious corporate affairs, as occurred with Coles Myer Ltd.[755] Extensive media coverage of the *cause celebre* does not make for an effective media. Also my impression as a semi-regular reader and viewer is that they provide some, but not a lot, by way of criticism or investigative journalism.[756] Of course scholarship cannot be based on impressions and this would be a good area to undertake some empirical research.

One critical role played by the media in the political context is to provide or report a range of "diverse and antagonistic" opinions so that voters learn about the qualifications of candidates, their suitability for office and who their associates are.[757] However the same can not be said in the corporate context. As argued above, shareholders enjoy a range of powers, but the election of directors is critical[758] and therefore serves as a useful example of the shallowness of media coverage of corporations. As I stated earlier there simply is not an active opposition and as a result virtually no debate that the media can simply report about the suitability of candidates for directorships. There is usually some bland information of the nominee's business experience but little else. For example, there is no disclosure or reporting on the person's ability to exercise a rigorously independent judgement and very little information about any potential conflicts between their personal interests and their duties to the company.[759] Neither is there usually any information about the process whereby a new nominee is presented to shareholders for their endorsement by vote. Usually the incumbent board nominates the person, but it is not disclosed how they made their selection.[760] It may simply be a case of the old boy network rather than by a more open, professional searching procedure. This is one area where the press is relatively active in the political arena but inactive in the corporate context.

In my opinion it can be concluded with sufficient certainty that the media plays a relatively weak role in the corporate context. Certainly there is a fair amount of reporting of corporate performance and developments and there is evidence that shareholders rely on such reporting as a source of information.[761] However their role is relatively weak in the sense of the extent of their coverage of corporate behaviour and in particular the extent of their investigative journalism and critical analysis.[762] This weakness is apparent both in considering the media's role just in relation to companies and also relative to their equivalent role in the political arena (where the media are more active and at least somewhat more effective even if only because they report the views of the opposition). This is another significant weakness that applies to companies. In my opinion the mandatory disclosure obligations and associated liability rules which require the company to report about itself can not be equated with the independent (of the subject

755 Tricker, 'Corporate Governance-Australian Experience in the '90s' paper presented at a conference 'Corporate Governance: Critical Board Issues' organised by the Australian Institute of Company Directors in Sydney on 24 May 1993 (author on file).

756 Examples of successful investigative journalism in the corporate context are described in Fisse and Braithwaite, *The Impact of Publicity on Corporate Offenders* (State University of New York Press, USA, 1983) at 254 to 260.

757 Schultz, *Reviving the Fourth Estate: Democracy, Accountability and the Media* (Cambridge University Press, Australia, 1998) at 201.

758 See chapter 4.3 under the heading 'Role of Shareholders'.

759 See chapter 7.4 under the heading 'Loyalty'.

760 Stewart, 'The King Is Dead' (1993) 64 Charterer 10 notes how in some U.S. companies nomination of new directors has passed to the CEO or a small nominating committee of the Board.

761 Courtis, 'Attitudes to Annual Reports' in Courtis (ed), *Communication Via Annual Reports* (Financial Management Research Centre, Armidale, 1981).

762 Pilger, *Hidden Agendas* (Vintage, Great Britain, 1998) at 539 to 542 who argues that the press have been co-opted by business to present a pro-business world view.

being reported on), investigative and critical role of the media. I address the implications of my conclusions concerning the role of the media in the corporate context in the conclusion to this chapter.

5.5 FREEDOM OF INFORMATION

Description of FOI Legislation

In Australia, both at the Federal level[763] and in various States,[764] there is freedom of information legislation. This legislation enables any person to obtain access to a very broad range of information produced by or for governments. In this part of the thesis I examine the FOI legislation and then discuss whether such a disclosure regime is appropriate in the corporate context.

The philosophy underlying FOI legislation is to:

(1) improve the quality of decision making by removing unnecessary secrecy;
(2) inform people of government functions and decisions which affect them and of the criteria which were applied in making those decisions;
(3) develop political democracy by giving more opportunities for public participation in decision making; and
(4) give people access to the personal records kept by government to enable them to correct any information which is untrue or misleading.[765]

The scheme of the Commonwealth FOI Act[766] is that anyone,[767] for a low to moderate fee[768] can apply to have access to the documents of the government and most government departments and agencies.[769] However there are a range of documents which are exempted from disclosure. The issue of exemption is not straightforward because the categories of exempt documents is linked to:

- the issue of public interest, which applies in different ways to different types of documents;
- a system under the FOI Act of certification that a document is exempt ; and
- the rights of review and appeal available under the Act.

Without looking at the detail of the pattern of exemptions, broadly speaking some of the more important categories of exempt documents are:

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763 *Freedom of Information Act* 1982 (Cth).

764 Freedom of Information Acts exist in Vic (1982), NSW (1989), ACT (1989), SA (1991), Qld (1992) and WA (1992).

765 Harrison and Cossins, *Documents, Dossiers and the Inside Dope* (Allen & Unwin, NSW 2nd ed, 1993) derived from Attorney-General's Department, *1982–1983 Annual Report of The Freedom of Information Act* (AGPS, Canberra, 1983) at 2 to 3. See also the original justifications for the federal FOI Act postulated by Senate Standing Committee on Constitutional and Legal Affairs, *Freedom of Information* (AGPS, Canberra, 1979) at [3.3] to [3.5] which roughly corresponds to those above.

766 From this point on references will be exclusively to the Commonwealth FOI Act, unless otherwise indicated. There are differences in detail of the various Acts, but the pattern of regulation is roughly the same.

767 *Freedom of Information Act* 1982 (Cth) s11 refers to "every person".

768 The charging structure is not straightforward but there are fees for requests for information and hourly rates for handling those requests by relevant government department or agency. See generally Harrison & Cossins, *Documents, Dossiers and the Inside Dope* (Allen & Unwin, NSW, 2nd ed, 1993) at 9 to 10.

769 Schedule 2 of the *Freedom of Information Act* 1982 (Cth) exempts certain agencies from the operation of the FOI Act either completely or for some of their specified activities or for particular documents.

(1) documents concerning the security, defence or international relations of the Commonwealth or its relations with the States;[770]
(2) documents the government received in confidence from a foreign government, international organisation or a State government or agency;[771]
(3) Cabinet[772] and Executive Council[773] documents. Under some of the State FOI Acts documents in this category which are at least 10 years old lose their exempt status;[774]
(4) documents concerning trade secrets and commercial-in-confidence;[775] and
(5) "Internal Working Documents".[776] One Author has indicated that this category includes the following:
- records of advice, opinions or recommendations given to or prepared by an agency or Minister;
- records of discussions between Ministers or between Ministers and departmental officials;
- policy-making documents;
- committee reports and recommendations;
- draft reports;
- drafts of Cabinet submissions;
- internal minutes;
- referee and staff reports;
- interdepartmental memoranda; and
- any other documents which discloses internal consultations or deliberations.[777]

FOI in Corporations?

FOI is seen in Australia as a valuable component of open government.[778] Given that companies may be regarded as mini-democracies the obvious question becomes whether FOI style principles can be applied to corporations. Certainly shareholders have rights to periodic information, principally the annual report containing the financial statements (discussed in the next chapter). But shareholders generally do not receive other information such as information concerning specific transactions or about the circumstances of a breach of the law by the company or its managers. An FOI style regime would give shareholders the right to investigate such matters. The regime would complement the information shareholders receive periodically.

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770 *Freedom of Information Act* 1982 (Cth) s33(1)–33A(1).
771 Above.
772 Above at s34.
773 Above at s35.
774 *Freedom of Information Act* 1982(Vic) s 28(2); *Freedom of Information Act* 1989 (NSW) Sch 1, Ch 1(2)(b); cf *Freedom of Information Act* 1991 (SA) Sch 1, clause (1)(2)(b) — 30 years.
775 *Freedom of Information Act* 1982 (Cth) s43.
776 *Freedom of Information Act* 1982 (Cth) s36.
777 Harrison and Cossins, *Documents, Dossiers and The Inside Dope* (Allen & Unwin, NSW, 2nd ed, 1993).
778 Australian Law Reform Commission and Administrative Law Council, *Open Government: A Review of the Federal Freedom of Information Act 1982* (AGPS, Australia, 1995) at 2.8 conclude, after reviewing the operation of the federal FOI regime for 13 years, that FOI is beneficial and supports open government, albeit with some qualifications. There is evidence that journalists use the FOI regime as a technique of investigative journalism; see Schultz, *Reviving the Fourth Estate: Democracy, Accountability and the Media* (Cambridge University Press, Australia, 1998) at 202.

The underlying philosophy which supports FOI in the political context (discussed under the previous heading) clearly are appropriate in the corporate context. Who would argue against improving the quality of manager's decision making, informing investors of decisions taken and the criteria for those decisions and giving more opportunities to participate in the making, or assess the quality, of a decision. The last justification which supports FOI in the political context, concerning access to personal records, would not normally apply in the corporate context. Companies generally do not keep personal information on their shareholders and normally do not make decisions which affect shareholders individually rather than as one of a class of shareholders. Nonetheless in my opinion an FOI style of disclosure should apply to companies.

One potential argument against adapting an FOI regime (and reasons for decisions, considered next) into corporations is the argument that these are public law remedies unsuited to the private domain. This argument can be met on at least two fronts. First, in the previous chapter I argued that it is no longer appropriate to have a strict public/private conception of corporations. Public corporations operate in the public domain and exercise public style powers. Second, to say that their is a line between the public and private is not persuasive unless there are convincing and substantive reasons that continue to justify that line. In my opinion the close analogy between the political and corporate democratic models obliterates that line.

The terms of the FOI regime would be the same as the existing system that operates in the political context. The regime should be available to any shareholder,[779] although a requirement that shareholders own a certain number of shares may avoid the problem of nuisance requests by busybodies who do not have a legitimate stake in the company. However in my opinion the threshold shareholding level should be quite small and could perhaps be tied to the concept of a "marketable parcel" of shares as set out in the Listing Rules.[780] If this share qualification had to be held over one year then this would lessen the ability of people to act opportunistically and strategically. These shareholders should be able to access the corporation's information for a small fee.

The next issue is what information should be made available to shareholders under an FOI style regime and should there be any exemptions. The logical starting point should be the same as the existing regime that all information is potentially available under an FOI regime subject to limited exemptions. At least two potential exemptions require serious consideration. Those two exemptions are of commercially confidential information and for an exemption based on equating the Board of Directors with Cabinet. I consider each these potential exemptions in turn.

A lot of commercial information of the company is highly confidential and should not necessarily be subject to immediate disclosure under an FOI regime. Confidential information, as discussed in chapters 1 and 3 should be exempt. As discussed there, information loses its confidentiality over time. So directors should be allowed to refuse disclosure whilst the matter is commercially sensitive but subject to a sunset provision of

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779 Arguably others such as creditors, employees and even the general public should have access to corporate information, but this issue is beyond the scope of this thesis.

780 The definitions in Listing Rule 19 provide, by cross reference to the business rules, that a marketable parcel is $500 worth of securities based on market prices. In my opinion a 5% of voting share threshold, like that which entitles shareholders to requisition (CL s249D) or convene (CL s249F) a general meeting, is too high (cf with the US position where shareholders must own for at least one year 1% or $1,000 in market value of shares-Rule 14a-8(a)). Where large public companies have on issue tens of millions of dollars worth of shares then if there were a 5% threshold then only the biggest investors would have any right to utilise the proposed FOI regime, which defeats its purpose.

some sort, say two years. This would allow particularly sensitive material not to be disclosed at the time it is most sensitive but allows for eventual disclosure and accountability, hopefully during the term of office of the majority of the directors who made the decision. This is consistent with the FOI legislation which only exempts cabinet documents from disclosure for a set period of time.

The second exemption concerns the exemption for cabinet documents and involves the argument that directors in governing their companies are in a position analogous to Cabinet. However before pursuing the analogy it is questionable whether there should be such an exemption for cabinet documents. The justifications for the exemption in the political arena is examined below, but I conclude that even if the analogy is correct the position of the Board can be distinguished from that of Cabinet so that a blanket exemption is not appropriate for Boards of directors. Therefore I do not need to resolve the fundamental question concerning the Cabinet exemption (after all this is a thesis about corporate information).

If the analogy is appropriate then arguably the blanket exemption which protects from disclosure all Cabinet documents, should similarly apply to all of the Board's decisions and documentation. If this is correct then all of their routine decisions and consummated business should also be exempt. The analogy between the Board and Cabinet is correct but only to a certain point. Both bodies are elected representatives charged with the function of making ultimate decisions. However they are sharply different in that Cabinet is only a portion of the elected representatives drawn from the political party which commands a majority in Parliament. That majority political party has an established opposition party (or parties) who jealously await and manoeuvre to become the majority party. In contrast the board of directors are a unitary body consisting of all the elected representatives. The significance of this becomes apparent in the discussion below.

Even if in a broad way the board of directors is analogous to Cabinet this does not conclusively point to an exemption from an FOI regime of disclosure being appropriate. To consider the appropriateness of such an exemption I must consider why Cabinet decisions are exempt and consider whether the justification for exemption is persuasive in the corporate context.

The standard justification for the cabinet document exemption is that otherwise their deliberations would be gravely inhibited.[781] The Legal and Constitutional Committee of the Victorian Parliament extensively examined the justification for the exemption in a 1989 report.[782] The committee stated that the "rationale for Cabinet secrecy derives from the convention that members of Cabinet must collectively accept responsibility for its decisions and the actions taken to implement those decisions".[783] The committee sought to explain the convention of collective ministerial responsibility by reference to three rules. They explained those rules as follows:

> First, there is the "confidence" rule. In short, this rule provides that a government which loses the confidence of Parliament must either resign or advise dissolution. Secondly, there is the "unanimity" rule. This rule provides that if a Minister cannot agree publicly with the decisions or actions of Cabinet then he or she must resign. Thirdly, there is the "confidentiality" rule. This provides that the

781 *Re Waterford and Director-General of Health*, AAT, No 83/14, 2 Sept 1983 at 13 to 14.

782 Victoria, Parliament, Legal and Constitutional Committee, *A Report To Parliament Upon Freedom Of Information In Victoria* (Victorian Government Printer, Melbourne, 1989).

783 Above at 69.

> deliberations and decisions of Cabinet must remain secret. Without such a rule, Cabinet unanimity would be impossible to uphold.

Cabinet is designed to operate so there is full, frank and robust debate within the Cabinet, but behind closed doors. That is the time for Ministers to fully express their individual opinions and seek to persuade their colleagues about what the government's policy should be. This process of rigorous debate with a diversity of views being put enhances the quality of the decision-making process. However once a decision has been taken all Ministers must support and are collectively responsible for that decision even if they took a stridently opposing view in Cabinet. If the opposing views they held during Cabinet meetings were disclosed then this would undermine collective responsibility. In turn this may lead Ministers to not be as open in their views in Cabinet as they should or would like to be for fear of it later being used to undermine their own collective decision. This would affect the quality of their decision making process.

It is important to contextualise this convention. The convention exists in a democratically elected Parliament which is usually dominated by two political parties. Political parties are elected based on their political platform and therefore unanimity is important in pursuing the policies that got them there. In addition the party in opposition is well aware of the adage of "divide and conquer". If there is a division in the majority party the opposition will be able to destabilise the incumbent government and ultimately may be able to succeed on a vote of no confidence. As the committee makes clear the convention is not a matter of "constitutional necessity" but of "political survival".[784]

The convention of collective ministerial responsibility, and its resultant doctrine of cabinet secrecy, operates at the expense of open government and the free flow of information. This was poignantly reported by the Fitzgerald Inquiry into corruption in Queensland conducted in the late 1980's which stated:

> It is obvious, however, that confidentiality also provides a ready means by which a Government can withhold information which it is reluctant to disclose...
>
> The ultimate check on public administration is public opinion, which can only be truly effective if there are structures and systems designed to ensure that it is properly informed. A Government can use its control of Parliament and public administration to manipulate, exploit, and misinform the community, or to hide matters from it. Structures and systems designed for the purpose of keeping the public informed must therefore be allowed to operate as intended.
>
> Secrecy and propaganda are major impediments to accountability, which is a pre-requisite for the proper functioning of the political process. Worse, they are the hallmarks of a diversion of power from the Parliament.
>
> Information is the lynch pin of the political process. Knowledge is, quite literally, power. If the public is not informed, it cannot take part in the political process with any real effect.[785]

Perhaps the whole Joh Bjelke-Peterson government, which the Fitzgerald Inquiry was investigating, was infected with this style of government. Another particularly notable example occurred in Federal politics in 1984. A document titled " The Strategic Basis of

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784 Above at 70.

785 Quoted in Victoria, Parliament, Legal and Constitutional Committee, *A Report To Parliament Upon Freedom Of Information In Victoria* (Victorian Government Printer, Melbourne, 1989) at 71 to 72.

Australian Defence Policy" of the Hawke Labour Government was leaked. This document was contrary to ALP's policy platform on this issue. The leak caused the Hawke government significant embarrassment.[786] If the result of Cabinet secrecy[787] is that the endorsed position is significantly different than the one sold to the public then secrecy must be seriously questioned. This must be more so in companies where leaks do not occur with any frequency.

So how do these arguments translate to the corporate context? I suggest they do not. Directors are not elected on the basis of a party platform and do not have an opposition seeking to divide and conquer them. Hence the fundamental political environment which provides the justification for cabinet secrecy is not present in companies. There is no compelling political need for unanimity.

If there was FOI style disclosure for companies shareholders would have access to the documents that record board decisions and the documents on which those decisions were based. Shareholders without more would not necessarily be aware of the diversity of views that exist or should exist amongst their elected directors. Much of such diversity will only be evident during the discussion at the meetings. However I make suggestions for reform concerning this in chapter 7.4 under disclosures about the duty of care. Without wanting to pre-empt that analysis, if those reforms were adopted then in conjunction with such FOI style disclosure shareholders would have access to documentation that would reveal the diversity of views that exist or should exist amongst their elected directors. It is worth emphasising that if FOI principles applied to companies this would not create the diversity of opinion, just enable shareholders to be aware of that diversity. If they are aware of these differing views this may well assist them in ultimately assessing the wisdom of any majority decision taken. Also if shareholders were aware of who expressed which views this would be useful information at the time directors offer themselves for re-election. Such disclosures can only make the directors more accountable to shareholders. Whether shareholders utilise this information in the ways I have suggested is a difficult question. But being provided with the information at least enables them to make rational decisions if they are so inclined.

However even without a policy platform and in the absence of an active opposition any collective decision making body needs a certain amount of stability in order to operate effectively. If any body is engulfed in factional infighting where a majority view is difficult to obtain or sustain then that body has degenerated into chaos and is not working effectively. There is the argument that reporting diverse opinions would undermine the stability of the collective decision making process of directors. However, in my opinion, this argument is both a question of degree and misses the mark. There is a spectrum from harmonious unanimity through some disagreement to complete disagreement and an inability to come to a collective decision. Simply because a diversity of opinion is expressed and reported or made available to shareholders does not mean that a body has degenerated to chaos, to the other end of the spectrum. Secondly it is not the reporting of the diversity of the opinion that is the problem but the extent of the disunity on the board. That will be a fact of the make-up of the board of directors; reporting or non-reporting does not alter this. Even if there is profound disunity in my opinion shareholders should be aware of this. It is not a case of an opposition waiting in the wings to take advantage of the disunity. If disunity exists or even if there is only a diversity of opinion then all

786 See the account of this affair in Toohey and Wilkinson, *The Book of Leaks* (Angus & Robertson, Australia, 1987).

787 Although non-disclosure of this document is better classified under the defence and security exception since it is a final decision.

the more reason for shareholders to be able to find out and, if appropriate, take action to resolve the issue.[788]

However most collective decision-making bodies have a strong distaste about disclosure of any hint of dissension amongst their ranks. This distaste is evident across a broad range of diverse groups such as political parties, administrators of sporting bodies and even families (such as the Royal Family or a prominent dynasty). The common dynamic seems to be driven by the following common impulses:

- insulation from criticism;
- protection of collective self esteem;
- concern over unsubstantiated criticism based on misinformation or motivated by malice; and
- perceptions of dissension and infighting implies that as a group they are unable to deal with disagreement in a constructive manner and are therefore ineffective in their role.

In the corporate context (at the least) the first two concerns are not sufficiently significant to justify non-disclosure. Directors should not be insulated from criticism because of a screen of non-disclosure and their self-esteem is of no concern in the face of the strong justifications for disclosure. The third concern is legitimate but is a risk all people face and can be countered by the directors disseminating more accurate information. In my opinion this third reason also does not substantiate an exemption from disclosure. The fourth concern is primarily concerned with perceptions and confidence. If there is dissension amongst directors which they are unable to constructively resolve and shareholders become aware of it, then the probable consequence is shareholders will lose confidence in the directors and question their leadership. From the directors perspective they are obviously interested in ensuring that this perception is not created as it may jeopardise their positions. If this perception is unfounded then the directors concern is legitimate. But if this perception matches the reality then any ongoing show of unity is merely a facade. A deceitful display of unity to insulate directors from warranted criticisms and perhaps remedial action does not justify an exemption from disclosure, especially from a disclosure rule designed to benefit shareholders.

Another reason to reject the immunity is based on a criticism raised by the Victorian Committee in the political context. The committee was of the view that the doctrine of cabinet secrecy:

> has served to aggregate power in the hands of the leader of the government. The primacy accorded to the value of coordination and the means which leaders have used to achieve it has been seen as transforming the convention from an instrument of political survival into a means of prime ministerial control. It is argued that the accretion of power at the centre of government has been at the cost of effective accountability to both Parliament and people.[789]

The correlate of the Prime Minister in the company is the managing director. The Cadbury Report on Corporate Governance stresses the importance of a properly

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788 Although shareholders do not have power to unilaterally reverse management decisions under standard corporate constitutions (*John Shaw & Sons (Salford) v Shaw* (1935) 2 KB 113; *NRMA v Parker* (1986) 11 ACLR 1) they could amend the articles to give them this power (CL s136(2)) or remove all or some of the directors from office; public companies CL s227; proprietary companies CL s226E (replaceable rule) and Table A cl 62.

789 Victoria, Parliament, Legal and Constitutional Committee, *A Report To Parliament Upon Freedom Of Information In Victoria* (Victorian Government Printer, Melbourne, 1989) at 71.

constituted board so that the company is "not dominated by any one individual".[790] Spectacular corporate collapses where a dominant CEO was at the helm, such as Marcus Clark with the State Bank of South Australia[791] and Friedrich and the National Safety Council,[792] stand as tombstones to this principle.

For these reasons the board of directors should not be equated with cabinet in order to justify an exemption from FOI style obligations applying to companies.

In my opinion the decisions of the Board of Directors and the information upon which those decisions are based should be subject to an FOI style regime of disclosure, subject to a limited exemption for confidential information (the terms of which would have to be closely defined). Shareholders have a right to court assisted access to information, which I consider in chapter 10.3. This right is the closest equivalent in the corporate context to a FOI regime. The conclusions in this chapter about FOI are pertinent to the analysis of this right of shareholders.

5.6 ADMINISTRATIVE LAW — REASONS FOR DECISIONS

The common law does not impose on administrators a general obligation to provide reasons for their decisions.[793] At the Federal level this position has effectively been reversed. Generally speaking any person who is unhappy with an administrative decision which affects them can take action which forces the decision maker to provide a written statement setting out the material factual issues, the evidence and information which supports those facts and the reasons for the ultimate decision.[794] Certain decisions are exempt, with the exemptions being similar to those under the FOI legislation.[795] The justification for the right to be given reasons for a decision is so the person affected can assess the fairness or correctness of the decision and decide whether to appeal the decision.[796] It is important to bear in mind the context of administrative decisions. Such decisions are about an individual or directly affect the individual in a manner substantially different from the public at large.[797] In this context there are clear and strong reasons to require the decision-maker to provide reasons. To require decision-makers to provide reasons is supported by the personal autonomy justification which supports freedom of expression. People are entitled to understand why a decision has been taken which will affect their life. The argument is most pertinent when the decision is about the person as an individual and may directly be about their autonomy.[798]

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790 Cadbury Committee, *The Financial Aspects of Corporate Governance* (Gee, Great Britain, 1992).

791 Auditor-General of South Australia, *Report on an Investigation Into the State Bank of South Australia* (Government Printer, South Australia, 1993) at chapter 21 (particularly at 21-9 and 21-78); Sykes, *The Bold Riders* (Allen and Unwin, Sydney, 1994), Chapter 15.

792 The facts of which are briefly explained in *Friedrich v Herald and Weekly Times* [1990] VR 995.

793 *Public Service Board of New South Wales v Osmond* (1986) 63 ALR 559; Allars, *Australian Administrative Law: Cases and Materials* (Butterworths, Sydney, 1997) at 215 to 225.

794 *Administrative Appeals Tribunal Act* 1975 (Cth) s28(1); *Administrative Decisions (Judicial Review) Act* 1977 (Cth) ss 13A and 14.

795 *Administrative Appeals Tribunal Act* 1975 (Cth) s28(2); *Administrative Decisions (Judicial Review) Act* 1977 (Cth) ss 13A and 14.

796 *Burns v Australian National University* (1982) 40 ALR 707 at 715; *Ansett Transport Industries (Operations) Pty Ltd v Wraith* (1983) 48 ALR 500 at 507.

797 See the rules for when the court will imply a requirement for natural justice discussed in *Kioa v West* (1985) 159 CLR 550 per Mason J at 584 and Brennan J at 619.

798 As in *Kioa v West* which was a deportation case.

A further argument which supports the requirement to provide reasons is that if decision-makers are forced to give the reasons for their decisions then this should improve the quality of their decisions. As Allars states in her textbook:

> It is at the very least plausible to assume, with the support of anecdotal evidence and the principles of decision theory that such duties do encourage decision-makers to take care to make decisions which are not arbitrary.[799]

The simple reasoning behind this is if decision makers know they will be asked to explain the rationale of their decisions, they will think more seriously before taking the decision. A more cynical approach suggests that decision-makers will still reach the decision they want to and then justify it by the available legitimate reasons that exist. This type of decision-making no doubt occurs but it is extremely unlikely whether any type of rule could successfully prevent this from occurring. A rule requiring reasons prevents the arbitrary decision being taken and it allows the reasons given to be evaluated and, if possible, challenged. Others may well regard the reasons given by the original decision-maker not to be persuasive.

So can these principles apply to corporations?

Usually the nature of a director's decision is different from that of a public servant. The decisions of directors will not directly affect the shareholder as an individual but rather as one of a class, namely shareholders. There is not the same immediate, direct affect on the individual, who is generally not the subject of the decision, which supports the need for the decision maker giving reasons in the administrative context. However in my opinion this does not destroy the argument for reasons for decisions being given by directors of corporations.

One of the primary justifications for giving reasons is so that persons affected by the decision can assess its fairness and correctness and therefore how well the decision-maker is performing their job and to decide whether to challenge the decision. The imposition of an obligation to provide reasons for decisions is another structural mechanism which endeavours to ensure decision-makers are accountable to those affected by their decisions. As it is a mechanism of accountability it is difficult to see why it should not apply to directors exercising discretionary decision-making powers. Although normally shareholders cannot appeal a directors decision in a court of law,[800] they have self help remedies such as removing the directors from office or amending the constitution so that they have the power to override a directors decision. These are powers that a citizen disgruntled with an administrator's decision would be envious of. In my opinion shareholders should have the right to the reasons which actuated directors to take a decision. I develop this notion further later in the thesis where I analyse the potential information available under the duty of care.[801]

5.7 CONCLUSION

In the political arena there are no constitutional rules binding the government of the day to disclose information to the electorate. In some senses this is not so surprising given that they hold sovereign power in a nation state. However in contrast our notions of democracy have evolved. As citizens in a participatory style of democracy we have

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799 Allars, *Introduction to Australian Administrative Law* (Butterworths, Australia, 1990) at 133.

800 As mentioned earlier in this chapter at 5.2. See also the analysis of the exclusive management power cases at chapter 4.3.

801 See chapter 7.4 under the heading 'Care'.

rights and demand open and responsible government in order to try to ensure the accountability of our elected representatives. In accord with these notions governments have bound themselves by a variety of laws to provide a vast array of information. Generally citizens under notions of open government have access to information on any topic within the political spectrum, subject to some notable exceptions, such as security, defence and international relations.[802] Citizens receive information by way of voluntary disclosures from or under the authorisation/command of the government, by means of the opposition and media and by pro-actively pursuing it under Freedom of Information legislation.[803] Similarly shareholders as corporate citizens should as a general principle be entitled to information on any topic concerning the corporation. This should be subject only to appropriately justified and closely constrained exceptions. The task then is to identify those exceptions. As discussed in chapter 3, only commercial-in-confidence information and trade secrets should be excluded. The conclusion for the purposes of this thesis is that shareholders as citizens need comprehensive information concerning the corporation in order to properly acquit themselves in this role.

Besides the bare disclosure of information there are also structural dynamics in place which help to fashion a workable degree of accountability. That accountability ensures not just a flow of information to the electorate but also scrutiny of that information by capable and self interested people. Those structural dynamics are principally:

- a governing political party which must offer itself for re-election every 3 or 4 years in the face of an established, permanent opposition; and
- active media coverage and scrutiny of political life.

In the corporate context the dynamic is not the same. Certainly directors are elected by shareholders but on a rotational basis.[804] Normally the entire slate of directors do not face re-election at the same time. Also re-election certainly does not normally occur in the face of a permanent and active opposition, which is generally absent in the corporate context. The media operates in the corporate context but their coverage is not comprehensive and independent scrutiny is relatively weak. Therefore there is not the same structural dynamic in place to enable accountability and a flow of information to shareholders. Two inferences can be drawn from this conclusion.

First, it is not surprising to see a range of statutory rules which compel directors to disclose information to shareholders. As an aside it is interesting to note that nearly all disclosure rules are statute based. This seems to be a consequence of companies being an artificial creature of statute themselves. Therefore Parliament itself has been responsible for designing accountability rules for its creation. The general law has only played a relatively minor role in this area.[805]

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802 See for example the exceptions to disclosure under the *Freedom of Information Act 1982 (C/W).* at ss33 to 36 discussed above.

803 *Freedom of Information Act 1982 (C/W)*. Freedom of Information Acts also exist in Vic (1982), NSW (1989), ACT (1989), SA (1991), Qld (1992) and WA (1992).

804 See chapter 4.3 under the heading 'Role of Shareholders'. Certainly the members of the Senate are elected on a rotational basis, with one half of the Senators retiring every 3 years after holding office for 6 years (*Commonwealth of Australia Constitution Act* 1901 s13). But the members of the House of Representatives all face election at the same time. As a matter of convention the party which commands a majority in the House of Representatives forms the government of the day. So certainly the rotational election system is not the crucial one in the political context, as it is in the corporate context where there is a unitary Board of Directors.

805 The two most notable areas where the general law has played a key role is insisting on information that goes to shareholders with a notice of meeting (see chapter 10.4) and allowing applications to court for inspection of corporate documents (see chapter 10.3). Although the

The second inference is that in the absence of an active opposition and thorough media coverage other structural mechanisms need to be in place to ensure the independent scrutiny of company sourced information to ensure its credibility. Without such independent scrutiny the real risk is directors will not frankly and accurately disclose information about their own performance, particularly if it is lacklustre or bad. Market forces are not suited to this task and do not equate to an active opposition or effective media. This need for independent scrutiny has been recognised by Parliament in the key area of financial statements. The law insists that the financial statements of the company be scrutinised by independent auditors before that information is released to shareholders. The requirement for an audit of financial statements is so well entrenched it is easy to lose sight of the fundamental reasons for such a requirement or to question its cost. In this thesis I will critically examine whether independent scrutiny by auditors is appropriate for other types of information disclosed by directors. However running in tandem with this inquiry is always the pragmatic issue of whether the benefits of such audits justify their cost. Put at its most basic level the issue is whether shareholders are willing to pay for these audits. It is not quite that simple because the need for an audit may be so acute and concerning such important issues of corporate behaviour affecting people other than just shareholders that public policy requires such an audit. The most obvious example of this is information concerning the environmental and other social impacts the company has in the community (which I examine in chapter 9).

Finally in this chapter I examined the FOI regime and the requirement for reasons for decisions in administrative law. Both of these requirements are statutory based mechanisms designed to ensure the accountability of decision-makers in the public arena by ensuring certain types of information is available to those affected by their decisions. Both of these measures have been adopted in Australia in the last 20 years and are seen as a (necessary) adjunct to a democratic system of government. From the perspective of citizens, they are important legal rights that underpin the idea of open government in a modern democracy. Modelling the governance of companies on the democratic system predates by a significant period the advent of FOI disclosure regimes and the requirement that administrators provide reasons for their decisions. Therefore it is not surprising that they are generally absent from corporations. In my opinion these public law regimes are equally appropriate to be adapted and applied in the corporate context and their inclusion is now overdue. That is, shareholders as citizens in a corporate democracy require equivalent legal rights if they are to enjoy open government in order to bolster the accountability of their elected representatives. I apply the principles of freedom of information to suggest improvements to the weaker right of shareholders to court assisted access to information in chapter 10.3. I utilise the reasons for decisions doctrine in chapter 7.4 in arguing for increased disclosures under the duty of care.

The conception of shareholders as corporate citizens, with concomitant rights to information, reinforces the implication arising from information not being property. That implication is that corporations do not have exclusive rights to their information and certainly are not entitled to restrict access to corporate information by shareholders. That is shareholders should have rights to all corporate information, subject only to trade secrets and other forms of commercial-in-confidence information. This conclusion is the foundation for my call for increased disclosure of "non-financial" style information made in chapters 7, 8 and 9.

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latter general law position has now all but been superseded by a superior statutory right of inspection set out in CL s247A.

5.8 SUMMARY OF MODEL DEVELOPED: SHAREHOLDERS AS MONITORS, INVESTORS AND CITIZENS

So far in this thesis the analysis has traversed a broad range of areas and material. It is appropriate after all of this analysis to summarise the model developed and explain how it applies in the subsequent chapters dealing with corporate information.

The opening proposition and beginning of the thread to the whole analysis is that shareholders and directors occupy different but inter-related governance roles and functions in corporations. As a result of the segregation of roles and functions communication between them is necessary. Communication was defined as the endeavour of passing knowledge, by information, from one person to another. This definition begged the questions, who is speaking, to whom, and for what purpose? That is, it is imperative to identify speaker and their audience and the purpose of their communication. Translated in the corporate context, this required deconstructing the concept of shareholders in an endeavour to understand the information needs of shareholders and therefore what information directors should communicate to them. Chapter 4 analysed legal conceptions of shareholders, the role and functions of shareholders and directors, what is the company and the people who are shareholders. The conclusion drawn from this chapter is that shareholders are comprehensive monitors and investors. Chapter 5 involved a less traditional analysis by drawing an analogy between corporations and democratic governments. The principal conclusion from this chapter is that shareholders are a class of citizens with identifiable rights and obligations flowing from this designation.

This model of shareholders as monitors, investors and citizens is used in subsequent chapters of the thesis for three purposes, namely:

1. to determine if the types of information shareholders currently receive is justifiable;
2. to analyse whether additional types of information and improvements to existing disclosures or disclosure methods are justified; and
3. to determine whether the information shareholders currently receive is suited and useful to their needs.

The first purpose is to determine if the types of information shareholders currently receive is justifiable. That is, is the information currently disclosed to shareholders legitimately directed to satisfying the needs of shareholders in their role as monitors, investors or citizens. For shareholders to properly function in those different roles requires and justifies the disclosure of different types of information. A separate section in chapters 6 and 9 and separate sections in chapters 7 and 8 address the justification for each substantive area of disclosure made or proposed to be made therein. Whether the disclosure methods described in chapter 10 are justifiable is also analysed using the model.

Second, the model is used to analyse whether additional types of information and improvements to existing disclosures or disclosure methods are warranted. The information needs of shareholders as monitors and investors are broadly speaking the traditional legal model used to justify existing disclosures. Shareholders as citizens is an unorthodox legal paradigm which justifies disclosure of all types of corporate information, subject only to specially justified and tightly constrained exceptions (principally commercial-in-confidence information and trade secrets). Citizenship also justifies an FOI style disclosure regime in corporations consistently with evolving notions of open government. This broad view of the information needs and rights of shareholders is also supported by the conclusion that information is not property and therefore it can not be successfully argued that information can be withheld from shareholders because it is exclusively owned by the company. It is also supported by the "spreadability" characteristic of information and the "public good" notion of information. Shareholders as citizens constitute the public in corporations. Therefore general arguments that disclosure of information is in the public interest translate in the corporate context to justify disclosure of information in the interests of shareholders as citizens.

Third, the model is used to determine whether the information shareholders currently receive is suited and useful to their needs. This purpose squarely brings into play the quality criteria developed in chapter 2. The criteria are accuracy (including completeness), credibility, relevance, comparability, understandability, accessibility, timeliness, cost and confidentiality. In each chapter, the information that is disclosed is measured against these quality criteria to determine the suitability and utility of the information provided to shareholders in their capacity as monitors, investors and citizens. In particular the criteria of relevance addresses the issue of suitability and the other criteria address the utility of the information.

CHAPTER 6

FINANCIAL INFORMATION NEEDS OF SHAREHOLDERS

6.1 INTRODUCTION

In the first five chapters I developed a model from which to examine the information needs of shareholders. I examined information and the communication process from a variety of disciplines, including law. This led to deconstructing the defining characteristics of shareholders in order to analyse their information needs. Shareholders have needs as monitors, investors and as citizens. Early in the analysis I also established the need to ensure the quality of information judged according to various criteria. Analysis of the analogy to the political democracy pointed to the lack, or relative weakness, of structural mechanisms to ensure the quality of corporate information (notably absence of an active opposition and weaker role of the media). Thus other mechanisms are necessary to shore up the quality of corporate information. I use these notions of who shareholders are and their concomitant information needs and these quality criteria as the model from which to analyse the information shareholders do or should receive, starting with financial information in this chapter.

In this chapter I examine the justification for the disclosure of financial information (6.2) and then analyse the financial statements shareholders receive together with the attached directors' declaration (6.3 and 6.4 respectively). Next I examine the requirement that the financial statements be audited (6.5). Auditors independently scrutinise financial statements, which enhances their credibility.[806] The financial statements, directors' declaration and audit report comprise the principal information shareholders receive about the financial position of their company. The financial statements "present in dollar terms the stories of enterprises".[807] These periodic financial statements are the focus of this chapter. However I also discuss the annual report (6.6), the half-yearly financial reporting requirements (6.7), financial reporting to the ASX (6.8) and the obligations concerning a dividend announcement (6.9). I separately analyse the quality of the information discussed in this chapter (6.10) and finish with a conclusion (6.11).

Financial information is not hermeneutically sealed within this chapter. Some of the information on topics dealt with in subsequent chapters is properly classified as financial information. Also it should be noted that shareholders receive financial information by other means, for example pursuant to the continuous disclosure regime or when a prospectus is issued. These other means of disclosure are also discussed in subsequent chapters.

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806 Auditing Standard 202 'Objective and General Principles Governing an Audit of a Financial Report' ("AUS 202") at paragraph .08 states an audit "provides reasonable assurance as to whether the financial report as a whole is free from material misstatement"; *Re London and General Bank Ltd ex parte Theobald (No. 2)* [1895-9] All ER 953 at 956; Tomasic, Jackson and Woellner, *Corporations Law: Principles, Policy and Process* (Butterworths, Sydney, 3rd ed, 1996) at [9.2]. Audit is discussed below in chapter 6.5.

807 Hey-Cunningham, *Financial Statements Demystified* (Allen & Unwin, Sydney, 2nd ed, 1998) at 1.

6.2 JUSTIFICATION FOR DISCLOSURE OF FINANCIAL INFORMATION

Providing financial information to shareholders is principally and clearly justified in their role as investors and also as monitors.[808]

Shareholders invest in public listed companies with the expectation that the company will prosper and in turn increase their own wealth. Shareholders reap the profits of the company either in the form of a dividend or if the net worth of the company increases, which should be reflected in the trading price of their shares on the stock market (ie capital gains or losses).[809] Wealth generation is the bottom line of modern trading companies.[810] Therefore shareholders as investors are vitally and principally interested in receiving timely, quality information about the financial health or otherwise of the company. Indeed the primary purpose of financial statements is to provide reliable financial information to users of them,[811] who in "for-profit" corporations are principally shareholders. Shareholders can thereby appreciate the company's financial position at a particular time and its performance over a particular period. Shareholders and potential shareholders use financial information to assist in investment decisions; either to withdraw their investment (sell shares), increase their investment (buy more shares)[812] or hold their investment. This is supported by the efficient markets hypothesis discussed in chapter 4.6.[813] Little argues persuasively that it has been the intent of Parliaments that investment decisions be protected and that financial statements are prepared not just for the benefit of existing shareholders but also for potential shareholders.[814]

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808 The role of shareholders as investors and monitors was discussed in chapter 4. The separate investment ("allocation of scarce resources") and monitoring ("accountability") roles are recognised in SAC 2 in paragraphs 12 to 14.

809 Anderson, 'The Usefulness of Annual Reports' in Courtis (ed), *Communication Via Annual Reports* (Financial Management Research Centre, Armidale, 1981) 61 at 63 states that as "market prices are available for shares listed on the Stock Exchange of Melbourne, the major requirement of investors would be information to assist in the prediction of future dividends". Also at 65 Anderson reports the results of a shareholder survey which led him to conclude that "an equal combination of dividend income and capital gains was considered the most important objective...The next most important objective was that of long-term capital gains. Dividend income by itself was considered almost as important as long term capital gains whilst the objective of short term capital gains was considered relatively unimportant". This survey was of individual investors only (at 64).

810 This conception of the company is described in Clark, *Corporate Law* (Little Brown & Co, New York, 1986) which I have discussed at chapter 4.4.

811 Statement of Accounting Concept 2 'Objective of General Purpose Financial Reporting' ("SAC 2") at paragraph 11; Ford, Austin and Ramsay, *Ford's Principles of Corporations Law* (Butterworths, Sydney, 9th ed., 1999) at [10.010]; McQueen, 'The Corporate Image-The Evolution of the Annual Report in Australia 1950-1990' (Paper delivered at the Corporate Law Teachers Conference, The University of Melbourne Law School, February 1997, author on file) at 10 and 16; Epstein and Pava, *The Shareholder's Use of Corporate Annual Reports* (JAI Press, Connecticut, 1993) at 3 and chapter 2.

812 Or in the case of potential shareholders, buy an initial parcel of shares.

813 There is evidence that an audit report has little effect on investor decisions and attitudes; see Estes, *The Auditors Report and Investor Behaviour* (Lexington Books, U.S.A., 1982) at 87. One explanation of this is that investors have already incorporated the information contained in the audit report and the financial statements into the share price and unless the audit report contains a surprise (which is rare) then the audit report is old news (at 91).

814 Little, 'The Policy Underlying Financial Disclosure by Corporations and its Effect upon Legal Liability' (1991) Australian Journal of Corporate Law 87. Little also argues that the financial statements are designed to protect other stakeholders in the company, namely creditors, and possibly also employees, unions, consumers and the public. There is some judicial support for this: see *Directors of Liquid Air (WA) Pty Ltd v Commissioner for Corporate Affairs* (1989) 7 ACLC 351. The interests of these people is generally beyond the scope of this thesis.

Disclosure of financial information is also justified from the perspective of shareholders as monitors. The financial performance of the company can be and is linked with director's performance.[815] After all it is the job of directors and the executives to manage efficiently and effectively their corporations so profits are maximised. If the company is not prospering then the natural inference is that directors and executives are not adequately performing their job. It is almost trite to state that shareholders as monitors are justified in requiring information that explains how well or poorly directors are acquitting this principal function of managing the corporation profitably.

Of course the directors and executives may be providing the best management possible but for a variety of extraneous reasons the company may nonetheless be struggling. For example a new competitor may enter the market with new and advanced technology or with lower operating costs against which the company cannot compete.[816] More generally the economy may be in recession and this may cause a downturn in profitability. These types of possibilities indicate that the financial results of a company are not necessarily a measure of managerial performance. This justifies the need for other more direct measures of management performance, an issue which I explore in chapter 7.3. It does not invalidate the financial statements currently being the primary indicator of management performance, although the financial statements may not be conclusive.

As suggested by the above analysis, one point worth bearing in mind is that the roles of monitoring and investing are not entirely separate. For monitoring to be a worthwhile exercise, shareholders have to be able to take appropriate action. As I examined in chapter 4, shareholders have an array of self-help remedies at their disposal. However one action, and often the easiest, is to buy or sell shares. This has traditionally been the choice of institutional investors who are often accused of having an investment horizon that is too short-term.[817]

Shareholders as citizens do not have any claim to financial information different to the claim from their perspective as investors and monitors.

6.3 FINANCIAL REPORT

Accounting Records

In order to prepare financial statements the company must keep adequate accounting records. CL s286(1) provides:

> A company...must keep written financial records that:

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815 Blair and Ramsay, 'Mandatory Corporate Disclosure Rules and Securities Regulation' in Walker and Fisse (eds.), *Securities Regulation in Australia and New Zealand* (Oxford University Press, Auckland, 1994) at 269 to 270. This is also the rationale of the decision in *Caparo Industries Plc v Dickman* [1990] 2 WLR 358, discussed below in chapter 6.5 under the heading 'Report To (Whom)?'.

816 This is a growing risk in an increasingly globalised economy; see Wriston, 'The State of American Management' (1990) 68 Harvard Business Review 78 at 81.

817 Commonly called the Wall Street Rule; see Rock, 'The Logic and (Uncertain) Influence of Institutional Shareholder Activism' (1991) 79 The Georgetown Law Journal 445 at 462 to 463; Herzel, 'Boards of Directors Versus Institutional Investors' in Baums, Buxbaum and Hopt (eds), *Institutional Investors and Corporate Governance* (Walter de Gruyter, Berlin, 1993) at 162. There is empirical evidence which contradicts short termism; see Epstein and Pava, *The Shareholder's Use of Corporate Annual Reports* (JAI Press, Connecticut, 1993) at xii and 74.

(a) correctly record and explain its transactions and financial position and performance; and
(b) would enable true and fair financial statements to be prepared and audited.

The obligation to keep proper accounting records is cast upon the company. However given this important function is a management function it therefore is the ultimate responsibility of directors.[818] Directors usually delegate this function to the executives. In the normal course of events this is appropriate as directors are entitled to rely on management unless directors "know of facts, or by the exercise of reasonable care should have known, any facts which would awaken suspicion" which indicates that reliance on the executives is unreasonable.[819] However beyond this general proposition, under the Corporations Law the directors are potentially liable to a civil penalty if they fail to take reasonable steps to ensure the company complies with any of the company's obligations concerning the financial statements, including keeping proper financial records.[820] Besides this civil penalty liability, there is also a presumption of insolvency if the company failed to keep adequate financial records.[821] In turn this may lead to directors being personally liable for debts incurred by the company whilst it was insolvent.[822]

Also the auditors must form an opinion about and report whether sufficient financial records have been maintained to enable a financial report to be prepared and audited.[823] This check goes a long way to ensure proper accounting records are maintained.

Content of Financial Report

The Corporations Law obliges all disclosing entities, public companies, large proprietary companies and registered schemes, to prepare a financial report each financial year.[824] Small proprietary companies have to prepare financial reports only if directed by 5% of its shareholders or by the ASIC.[825]

The financial report comprises the financial statements, the notes to the financial statements and the attached directors' declaration.[826] The financial statements comprise:
- a balance sheet as at the end of the year;
- a profit and loss statement for the financial year; and
- a statement of cash flows for the year.[827]

These different documents show different financial information.[828] The balance sheet shows, as at the a certain date, the assets and liabilities of the corporation and a net

818 Ickeringill, 'Statutory Responsibilities of Directors and Auditors In Relation To Company Accounts (including a consideration of approved accounting standards)' (1988) 6 C&SLJ 3 at 24.
819 *Daniels v Anderson* (1995) 13 ACLC 614 at 663 to 664. I discuss this issue in chapter 7.4.
820 CL s344 & 1317DA.
821 CL s588E(4).
822 CL s588G to 588Z. The combined effect of ss 588E(4) and 588G to Z overcomes an old problem of incompetent or deceitful directors not maintaining adequate accounting records and therefore it was impossible to prove liability to the requisite standard under the insolvent trading provisions; see *International Business Strategies Pty Ltd v Lucas* (1995) 17 ACSR 269.
823 CL s307(c), s308(3)(b) and s311.
824 CL s292.
825 CL ss 292(2), 293 and 294.
826 CL s295(1) and (3).
827 CL s295(2).
828 See generally Hey-Cunningham, *Financial Statements Demystified* (Allen & Unwin, Sydney, 2nd ed, 1998) at chapter 2.

position together with the shareholders equity position. The profit and loss statement shows, over a certain period (usually one year), the income earnt and expenses incurred and the net profit or loss as a result. The statement of cash flows shows, over a certain period (usually one year), the cash that has flowed in and out of the corporation and the difference at the start and end of the periods.[829] There is great breadth, detail and sophistication to the financial statements. Besides the hard financial information that appears directly in the financial statements there is a whole range of other information that appears in notes to the financial statements. Often such information amplifies what appears in the financial statements. In other cases additional information is required to be disclosed, such as directors and executive remuneration and related party disclosures.[830] Many of these additional disclosures relate to discrete topics which are discussed in subsequent chapters.

The touchstone for information being included in the financial statements or the notes is materiality.[831] Information is material if:

> its omission, misstatement or non-disclosure has the potential to adversely affect:
> (a) decisions about the allocation of scarce resources made by users of the financial report; or
> (b) the discharge of accountability by the management or governing body of the entity.[832]

In determining materiality the nature and amount of items have to be considered but usually a quantitative threshold is established below which disclosure is not required.[833] This threshold will vary according to the financial size and strength of the corporation;[834] what is immaterial for BHP may be material for a smaller company.

The Corporations Law regulates the content of these financial statements. There are two specific requirements. The financial statements must be made out in accordance with the Accounting Standards[835] and so as to give a true and fair view.[836] The financial

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829 The requirement for cash flow statements is relatively recent and there is general support for their usefulness. The principal usefulness of cash flow statements is to establish whether the company is a going concern. See AASB 1026 at commentary paragraph (v); Lavarch Committee, *Corporate Practices and the Rights of Shareholders* (AGPS, Canberra, 1991) at paragraph 4.6.14; Cadbury Committee, *The Financial Aspects of Corporate Governance* (Gee, Great Britain, 1992) at paragraphs 5.18 to 5.22; Jones, Romano and Smyrnios, 'An Evaluation of the Decision Usefulness of Cash Flow Statements By Australian Reporting Entities' (1995) 25 Accounting and Business Research 115; Jones and Ratnatunga, 'The Decision Usefulness of Cash Flow Statements By Australian Reporting Entities: Some Further Evidence' (1997) 29 British Accounting Review 67; Epstein and Pava, *The Shareholder's Use of Corporate Annual Reports* (JAI Press, Connecticut, 1993) at 48 to 52.

830 AASB 1017 'Related Party Disclosures' discussed in chapter 7.4.

831 See AASB 1031 'Materiality' and AUS 306 'Materiality'; *Quantum Performance Pty Ltd v Northpak Pty Ltd* unreported judgement of Hunter J, Supreme Court of New South Wales, 24 April 1997.

832 AASB 1031 'Materiality' at 4.1; *Australian Corporations Law* (Butterworths, Australia, looseleaf service) at [3.6.0143.5]. See also discussion of materiality at chapter 10.2 in the context of the continuous disclosure regime. SAC 3 'Qualitative Characteristics of Financial Information' at paragraph 48 regards materiality as a necessary characteristic of financial information. A materiality test which information must pass is defined in paragraph 5 to mean "that test which is used to assess the extent to which relevant and reliable information may be omitted, misstated or not disclosed separately without having the potential to adversely affect the decisions by users about the allocation of scarce resources made by users of a general purpose financial report or the rendering of accountability by preparers".

833 Above at 4.1.3 and 4.1.6.

834 Above at 4.1.4.

835 CL s296.

836 CL s297.

statements must also be made out in accordance with requirements prescribed by regulations to the Corporations Law.[837] However for financial years ending on or after 30 June 1997, there are no longer any prescribed requirements.[838] Prior to this time the prescribed requirements were set out in Schedule 5 to the regulations. Schedule 5 detailed the information that must appear in the financial statements and provided a standard format for both the profit and loss statement and the balance sheet.[839] Schedule 5 has now effectively been replaced (with modifications) by AASB 1034 'Information to be Disclosed in Financial Reports' (discussed further below).[840]

Before I look at these requirements I wish to make one qualification to the discussion which follows. Where a company has a range of subsidiary companies or other entities which it controls who operate a range of businesses then the Corporations Law requires the holding company (chief entity) to prepare consolidated financial statements.[841] As the shareholders are investing in shares in the holding company knowing that it is part of a group this is totally appropriate. However besides ensuring the consolidated financial statements accurately sets out the group result the substantive requirements for the consolidated financial statements (and the directors' declaration and report) are the same as for an individual company operating one or more businesses. For this reason the analysis that follows is expressed in terms of a single company's reporting obligations but it equally applies to a group of companies and consolidated financial statements. However consolidating financial information creates the problem of not being able to separately analyse the financial performance of the component parts. This is addressed by segment reporting, discussed in chapter 8.2.

Accounting Standards

First, the financial statements must be made out in accordance with the approved Accounting Standards.[842] The Australian Accounting Standards Board "AASB", previously called Australian Accounting Review Board, which is constituted pursuant to legislative fiat promulgates the Accounting Standards.[843] These Accounting Standards

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837 CL s296(2); CL Regulation 2M.3.01 (previously 3.6.02(2)).

838 CL Regulation 2M.3.01.

839 The appendices to AASB 1026 provide examples of statement of cash flows but these examples are not prescriptive.

840 Wagner, 'Schedule 5 Is Out' (1997-April) Australian Accountant 56.

841 CL s295(2)(d) and AASB 1024 'Consolidated Accounts'.

842 CL s296(1). In addition to complying with the Accounting Standards the company must in the annual report describe all the material accounting policies which have been used in the preparation of the financial statements: AASB 1001 'Accounting Policies'; disclosure must also be made of any changes in accounting policies since the last report: see Appendix 4B (at 13) of the Listing Rules.

843 CL s334(1) and s225 of the *Australian Securities Commission Act* 1989 (Cth). For a fuller description of how accounting standards are made see Parker, Peirson & Ramsay, 'Australian Accounting Standards & the Law' (1987) 5 C & SLJ 231. The *Corporate Law Economic Reform Program Bill* 1998 (Cth) proposes to change the regulatory framework in place for the formulation of the Accounting Standards. The main changes are to:

- establish a Financial Reporting Council to supervise the Australian Accounting Standards Board (s225);
- explicitly state a purposive interpretation of the standards (s228), including providing what the general objects of the standards are (s224). These objects include developing accounting standards that require the provision of financial information that is relevant, reliable, comparable and understandable (s224(a)(iv) (v) & (vi));
- attempt to harmonise the Australian standards with international standards (s233 & 225(2)(f)); and

have the force of law.[844] In addition the AASB, in conjunction with others, have issued Statements of Accounting Concepts ("SAC's") which establish the conceptual framework for the Accounting Standards. However compliance with the SAC's in preparing financial statements is not "mandatory" but simply "sources of guidance".[845]

There are also accounting standards promulgated by the Australian Accounting Research Foundation ("AARF"), a body established by the two peak bodies who represent the accounting profession, namely the Australian Society of Certified Practising Accountants and The Institute of Chartered Accountants In Australia. In addition the AARF established an Urgent Issues Group ("UIG"). The role of the UIG is to "review on a timely basis...accounting issues that are likely to receive divergent or unacceptable treatment in the absence of authoritative guidance".[846] This group issues abstracts which express their consensus view on a particular accounting issue (and usually specific and narrow issues). These accounting standards and UIG abstracts are binding on members of the two representative professional bodies but do not have the force of law.[847] Members who flout these prescriptions can be subject to disciplinary sanctions from their professional body, the ultimate sanction being expulsion.[848] These accounting standards and UIG abstracts are sometimes, but not necessarily, adopted (whether after being modified or not) by the AASB and become or form part of an approved Accounting Standard.[849] So there are a range of rules in addition to the approved Accounting Standards (although this thesis will henceforth concentrate on the latter).

Accounting Standards are designed to provide standardised rules for the preparation of financial statements. If standard rules are in place then there will be uniformity and hence comparability in the information being provided in financial statements.[850] Uniformity in both the sense that users will understand the basis on which a particular company's financial statements have been prepared and also will be able to make a meaningful comparison with the same company's previous financial statements[851] and with other companies' current and previous financial statements. The Accounting Standards role is to overcome an unacceptable degree of diversity in financial

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- mandating that before making or formulating an accounting standard a cost/benefit analysis must be undertaken (s231).

844 Principally because CL s296(1) provides that they must be complied with. But see also *Corporations Act* 1989 (ACT) at section 32 and ASRB Release 100 'Nature of Approved Accounting Standards and Statements of Accounting Concepts and Criteria for the Evaluation of Proposed Approved Accounting Standards' at paragraph 6.

845 Australian Profession Statement 1 'Conformity with Accounting Standards and UIG Consensus Views' at paragraph 21.

846 Charter of the Urgent Issues Group at paragraph 7.

847 Australian Profession Statement 1 'Conformity with Accounting Standards and UIG Consensus Views' at paragraphs 10 to 14.

848 For example see the constitution of the Australian Society of Certified Practising Accountants at clauses 26 to 33 and their By-Laws at clauses 301 to 310.

849 See Policy Statement 1 'The Development of Statements of Accounting Concepts and Accounting Standards', which does not explicitly mention these documents as sources of approved Accounting Standards but this is the practice; for example UIG Abstract 5 was withdrawn following the issue of AASB 1013 'Accounting for Goodwill'.

850 Surprisingly this is not made explicit anywhere, not even in ASRB Release 100 'Nature of Approved Accounting Standards and Statements of Accounting Concepts and Criteria for the Evaluation of Proposed Approved Accounting Standards'. The current government has recognised this anomaly and wants this requirement to be made explicit; see Corporate Law Economic Reform Program, *Accounting Standards* (AGPS, Australia, 1997) at 1 and 13 to 15. See also Andrew, 'Accounting Standards and International Opportunities-A Comment' (1997) Australian Journal of Corporate Law 227 at 228 to 229.

851 CL s336.

reporting[852] and the use of "creative accounting" which obscures the underlying economic realities.[853] As Langfield-Smith points out:

> once a range of different accounting procedures is permissible, involving differing recognition, measurement and transformation rules and having differing impacts on "all inclusive" profit as well as reported values of assets and liabilities, the more likely it is that management will try to implement that particular combination of alternatives which best achieves the profit and balance sheet impact they desire.[854]

That is management will manipulate the financial statements within the bounds of normal but different accounting practices in order to present a favourable set of numbers in the financial statements. There is empirical evidence supporting such manipulation.[855] Accounting Standards lessen the scope for this manipulation. For example during the 1980's there was the almost endemic problem of off-balance sheet financing. Due to narrow and legalistic interpretations of "subsidiary", group debt was able to be held in controlled non-subsidiaries and hence would not appear on the balance sheet of the group.[856] This enabled misleading financial reports to be published. This issue has been addressed by replacing the subsidiary test with the broader concept of entity under control, AASB 1024 'Consolidated Accounts' and to a lesser extent AASB 1017 'Related Party Transactions'.

The courts have supported this search for uniformity. In *QBE Insurance Group Ltd v ASC* [857] the plaintiff attacked the validity of AASB 1023 on a variety of grounds. The court rejected the attack and reasoned:

> the court is not considering whether the accounting practice inherent in paragraph 23 of AASB 1023 is the most acceptable or the wisest standard; the question is whether it is valid in law. Obviously accountants and men of business differ as to the desirability of bringing to account unrealised gains and losses of the investments of a company carrying on the business of general insurance; but the proposition cannot be supported that the standard is contrary to the requirements of the law.[858]

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852 Langfield-Smith, 'Enforcing Accounting Standards In Australia' (1990) 8 C&SLJ 5 at 6, fn 3; cf Clarke, Deane and Oliver, *Corporate Collapses: Regulatory, Accounting and Ethical Failure* (Cambridge University Press, United Kingdom, 1997) who argue that the accounting standards have not been very successful in fulfilling their role.

853 Langfield-Smith, 'Enforcing Accounting Standards In Australia' (1990) 8 C&SLJ 5 at 8. One author has utmost faith in the efficient capital markets hypothesis and the ability of professional investors to understand different accounting treatments and price shares accordingly so that he argues that there is no need for uniformity in accounting treatments: see Keane, *The Efficient Market Hypothesis: and the Implications for Financial Reporting* (Gee and Co., Great Britain, 1980) at 25 to 26 and 30. His is very much a lone voice calling in the desert and his view has not gained widespread acceptance.

854 Langfield-Smith, 'Enforcing Accounting Standards In Australia' (1990) 8 C&SLJ 5 at 9. See also Cadbury Committee, *The Financial Aspects of Corporate Governance* (Gee, Great Britain, 1992) at paragraph 4.47.

855 Adelberg, 'Narrative Disclosures Contained in Financial Reports: Means of Communication or Manipulation?' (1979-Summer) Accounting and Business Research 179.

856 Markovic, 'Off Balance Sheet Financing: The Legal Implications' (1992) 10 C&SLJ 35; Markovic, 'Auditors Criminal Liability: Another Approach' (1996) Australian Journal of Corporate Law 48 at 51 to 52.

857 (1992) 8 ACSR 631. See Baxt, 'Standard Approach' (1993) 64 No. 3 Charter 18.

858 *QBE Insurance Group Ltd v ASC* (1992) 8 ACSR 631 at 651 to 652.

A comprehensive set of objective, non-ambiguous, Accounting Standards would curtail the scope for managers to manipulate the results that appear in the financial statements. This raises two issues — ambiguity and comprehensiveness.

Arguably language is inherently ambiguous. But the issue is whether the Accounting Standards have been drafted with sufficient precision to clearly communicate the appropriate concepts to users and enforcers. Historically the Accounting Standards[859] and their predecessors[860] were criticised on the basis that they were ambiguous. The most poignant criticism is that managers in preparing the financial statements and auditors in auditing them have construed such ambiguity in a technical, legal way to enable accounting outcomes that are very dubious.[861] However the Accounting Standards have been and continue to be revised. The absence of any recent trenchant or sustained criticism suggests that the Accounting Standards are now sufficiently unambiguous, although ambiguity can never be completely eradicated.

Comprehensiveness is difficult to gauge. There are 35 current Accounting Standards which deal with a variety of subjects and a range of exposure drafts of proposed Accounting Standards.[862] As discussed in chapter two, completeness is a matter of evolution and a relative concept.[863] But at the least a certain maturity has been reached in the number and scope of Accounting Standards.[864]

This maturity of the Accounting Standards is evidenced by their paramountcy. The directors must ensure that the financial statements are made out in accordance with the Accountancy Standards even if as a result the financial statements do not provide a true and fair view (see later under the heading "True and Fair View").[865]

The paramountcy of the Accounting Standards also enhances their enforceability. Once again an earlier criticism was that with the vague concept of true and fair being the overriding requirement companies were entitled not to comply with the standards and hence it was almost impossible to enforce the Accounting Standards.[866] Non-compliance with the accounting standards also resulted in a diversity of reporting practices which

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859 Langfield-Smith, 'Enforcing Accounting Standards In Australia' (1990) 8 C&SLJ 5 at 9, fn 94.

860 Henderson & Peirson, *Issues in Financial Accounting* (Longman Cheshire, Melbourne, 1992, 5th ed) at 93.

861 Tomasic, 'Auditors and the Reporting of Illegality and Financial Fraud' (1992) Australian Business Law Review 198 at 198 to 199.

862 As at January 1999. In numbered sequence there are 39 accounting standards but two were replaced (ASRB 1012 replaced ASRB 1003 and AASB 1026 replaced AASB 1007), one amends a previous one (AASB 1035 amends AASB 1034) and there are some gaps in the numbering.

863 The evolutionary process of standard setting in response to changing and increasingly complex financial transactions is recognised by Parker and Downes, 'Coping With Financial Reporting Overload' (1996-April) Australian Accountant 28.

864 Considerable progress has been made since 1987 when only 11 standards and two exposure drafts existed. See Parker, Peirson & Ramsay, 'Australian Accounting Standards & the Law', (1987) 5 C&SLJ 231 at 241-243. Andrew, 'Accounting Standards and International Opportunities-A Comment' (1997) Australian Journal of Corporate Law 227 at 231 recognises Australia as one of the four countries having "the most comprehensive accounting standards".

865 CL s295(3)(c) and s297.

866 See Langfield-Smith, 'Enforcing Accounting Standards In Australia' (1990) 8 C&SLJ 5 at fn 93; Markovic, 'Auditors Criminal Liability: Another Approach' (1996) Australian Journal of Corporate Law 48 at 50 to 51; Lavarch, *Corporate Practices and the Rights of Shareholders* (AGPS, Canberra, 1991) at 121 to 123; Parker, Peirson & Ramsay, 'Australian Accounting Standards and The Law' (1987) 5 C&SLJ 231 at 244; McGregor, 'True and Fair View-An Accounting Anachronism' (1992-February) Australian Accountant 68 at 69 to 70 provides empirical support for this contention.

hindered comparability between different corporations. These criticisms have been addressed by reversing which requirement is paramount.

The Corporations Law prescribes the primary consequences for a failure to comply with the Accounting Standards.[867] The approach adopted is that a failure to comply with the Accounting Standards subjects the offender to civil penalty sanctions.[868] The issue of liability is discussed further below.

As mentioned above, previously the financial statements had to comply with Schedule 5 to the Corporations Law Regulations. Schedule 5 detailed the information that must appear in the financial statements with a prescribed, standard format for both the profit and loss statement and the balance sheet. The format of statement of cash flows was not previously prescribed.[869] This standardised format enabled easy comparison of a company's current financial statements with both its previous financial statements and other company's financial statements. Schedule 5 has been replaced by AASB 1034 and the requirements of that standard are worth mentioning.

The principal difference is that the format of the profit and loss statement and balance sheet are no longer prescribed.[870] The justification is that "the most appropriate format should be developed having regard to the particular circumstances of the *entity* and the presentation of relevant and reliable information about its performance, financial position, and financing and investing activities". Nonetheless AASB 1034 goes on to prescribe the items that must appear in the balance sheet, such as assets, liabilities, shares and units, retained profits/accumulated losses and reserves and revenue and expenses.[871] These requirements prescribe the content of these financial statements in a similar way to previously (including information that Schedule 5 previously required as notes to the financial statements). However in not prescribing the format of these financial statements the authors of AASB 1034 thought the need for flexibility was more important than the need for easy comparability.

AASB 1034 also requires certain additional information to be disclosed in the financial statements.[872] This information is:

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867 There are other consequences such as disciplinary proceedings by the accounting and auditing profession who are obliged to comply with the Accounting Standards. However reported cases of disciplinary action are rare and these sanctions do not apply to the directors unless they happen also to be members of the accounting or auditing profession. See generally Langfield-Smith, 'Enforcing Accounting Standards In Australia' (1990) 8 C&SLJ 5; and Henderson and Peirson, *Issues in Financial Accounting* (Longman Cheshire, Melbourne, 5th ed., 1992) at 99-100.

868 CL ss 344 & 1317DA. The alternative approach would be to entitle a registration body to refuse to register non-complying financial statements with automatic sanctions (such as delisting the company's securities). See Parker, Peirson & Ramsay, 'Australian Accounting Standards and the Law' (1987) 5 C & SLJ 231. This approach has not been adopted in Australia and the Australian Securities Commission decline to do any pre-vetting of such documents: see Cockburn, 'The ASC-Post Transactions and Annual Accounts Audits' speech given at the Twilight Seminar, 26 August 1992, reproduced in *Australian Corporations Law* (Butterworths, Sydney, 1996) at 11,001.

869 Whilst the appendices to AASB 1026 provide examples of statement of cash flows these examples are not prescriptive.

870 AASB 1034 'Information to be Disclosed in Financial Reports' at paragraph 3.

871 AASB 1034 'Information to be Disclosed in Financial Reports' at paragraphs 5 to 10.

872 The requirements for notes to the financial statements in Schedule 5 were more extensive than what appears in AASB 1034. However the omitted requirements are picked up in other Accounting Standards; see AASB 1034 appendix 3 'Schedule 5 Disclosure Requirements

- the remuneration of the auditors both for their audit services and other services;[873]
- details of any economic dependency (ie where the corporation is dependent on another entity for a significant volume of business or financial support);[874]
- details concerning franking credits;[875] and
- remuneration and retirement benefits of executive officers of the company (which I discuss in chapter 7.4).[876]

True & Fair View

Second, the financial statements must give a true and fair view of the company's financial position and performance.[877] As I explained above this requirement is subordinate to the Accounting Standards. So if after complying with the Accounting Standards the financial statements do not give a true and fair view then the financial statements are not changed but additional information and explanations must be given so that a true and fair view is given.[878]

The strength of a fuzzy law requirement like true and fair view is its broadness and flexibility. However the problem with the concept of true and fair is its inherent vagueness and this problem is generally viewed in this situation to outweigh the normal strengths associated with a fuzzy law approach. The words true and fair view are not defined in either the Corporations Law, or in the approved Accounting Standards, nor have they been defined judicially.[879] The concept has been described as lacking "sharp edges"[880] and "opaque".[881] However the real difficulty with the true and fair concept is much more fundamental and relates back to the philosophical issues discussed in chapter 2 concerning the accuracy of information. Some aspects of financial reporting are based

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Included in the Standard (With Amendments)' and appendix 4 'Schedule 5 Disclosure Requirements Omitted from the Standard'.

873 AASB 1034 at paragraph 11.1(a) and (b) and 11.1.1; previously CL Regulations Sch 5, Clause 27.

874 AASB 1034 at paragraph 11.1(c); previously CL Regulations Sch 5, Clause 31.

875 AASB 1034 at paragraph 11.1(d) and (e).

876 AASB 1034 at paragraph 12; previously CL Regulations Sch 5, Clauses 29. Disclosure of directors remuneration, previously covered by CL Regulations Sch 5, Clauses 25 and 26, is now covered by AASB 1017 'Related Party Disclosures' in paragraphs 4.2 to 4.14.

877 CL s297.

878 See also *QBE Insurance Group Ltd v ASC* (1992) 8 ACSR 631 at 651. If this occurs the auditor must either express a qualified opinion or comment in the auditor's report; see below in chapter 6.5 under the heading 'Content of Report'.

879 Ickeringill, Poke, Sheller and Kent, 'Audit' in *Australian Corporations Law* (Butterworths, Sydney, 1996) at [3.7.0115]; Parker, Peirson & Ramsay, 'Australian Accounting Standards and The Law' (1987) 5 C & SLJ 231 at 244; McGregor, 'True and Fair View-An Accounting Anachronism' (1992-February) Australian Accountant 68 at 69. However see Baxt, 'True and Fair View: A Legal Analysis' (1968-April) Accountants Journal 301 who argued that at the least true and fair view rendered historical cost accounting in the face of inflated asset prices and secret reserves as rendering financial statements not true and fair.

880 Ford & Austin, *Principles of Corporations Law* (Butterworths, Sydney, 6th ed., 1992) at 557 (this quote is not in the latest edition of this text).

881 Ickeringill, 'Statutory Responsibilities of Directors and Auditors In Relation To Company Accounts (including a consideration of approved accounting standards)' (1988) 6 C& SLJ 3 at 22. One author goes so far to say that the concept of true and fair view is so flawed that it should be removed as a requirement (although he wants it to be replaced with "present fairly"!); see McGregor, 'True and Fair View-An Accounting Anachronism' (1992-February) Australian Accountant 68 at 71.

on factual transactions, for example how many widgits were sold during a year, at what price compared to their cost etc. This reality is relatively easy to report which report will either be accurate (true) or not. However other aspects of financial reporting are much more sophisticated and complex, such as goodwill and depreciation.[882] For these types of concepts there simply is no fundamental or absolute truth,[883] just different ways to treat them. As a result economic reality is "simply what most people agree it is" and therefore reflects the "mores, values and ideology of a particular society, at a particular time".[884] Accordingly it is difficult if not impossible for an enforcer, or users of the financial statements, to establish that the treatment of an item in the financial statements does not reflect a true and fair view.[885] This greatly impedes the comparability of financial information. Only if the preparers of accounts deliberately manipulate the financial statements or use an accounting treatment that is obviously dubious or completely out of step with current practice could a court hold that a set of accounts do not present a true and fair view.

This difficulty with the true and fair view concept traditionally gave the preparers of financial statements (executives and directors) significant room to manoeuvre to present the financial picture that best suited them. This room to manoeuvre has been narrowed since the Accounting Standards are paramount.[886] As a result accounting, and in particular the Accounting Standards, does not have legitimacy as a quest for absolute truth, which is nonsensical. Other qualities of information become important, such as comparability, which the Accounting Standards are directed to. The Accounting Standards have legitimacy not in a quest for truth, but because of their acceptance by a majority of preparers, users and regulators of financial statements[887] and in that they provide a consistent and comparable approach between reporting periods and entities.

Certainly the room for preparers of financial statements to massage the financial statements as best suits them has been narrowed by the Accounting Standards. Nonetheless the true and fair requirement remains a flexible concept that at the margins or where an Accounting Standard does not apply, or is ambiguous, can be used by

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882 A matter recognised by Gummow J in *Esanda Finance Corporation v Peat Marwick Hungerfords* (1997) 142 ALR 750 at 798 concerning the financial statements and the audit function.

883 Weiss, 'Teaching Accounting and Valuation in the Basic Corporation Law Course' (1997) 19 Cardozo Law Review 679 at 682.

884 Hines, 'Financial Accounting Standard Setting: From Truth to Due Process' (1987) 58 Chartered Accountant In Australia 30 at 30-31.

885 Markovic, 'Auditors Criminal Liability: Another Approach' (1996) Australian Journal of Corporate Law 48 at 48 to 52. This very difficulty forced the ASIC to conclude in its investigation of Burns Philp & Company Limited that there was no "correct" valuation of that company's intangible assets. Therefore the ASIC concluded that it could not recommend the commencement of proceedings. See ASIC, *Report of the Investigation Into Burns Philp & Company Ltd* (ASIC, Australia, 1998) at [11.7] and [11.9]. However for a defence of the true and fair view see Clarke, Deane and Oliver, *Corporate Collapses: Regulatory, Accounting and Ethical Failure* (Cambridge University Press, United Kingdom, 1997) at 13.

886 Although at least some authors contest how effective the accounting standards have been in reducing creative accounting; Clarke, Deane and Oliver, *Corporate Collapses: Regulatory, Accounting and Ethical Failure* (Cambridge University Press, United Kingdom, 1997) in chapter 2.

887 Acceptance is obtained by ensuring "due process" (ie. public involvement) in the formation of Accounting Standards. This generally occurs in Australia; see Policy Statement 1 'The Development of Statements of Accounting Concepts and Accounting Standards' at paragraph 16 (consultative groups are consulted) and paragraphs 23 to 27 (exposure drafts of proposed Accounting Standards are released); Parker, Peirson & Ramsay, 'Australian Accounting Standards and The Law' (1987) 5 C & SLJ 231.

managers to present the accounting treatment that best suits them. Perhaps there is no way around this because any system needs a certain amount of flexibility to be able to work in practice. For it is very difficult for any body of black letter laws to cover every eventuality. However even with that rider the importance of a comprehensive set of unambiguous Accounting Standards is obvious.

Liability

The Corporations Law holds directors liable if they fail to take all reasonable steps to comply with, or to secure compliance with, the financial reporting provisions of the Corporations Law.[888] Breach of this section leads to civil penalty sanctions.[889] Therefore not only the directors but also those involved in a contravention can be liable for the breach.[890] Therefore it seems the executives who are involved in the preparation of the financial statements may also be liable. More problematic is whether the auditors are potentially liable under these ancillary liability provisions. One argument against such liability is that auditors are not involved in the preparation of the financial statements, only the audit of them. Also the principal prohibition addresses those parts of the Corporations Law concerned with maintenance of financial records and preparation of financial statements, not their audit (which is in a separate part of the Corporations Law).[891] Therefore the better view is that auditors are not liable under these ancillary liability provisions (auditor liability is discussed later).

The principal consequence for breaching the civil penalty provisions is an order prohibiting the person from managing corporations (but not if the person is nonetheless a fit and proper person) or a fine of up to 2,000 penalty units.[892] The ASIC has in effect exclusive jurisdiction to enforce the civil penalty provisions.[893] The civil penalty provisions can constitute a criminal offence if committed knowingly, intentionally, or recklessly and dishonestly in order for someone to gain or intending to deceive or defraud someone.[894] If a person is so convicted they face a fine of up to 2,000 penalty units or imprisonment for 5 years or both.[895] In addition to these criminal and quasi-criminal consequences the court hearing these matters can order the offenders to pay compensation to the corporation if it has suffered loss or damage as a result of the contravention[896] or order the recovery of any profits made by the offenders (if any).[897] As this compensation is paid to the corporation for loss or damage it suffers then shareholders are not entitled to any compensation for loss or damage they may suffer in their role as investors. For example they may buy shares in the secondary market at an overvalue in reliance of the published financial statements which prove to have overstated the company's financial position. Shareholders cannot recover such losses. Those found guilty of an offence can be excused if the person acted honestly and in all the circumstances the person ought fairly be excused.[898]

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888 CL s344.
889 CL s1317DA.
890 CL s1317DB.
891 CL s344(1).
892 CL s1317EA(3).
893 CL s1317EB.
894 CL s1317FA.
895 Schedule 3 to the Corporations Law. Section 9 defines penalty unit as $100.
896 CL s1317HA and HB.
897 CL s1317HD.
898 CL s1317JA.

In addition to these specialist liability rules that apply to financial statements, some miscellaneous liability rules may also apply. Section 1308 of the Corporations Law provides:

> (2) A person who, in a document required by or for the purposes of this Law or lodged with or submitted to the Commission, makes or authorises the making of a statement that to the person's knowledge is false or misleading in a material particular, or omits or authorises the omission of any matter or thing without which the document is to the person's knowledge misleading in a material respect, is guilty of an offence.
>
> (4) A person who, in a document required by or for the purposes of this Law or lodged:
>
> > (a) makes or authorises the making of a statement that is false or misleading in a material particular; or
> >
> > (b) omits or authorises the omission of any matter or thing without which the document is misleading in a material respect;
>
> without having taken reasonable steps to ensure that the statement was not false or misleading or to ensure that the statement did not omit any matter or thing without which the document would be misleading, as the case may be, is guilty of an offence.

The different degrees of culpability (knowledge compared with failure to make reasonable steps) is reflected in the appropriate penalties. A fine of up to 100 penalty units, or imprisonment for 2 years or both visits a person who breaches sub-section (2),[899] whereas the liability under sub-section (4) is only 5 penalty units.[900]

Section 1309 of the Corporations Law provides for a similar pattern of liability on officers of the corporation providing false or misleading information to a director, auditor, member, debenture holder (or their trustee), or a securities exchange (or an exchange's officers).[901] These liability rules apply not just to the financial statements but also to the directors' declaration and the contents of the directors' report.

To give meaning to these sanctions there must be adequate monitoring of financial statements to detect any non-compliance and the will and resources to prosecute the matter in the courts. The ASIC is responsible for these tasks.[902] The ASIC views the examination procedure of financial statements by its predecessor, the various State Corporate Affairs Commissions, as being "not particularly successful".[903] The ASIC (then the ASC) introduced a program to review financial statements, which was a priority surveillance program for the 1992-93 financial year. Notably the focus included listed

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899 Schedule 3 to the Corporations Law. Section 9 defines penalty unit as $100.

900 CL s1311(5).

901 The same penalties apply, see Schedule 3 to the Corporations Law.

902 All of the substantive sections concerning the financial statements are set out in chapter 2M (formerly Part 3.6) of the Corporations Law. A failure to comply with chapter 2M is a civil penalty provision (CL ss344 & 1317DA) over which the ASIC has exclusive jurisdiction (unless the Minister authorises someone else to have jurisdiction) (CL s1317 EB).

903 For a description of the enforcement of the Accounting Standards by the NCSC (the predecessor to the ASIC and the ASC) see Parker, Peirson & Ramsay, 'Australian Accounting Standards and The Law' (1987) 5 C & SLJ 231 at 244. See also Langfield-Smith, 'Enforcing Accounting Standards In Australia' (1990) 8 C&SLJ 5; and for an even worse compliance record with accounting standards before they had the force of law see McKeon, 'Communication in Annual Reports' in Courtis (ed), *Corporate Annual Report Analysis* (Dept of Accounting and Financial Management, Armidale, 1978) 5 at 8 to 9.

companies.[904] Since that time up until 1996/97 the ASIC continued its financial statements examination program.[905] However during 1996/97 the ASIC changed its priorities. The ASIC no longer undertakes "random checks of company financial statements, but instead examine matters based on intelligence gathering or complaints".[906] It is difficult to gauge whether this occurred because it was regarded as a more efficient way to detect non-compliance. However given that the ASIC had its funding substantially reduced during this reporting period there is a suspicion that it was simply a cost cutting measure driven by economics, not sound principle.[907] More recently, the chairman of the ASIC, Mr Alan Cameron, announced that the ASIC will shortly begin a national financial accounts surveillance program to be coordinated by the new Office of Chief Accountant.[908] Clearly the level of enforcement has fluctuated over time.

The auditors assist ASIC in its monitoring role. Corporations Law section 311 provides:

> The auditor conducting an audit or review must, as soon as possible, notify ASIC in writing if the auditor:
>
> (a) has reasonable grounds to suspect that a contravention of this Law has occurred; and
>
> (b) believes that the contravention has not been or will not be adequately dealt with by commenting on it in the auditor's report or bringing it to the attention of the directors.

This provision requires auditors to exercise their professional judgement. However upon exercising that judgement, if the auditor forms the requisite opinion under section 311 then the obligation to report to the ASIC overrides any professional or contractual obligation of confidentiality to the client.[909] If an auditor breaches s311 the auditor commits an offence.[910] Since the section provides that instances of non-compliance need not be reported to the ASIC if the matter is otherwise adequately addressed by the company, the policy seems to be of ensuring compliance (rather that prosecuting every instance of non-compliance) or ensuring that shareholders are informed of non-compliance. Reporting to the ASIC is a measure of last resort and sparingly used by auditors. The ASIC has stated it will follow up any reports auditors make under section 311.[911]

The ASIC takes a compliance approach to the financial statements. If they detect an instance of non-compliance the ASIC seeks by cooperation, or if necessary by mandatory injunction, to ensure the directors comply with the legal requirements concerning the

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904 Cockburn, 'The ASC-Post Transactions and Annual Accounts Audits' speech given at a twilight Seminar, 26 August 1992, reproduced in *Australian Corporations Law* (Butterworths, Sydney, 1996) at 11,001.

905 ASC, *Annual Report 1993/94* at 50; ASC, *Annual Report 1994/95* at 18 to 19; ASC, *Annual Report 1995/96* at 28.

906 ASC, *Annual Report 1996/97* at 31.

907 ASC, *Annual Report 1996/97* at 14. Funding was also reduced by 1.4%, which led to a staff reduction of 3.2%, in the 1997/98 year; see ASIC, *Annual Report 1997/98* at 4.

908 In an address to the Institute of Chartered Accountants in Melbourne on 23 August 1998.

909 CL s1289 protects auditors with qualified privilege for such reports.

910 CL s1311; Schedule 3 provides that the penalty is 10 penalty units or imprisonment for 3 months or both.

911 Cockburn, 'The ASC-Post Transactions and Annual Accounts Audits' speech given at the twilight seminar, 26 August 1992, reproduced in *Australian Corporations Law* (Butterworths, Sydney, 1996) at 11,001; and Parker, 'Future Strategies: Streamlining, Surveillance and Deterrence' speech given to CPA Groups on 15 March 1993.

financial statements and if necessary send additional information to shareholders.[912] The civil penalty provisions (and formerly the criminal sanctions) appear not to have been used.[913]

The predecessor to section 311 (which came into effect on 1 July 1998) was section 332(10). Section 332(10) required the auditor be "satisfied" of a breach of the law before the obligation to report arose. This had been criticised by the auditing profession on the basis that "satisfied" of a breach imposes too high a standard of proof.[914] In 1991, the Lavarch Committee agreed with this criticism and recommended that "satisfied" be replaced with "reasonable grounds to suspect".[915] As this section imposes on auditors a kind of policing function then the Lavarch standard is consistent with the standard usually imposed on the police in conducting their investigations.[916] Fortunately this recommendation has now been adopted.

6.4 DIRECTORS' DECLARATION

The directors' responsibilities for the financial statements do not stop at the preparation stage. The directors have to sign off on the financial statements in the directors' declaration.[917] The directors' declaration forms part of the financial report.

Section 295(4)[918] of the Corporations Law provides that the directors' declaration is a declaration by the directors:

> (a) that the financial statements, and the notes [to them], comply with the accounting standards; and
> (b) that the financial statements and notes give a true and fair view; and
> (c) whether, in the directors' opinion, there are reasonable grounds to believe that the company...will be able to pay its debts as and when they become due and payable;[919] and

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912 Cockburn, 'The ASC - Post Transactions and Annual Accounts Audits' speech given at the twilight seminar, 26 August 1992, reproduced in *Australian Corporations Law* (Butterworths, Sydney, 1996) 11,001 at 11,006.

913 Markovic, 'Auditors Criminal Liability: Another Approach' (1996) Australian Journal of Corporate Law 48 at 49 to 50; Markovic and Langton, 'Directors and Misleading Financial Statements: Another Perspective' (1995) 8 Corporate and Business Law Journal 27.

914 Lavarch Committee, *Corporate Practices and the Rights of Shareholders* (AGPS, Canberra, 1991) at paragraph 4.7.34.

915 As above, at paragraph 4.7.59.

916 Leaver, *Investigating Crime* (Law Book Company, Sydney, 1997) at 78 to 79 and 96 to 98.

917 CL s295(1)(c) & (4).

918 The equivalent provision for the half year directors' declaration is CL s303(4), except this subsection does not have a paragraph (d) (as quoted above).

919 The financial statements themselves are also usually prepared on a "going concern" basis; see AASB 1001 at paragraph 6.1 which notes that reasons must be given if the going concern or accrual basis of financial reporting is not adopted. Also AUS 708 'Going Concern' at paragraph .06 recognises that "the going concern basis is so generally adopted in the preparation of financial reports that its use can be assumed in the absence of any statement to the contrary". This auditing standard also defined the going concern basis at paragraph .03 in the following terms:

> 'Going concern basis' means the accounting basis whereby in the preparation of the financial report the reporting entity is viewed as a going concern: that is, the entity is expected to:
>
> (a) be able to pay its debt as and when they fall due; and
> (b) continue in operation without any intention or necessity to liquidate or otherwise wind up its operations.

(d) whether in the directors' opinion the financial statement and notes are in accordance with this Law, including
(i) section 296 (compliance with accounting standards); and
(ii) section 297 (true and fair view).

The directors must resolve to make the declaration, date the declaration and one of them must sign it.[920] Requiring directors to make their declaration forces them to formally consider these matters and sign off on the financial statements. Arguably such a discipline helps to ensure the directors are collectively responsible for the financial statements and therefore more accountable to the shareholders.[921]

6.5 AUDIT

Introduction

The Auditors play a pivotal role concerning the financial statements. They are appointed to act as an independent watchdog of the accounting records of the company and the annual financial statements themselves.[922] Specifically auditors opine whether the financial statements are properly drawn up in accordance with the Law including whether in compliance with the Accounting Standards and so as to give a true and fair view.[923] Auditors enhance the credibility of the financial statements by independently examining and judging them.[924] As I argued in chapter 5, there are no other structural mechanisms in the corporate context, notably an active opposition or an effective media, which endeavour to ensure the credibility of information provided by those in control of the company. In the political context, in order to balance the self-interested information provided by the government of the day, there is the antagonistic voice of the opposition and the reporting and investigations by the media. It is not possible to artificially conjure an antagonistic opposition, even if this was thought desirable. Neither is it feasible to coerce the media to provide systematically reliable reporting of corporate affairs. However requiring independent auditors to examine and report on the financial statements endeavours to address the credibility problem inherent in financial statements prepared by self-interested managers. The credibility problem arises from the implication that management and directors cannot always be trusted in the crucial role of financial reporting, which is supported by case studies.[925] This is not necessarily surprising because in essence management and directors are reporting on their own performance. As a matter of human nature it is hard for any person to be truly objective: whether the bias is subtle, subconscious or deliberate, its risk is ever present but its extent

920 CL s295(5).

921 This point was made by Kirby P (dissenting) to justify a strict approach to the general law duty of loyalty in *Woolworths Ltd v Kelly* (1991) 9 ACLC 539 at 546 (NSW Full Supreme Court). The same reasoning supports the need for a directors' declaration.

922 CL s307.

923 CL s307(a); AUS 204 at paragraph .02.

924 Statement of Auditing Practice 32 'Audit Independence' at paragraph 6.

925 Some of the auditor liability cases are testament to this, for example the case studies considered in Tomasic, 'Auditors and the Reporting of Illegality and Financial Fraud' (1992) Australian Business Law Review 198. There is US empirical evidence that supports this contention, see Epstein and Pava, *The Shareholder's Use of Corporate Annual Reports* (JAI Press, Connecticut, 1993) at 36 to 39. See also the foreword by Sykes in Hey-Cunningham, *Financial Statements Demystified* (Allen & Unwin, Sydney, 2nd ed, 1998).

may vary. This is particularly true given that managers have different and sometimes conflicting interests from shareholders.[926]

Auditing Standards

Auditors in conducting their work have the benefit of Auditing Standards and Auditing Guidance Statements. The Auditing Standards Board ("AuSB") on behalf of the two peak accountancy bodies, The Australian Society of Certified Practising Accountants and The Institute of Charted Accountants in Australia promulgate these. The AuSB, unlike the Accounting Standards Board, has no statutory backing and as a result the Auditing Standards do not have the force of law. However members of these two bodies are bound to follow the Auditing Standards, whereas the Auditing Guidance Statements offer just that.[927] As with the non-approved accounting standards, members who flout these prescriptions can be subject to disciplinary sanctions from their professional body, the ultimate sanction being expulsion.[928] That the Auditing Standards do not have the force of law is a perceived weakness and the auditing profession itself is unsure of the level of compliance by auditors with the standards and statements.[929] This resulted in the Lavarch Committee recommending:

> that the Australian Auditing Standards Board should be given similar recognition in the Corporations Law as the Australian Accounting Standards Board. A unit should be established by the Australian Auditing Standards Board to monitor the compliance with the prescribed auditing standards.[930]

To give some force to the auditing standards the Lavarch Committee also recommended:

> that, where it is established that the auditors of a company have breached proper auditing standards, the Court should have the power to order that the accounts of that company be audited by an auditor appointed by the Court.[931]

These measures are yet to be adopted.[932]

Appointment, Removal and Resignation

I have explained and discussed the provisions concerning the appointment, removal and resignation of auditors in chapter 4. Either an individual or a firm (traditionally of accountants including registered company auditors) can act as the auditor of the company.[933]

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926 Discussed in chapter 4.2. See also Sherer & Kent, *Auditing & Accountability* (Pitman Books Limited, UK 1983) at 15.

927 Auditing Standard ("AUS") 102 'Foreword to Australian Auditing Standards and Guidance Statements' at paragraphs .06 to .11; and AUS 202 'Objective and General Principles Governing an Audit of a Financial Report' at paragraph .05.

928 For example see the constitution of the Australian Society of Certified Practising Accountants at clauses 26 to 33 and their By-Laws at clauses 301 to 310.

929 Lavarch Committee, *Corporate Practices and the Rights of Shareholders* (AGPS, Canberra, 1991) at 125 to 127.

930 Above at 135.

931 Above at 136.

932 The current government also has made no move to make this alteration either. Their Corporate Law Economic Reform Program, *Accounting Standards* (AGPS, Australia, 1997) is silent on this topic.

933 CL ss 324(1) and (2) respectively. See Ickeringill, Poke, Sheller and Kent, 'Audit' in *Australian Corporations Law* (Butterworths, Sydney, 1996) at [3.7.0035].

There are qualification requirements that must be satisfied before anyone can be appointed as an auditor. Only a person who is registered by the ASIC may consent to, or act as, a company auditor.[934] These prerequisites to registration ensure that registered auditors are appropriately qualified. The pre-requisites to registration are that the applicant:

- is a member of one of the relevant professional bodies;
- has an accountancy degree or diploma;
- has relevant practical experience of at least 3 years;
- is capable of acting as an auditor; and
- is a fit and proper person.[935]

Independence

It is crucial that auditors are independent of management and the directors. Auditors are appointed by and act for the benefit of shareholders and act as a foil to the managers' propensity to present skewed information reflecting their own biases. If auditors' independence is compromised they are likely to not adopt the robust stance that is required of them. For example, they may be pressured into agreeing with a certain accounting treatment they may otherwise disagree with or may be more inclined to accept an explanation of a dubious or suspicious transaction. In fact one commentator has stated that "[t]he probability that the auditors will report a discovered breach is effectively the auditing profession's definition of independence".[936]

On a more fundamental level if auditors are not independent of management then they are superfluous. The reason for having auditors is the belief that management and directors cannot be fully trusted in their financial reporting role. Only if auditors are fully independent is their role meaningful. This is particularly so given many companies have internal auditors.[937]

The auditors' independence is founded on the provisions concerning their appointment and removal from office which ensures that auditors have considerable security of tenure.[938] Whilst this is a solid foundation for their independence it cannot guarantee it. Part of the problem with this formal position is the issue of agenda setting (referred to earlier). Directors will usually have selected the firm of auditors they wish to work with and the shareholders will normally merely rubber-stamp this. I have already discussed how this problem could be addressed. Another concern is that managers will authorise the remuneration of the auditors and can use this as leverage or to restrict the scope of the audit (scope is discussed later). There seems no reason why shareholders could not authorise each year the remuneration, or rate of or formula to determine the remuneration, of the auditors. This simple shift would remove this problem.

The Corporations Law contains some formal requirements concerning independence of auditors. Auditors are prohibited from acting for a particular company if:

- the auditor owes that company more than $5,000; or

934 CL s324(1)(d).

935 CL s1280 and CL Regulations Part 9.2.

936 Watts & Zimmerman, 'Agency Problems, Auditing and the Theory of the Firm: Some Evidence' (1983) 26 Journal of Law and Economics 613 at 615.

937 Recognised in AUS 604 'Considering the Work of Internal Auditing'.

938 See Statement of Auditing Practice 32 'Audit Independence' at paragraphs 46 to 48. This is the same as judges having security of tenure which is the bulwark of their independence from the other arms of government; see *Commonwealth of Australia Constitution Act* 1901 section 72; de Smith, *Constitutional and Administrative Law* (Penguin, England, 5th ed, 1985) at 387 to 389.

- the auditor is:
  -an officer of the company; or
  -a partner, employer or employee of an officer of the company; or
  -a partner or employee of an employee of an officer of the company.[939]

This list is far from exhaustive. Fortunately the Auditing Standards deal more thoroughly with the issue of auditors' independence.[940] AUP 32 'Audit Independence' stresses the need for auditors to be able to express an independent opinion free from "bias, personal interest, prior commitment to an interest, or susceptibility to undue influence or pressure".[941] AUP 32 also emphasises the need for both actual independence and the perception of independence in the eyes of users of the audit report.[942] At the outset personal characteristics and attitudes of mind are stressed, such as integrity, objectivity and strength of character.[943] This is undoubtedly correct but the most any prescription can hope to achieve is to encourage these characteristics. To some extent people either have these attributes or consider them important enough to endeavour to achieve or improve on them In addition to these motherhood type comments, AUP 32 gives practical guidance on real world situations which may compromise an auditors independence and offers solutions to them.

Independence can be compromised in a variety of ways. The most direct and blunt way managers can attempt to compromise an auditor's independence is by overtly placing pressure on the auditor to toe the company line. Interestingly AUP 32 assumes that this will, or at least may, occur. If this occurs then the personal characteristics mentioned above must come into play. Auditors should staunchly resist such pressure or if this is not feasible then seek to resign.[944]

Also certain commercial or relational interests can compromise independence, as identified in the Corporations Law. Unfortunately the restrictions in the Corporations Law do not go far enough. For instance, there is no prohibition based on family relationships, or on the auditor owning shares in the client. AUP 32 guides auditors to not hold investments in the client company (whether directly or as trustee or nominee), hold office in the client company, have close personal or professional relationships with clients or have commercial or financial dealings with the client except on arms length terms.[945] Most of these are clear-cut guidelines that should be able to be implemented with little conceptual difficulty.

The issue of "close personal or professional relationships" is a more malleable and difficult issue. This is a more subtle and potentially more effective form of compromise

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939 CL s324(1). Similar criteria apply if a firm is appointed as an auditor (CL s324(2)). There are additional restrictions the most notable being "except where the company is a proprietary company, no officer of the company receives any remuneration from the firm for acting as a consultant to it on accounting or auditing matters" (CL s324(2)(h)).

940 AUS 202 'Objective and General Principles Governing an Audit of a Financial Report' at paragraph .04; and Statement of Auditing Practice 32 'Audit Independence'. The Statement of Auditing Standards were recently codified into the new Auditing standards. However AUP 32 was not codified because it was then being reviewed. The two accounting bodies in a notice to their members have stated that AUP 32 "retains its status as authoritative guidance".

941 Statement of Auditing Practice 32 'Audit Independence' at paragraph 8.

942 Above at paragraph 10.

943 Above at paragraphs 13 to 14.

944 As noted in chapter 4.2, the ASIC will consent to the auditor resigning in these circumstances.

945 Statement of Auditing Practice 32 'Audit Independence' at paragraphs 21 and 34. See also the Appendix to AUS 206 'Quality Control for Audit Work' which provides illustrative examples of internal quality control which addresses this issue at paragraph A.03 (a) (ii) and (iii).

of independence where the client will benefit from favourable bias. The ethic of "don't dob on your mates", which is particularly strong in Australia, comes into play. This certainly was one operative factor that Justice Rogers at first instance identified in the audit failure in the *AWA* case.[946]

A professional relationship must exist and auditors and managers would almost be inhuman if friendships didn't develop. It isn't necessarily the friendships that are the problem but the increased likelihood that this may compromise independence. It may be expecting superhuman integrity for the participants themselves to ensure complete independence in the context of a close relationship or for the auditors to relinquish a profitable business relationship because of a perception of relationships being too close. It would also be almost impossible for outsiders to monitor this on an ongoing basis.

As is the position in the USA, it has been proposed in Australia that where a firm of accountants is appointed (as is usually the case) as auditor the partner responsible for the audit should change every seven years.[947] This commonsense, practical solution would go a long way in addressing the problem of relationships between auditors on the one hand and management and directors on the other being too close. The more radical proposal of changing firms every seven years was not recommended as there is evidence that audit failures are more likely within the first couple of years of the appointment of an auditor due to the sharp learning curve of the particular company's business[948] and internal controls.[949] The change of partner within a firm was regarded as a suitable compromise between continuity and breaking established relationships. AUP 32 has picked up on this recommendation and has suggested that internal quality controls could include the periodic rotation of audit partners and audit staff.[950] Given that AUP 32 is itself a guideline then leaving this as a suggestion is weak.

The issue of auditors having other business relationships with the company is most pernicious in one situation. It is common practice for large accounting firms who have been appointed auditor to a company to also provide accounting services and other types of consultancies to the company. Often significant fees are involved.[951] Even if these other services are provided on arms length terms, the company can use the threat of removing this additional work from the firm as a way to pressure the auditors into taking

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946 *AWA Ltd v Daniels* (1992) 7 ASR 759 at 766 and 836.

947 Hilmer, *Strictly Boardroom* (The Business Library, Sydney, 1993) at 62. See also Cadbury Committee, *The Financial Aspects of Corporate Governance* (Gee, Great Britain, 1992) at paragraph 5.12.

948 AUS 304 'Knowledge of the Business' at paragraph .02 states that the "auditor should have or obtain a knowledge of the business sufficient to enable the auditor to identify and understand the events, transactions and practices that, in the auditor's judgement, may have a significant effect on the financial report or on the audit or audit work".

949 AUS 402 'Risk Assessments and Internal Controls' at paragraph .02 states that the "auditor should obtain an understanding of the internal control structure sufficient to plan the audit and develop an effective audit approach. The auditor should use professional judgement to assess audit risk and to design audit procedures to ensure it is reduced to an acceptably low level". These matters are recognised as important in AUS 302 'Planning' at paragraph .09. See also Petty and Cuganesan, 'Auditor Rotation: Framing the Debate' (1996-May) Australian Accountant 40.

950 Statement of Auditing Practice 32 'Audit Independence' at paragraph 51(e) and (f). See also the Appendix to AUS 206 'Quality Control for Audit Work' which provides illustrative examples of internal quality control which addresses this issue at paragraph C.01(d)(v) and .02 (a)(v) and (b).

951 For example in the 1996/97 financial year the auditors of Southcorp Holdings Ltd charged the company $2.219 million in audit fees and $1.083 million for other services; see Southcorp Holdings Ltd, *1997 Annual Report* at 63.

a less robust and independent stance than they would otherwise.[952] The Cadbury Committee rejected any reform based on this danger on the basis that "a prohibition would limit the freedom of companies to choose their sources of advice and could increase their cost".[953] This reasoning supports a free market economy approach and seems more driven at protecting the interests of large accounting firms than ensuring the independence of auditors. Also AUP 32 sees no objection to auditors providing other services to clients "in principle" so long as auditors take care that actual or perceived independence "is not at risk".[954] This deals with the issue less than convincingly. I am not persuaded by these arguments. In my opinion managers can clearly use, either overtly or tacitly, the fees derived from other business as leverage against auditors. As a matter of principle if independence is important then in my opinion auditors should be prohibited from providing other services to their clients. The problem arises because there is not a separation of the accounting and auditing professions. Any business wants to consolidate its relationship with its customers and get as much business as possible from each customer. This is standard capitalism. Is the need for audit independence more important than this? In my opinion it is. This issue could be addressed not necessarily by a separation of the profession but by a firm of accountants/auditors not acting for clients in both capacities. Firms will certainly lose one or other type of work from existing clients but presumably the total amount of work that clients need would not decrease and firms would pick up work from other firms' clients who could not act in one capacity or another. Such a change, which cuts so deeply against free market concepts, is very unlikely to come about voluntarily by firms. It is also difficult to see a government having the political will to mandate such a change. Such a change is likely to face strong resistance from the accountancy profession, who would surely mount a powerful lobby against it. However as a matter of principle such a change is warranted.

AUP 32 also picks up on other types of potential compromise of independence. Whilst these are also important they are not as pernicious as the ones discussed in more length above. Other forms of compromise include:

- the client company putting pressure on auditors about their fees which may inappropriately inhibit the scope of the audit undertaken;[955]
- undue economic dependence on the fees derived from any one client (roughly more than 15% of gross fees);[956]
- significant outstanding fees owed by a client;[957] and
- if the auditor and client are in significant dispute, particularly if litigation has been commenced by either of them against the other.[958]

As I stated at the outset, the reason independence is so crucial is to ensure that an unbiased and outside opinion is reached concerning the reliability of the financial statements and their conformance with the requirements of the Corporations Law. The auditor is appointed so that he or she brings his or her independent judgement to bear on

952 This danger was recognised by submissions made to the Cadbury Committee; see Cadbury Committee, *The Financial Aspects of Corporate Governance* (Gee, Great Britain, 1992) at paragraph 5.10. See also Statement of Auditing Practice 32 'Audit Independence' at paragraph 37.

953 Cadbury Committee, *The Financial Aspects of Corporate Governance* (Gee, Great Britain, 1992) at paragraph 5.11.

954 Statement of Auditing Practice 32 'Audit Independence' at paragraph 36.

955 Above at paragraph 24. See also Tomasic, 'Auditors and the Reporting of Illegality and Financial Fraud' (1992)Australian Business Law Review 198 at 225 to 226.

956 Statement of Auditing Practice 32 'Audit Independence' at paragraphs 26 to 29 and 42(c).

957 Above at paragraph 30.

958 Above at paragraph 35.

the financial statements. As a result the duties cast on the auditor are of a personal nature[959] and there is a limit on the degree auditors are entitled to rely upon others.[960] This helps to explain the laws attitude to increasingly rigorous standards imposed on auditors in undertaking an audit (discussed below under the heading 'Role of Auditors').

Access to Information

In order for auditors to properly perform their role they must have unhindered access to the company's information. The Corporations Law gives auditors this access and also requires any officer of the company, under sufferance of criminal sanctions, to give any explanation the auditors' desire for the purposes of the audit.[961] If the auditor is not satisfied that he or she has obtained all relevant information and explanations required then the auditor is obliged to make an appropriate comment in the auditors' report.[962] No managers want to be perceived as not cooperating with the auditors, so this acts as a powerful incentive on directors and executives to cooperate.

Role of Auditors

The key role of auditors is to report on the financial statements; the auditors are not responsible for preparing the financial statements.[963] Auditors only test the credibility of the financial information prepared by management. So auditors are not responsible for generating information except for their report (discussed below).[964] As mentioned previously, the auditors must opine whether the financial statements are properly drawn up in accordance with the Law including whether the financial statements comply with the Accounting Standards and give a true and fair view.[965] If the Auditor reaches an adverse opinion on any of these matters then the auditor must report accordingly and explain the adverse opinion.[966]

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959 *Dominion Freeholders Ltd v Aird* [1966] 2 NSWR 293 at 295; discussed in Ickeringill, Poke, Sheller and Kent, 'Audit' in *Australian Corporations Law* (Butterworths, Sydney, 1996) at [3.7.0075].

960 See AUS 602 'Using the Work of Another Auditor'; AUS 604 'Considering the Work of Internal Auditing'; and AUS 606 'Using the Work of an Expert'.

961 CL s310 & 312 (and sections 323, 323A and 323B for group companies). In addition at common law auditors are obliged to report any deficiencies in the internal controls of a company: see *AWA Ltd v Daniels* (1992) 7 ACSR 759 at 835 and 846.

962 CL ss 307(b) & 308(3)(b).

963 AUS 202 at paragraph .14; Ickeringill, 'Statutory Responsibilities of Directors and Auditors in Relation to Company Accounts including a consideration of approved accounting standards)' (1988) 6 C&SLJ 3 at 7 and 25; Cadbury Committee, *The Financial Aspects of Corporate Governance* (Gee, Great Britain, 1992) at paragraph 5.14. This was also explicitly recognised by two members of the High Court in *Esanda Finance Corporation v Peat Marwick Hungerfords* (1997) 142 ALR 750 per McHugh J at 785 and Gummow J at 798.

964 AUP 32 'Audit Independence' states that accounting services should only be provided by an auditor in exceptional circumstances. If this is done then when it comes to auditing the financial statements the auditor should not place undue reliance on work undertaken by colleagues (which assumes firms act as auditors and there can be a segregation of functions).

965 CL s307(a); AUS 204 at paragraph .02. I do not wish to revisit the earlier discussion of 'true and fair view' at chapter 6.3 above. However the common law considered the search for the true financial position of the company as the auditors principal function; see *Squire Cash Chemist Ltd v Ball, Baker & Co* (1911) 27 TLR 269. See Ickeringill, Poke, Sheller and Kent, 'Audit' in *Australian Corporations Law* (Butterworths, Sydney, 1996) at [3.7.0080].

966 CL s308(1). See below under the heading "Content of the Report". In addition CL s308(3) provides that the report must describe any defect or irregularity in the financial report.

The Corporations Law takes a particularly stringent attitude if the shortcoming in the financial statements concerns the Accounting Standards. If the financial statements are not drawn up in accordance with an Accounting Standards then "the auditor's report must, to the extent it is practicable to do so, quantify the effect that non-compliance has on the financial report. If it is not practicable to quantify the effect fully, the report must state why".[967] As mentioned previously, the auditor also has to report to the ASIC any shortcoming in the financial statements if the auditor believes the shortcoming is not adequately dealt with by commenting in the auditor's report or bringing it to the attention of the directors.[968]

The auditor's report is comprehensive covering the key matters about the financial statements (compliance with accounting standards and true and fair view). Clearly this is a type of compliance audit compared with more direct forms of auditing organisational performance to determine the organisational effectiveness or efficiency judged against set criteria.[969] For example management auditing[970] or social auditing[971] can be used as a more direct measure of management performance or social performance (eg. employee safety).[972] So it is important to realise what an audit of the financial statements is not.

However, in order to be satisfied of the matters auditors must report on, they must audit (or in colloquial terms, examine) the accounting records and transactions of the company. Clearly the auditors cannot verify every financial transaction the company has undertaken and count every cent earnt.[973] To do so would be a full time, permanent occupation and the auditors would then simply be another layer of management.[974] AUS 502 confirms this and provides that "auditors should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion".[975] Auditors obtain appropriate evidence by using "tests of control"[976] and "substantive procedures".[977] Auditors use various procedures to obtain sufficient audit evidence, namely "inspection, observation, inquiry and confirmation, computation and analytical procedures".[978] Only by using such procedures can an auditor be able to be adequately satisfied in order to give the required opinion.

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967 CL s308(2). This statutory requirement is supported by AUS 702. Paragraph .19 of AUS 702 obliges auditors who are going to issue any form of qualified report to provide:

> (a) a quantification of the effects or possible effects on the amounts and other disclosures contained in, or omitted from, the financial report; or
>
> (b) if the effects or possible effects are incapable of being measured reliably, a statement to that effect and the reasons therefor.

968 CL s311, discussed in chapter 6.3 under the heading "Accounting Standards".

969 Sherer & Kent, *Auditing & Accountability* (Pitman, UK 1983) at 8; see also AUS 806 'Performance Auditing'.

970 Discussed in chapter 7.3.

971 Discussed in chapter 9.

972 See Sherer & Kent, *Auditing & Accountability* (Pitman, UK 1983) for a description of these types of auditing.

973 AUS 502 'Audit Evidence' at paragraph .08.

974 Some companies have their own internal auditors who report to senior management and can be a link with the external auditors; see AUS 604 'Considering the Work of Internal Auditing'.

975 AUS 502 'Audit Evidence' at paragraph .02.

976 Above at paragraph .05 defines "tests of control" as "tests performed to obtain audit evidence about the suitability of design and effective operation of the internal control structure".

977 Above at paragraph .06 defines "substantive procedures" as "tests performed to obtain audit evidence to detect material misstatements in the financial report...". See also AUS 512 'Analytical Procedures' and AUS 514 'Audit Sampling'.

978 AUS 502 'Audit Evidence' at paragraph .19. Each of these procedures is subsequently explained in paragraphs .20 to .25.

In addition to the auditing professions own standards, the courts have assessed how extensive the audit must be in the context of the duty of auditors to exercise a reasonable degree of care and skill in the discharge of their functions. The cases quickly established that auditors must not just check the arithmetical accuracy of the financial statements prepared by management and directors (ie more than computation was involved).[979] Because auditors must ascertain and report on the true financial position of the company they must investigate the financial records and internal controls of the company. So the auditors have to go beyond the financial statements prepared by management and verify the underlying financial position of the company.[980]

Initially auditors were regarded as a watchdog but not a bloodhound.[981] So auditors were entitled to trust the directors and management of a company and only had to undertake serious independent investigations if their suspicions were aroused. Otherwise they were entitled to "select a few cases at haphazard, see that they are right, and assume the others like them are correct also".[982] More recently the courts, in keeping with higher public expectations, hold auditors to a more rigorous standard. So for example, in a leading Australian case, Moffit J made the following statement about reliance by an auditor on the internal controls of a company:

> There are three essentials that must be met before an auditor can reasonably rely on the company's system of internal control. First, there must be a proper inquiry to ascertain the company's system. This would include ascertaining such features as indicate the strength and weakness of the system and hence its reliability. Second, there must be an appraisal of it, in that a person of sufficient auditing competence should make a decision as to the extent, if any, that the auditors can properly rely upon it. He should decide what procedures should be adopted to check that it is operating as intended and what other conditions should be met before reliance can be placed upon it. Third, there must be a testing of its operation. All these essentials may call for revision in the course of the audit.[983]

In the same case Moffit J questioned how much trust can be reposed in officers of the company by saying "there is always a material possibility that human frailty may lead to error or fraud in the financial dealings of any organisation."[984] Moffit J stated that auditors have to be alive to the possibility of fraud and opportunities for fraud and plan and conduct their audit accordingly.[985] This is supported by AUS 210 which provides that auditors should plan and conduct an audit so as to have a reasonable expectation of detecting material misstatements arising because of irregularities, including by way of fraud, other illegal act or errors (discussed further below).[986]

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979 *Leeds Estate Building & Investment Co v Shepherd* (1887) 36 Ch D 787; *Fomento (Sterling Area) Ltd v Selsdon Fountain Pen Co Ltd* (1958) 1 ALL ER 11 per Lord Denning at 23.

980 Ickeringill, Poke, Sheller and Kent, 'Audit' in *Australian Corporations Law* (Butterworths, Sydney, 1996) at [3.7.0090].

981 *In re Kingston Cotton Mills Company (No.2)* [1896] 2 Ch 279 per Lopes L.J at 288 to 289.

982 *Re London & General Bank (No.2)* [1895] 2 Ch 673 at 683.

983 *Pacific Acceptance Corporation Ltd v Forsyth* (1970) 92 W.N. (NSW) 29 at 87.

984 Above at 63 to 64.

985 Above at 65; *re Thomas Gerrard & Sons Ltd* [1968] Ch 455; and *Arthur Young & Co v WA Chip and Pulp Co Pty Ltd* (1988) 13 ACLR 283 at 289. See also Ford, Austin and Ramsay, *Ford's Principles Of Corporations Law* (Butterworths, Sydney, 9th ed., 1999) at [10.550] and Ickeringill, Poke, Sheller and Kent, 'Audit' in *Australian Corporations Law* (Butterworths, Sydney, 1996) at [3.7.0155].

986 AUS 210 'Irregularities, Including Fraud, Other Illegal Acts and Errors' particularly at paragraphs .02, .05 and .10 to .11. This standard at paragraph .09 makes it clear though that the

Subsequent cases confirm that auditors will now be held to more exacting standards.[987] The auditing standards will guide any court as to the appropriate standard of care to be expected of auditors[988] but will not necessarily dictate where courts will pitch the standard.[989] These standards point to the role of auditors becoming more sophisticated and professionalised and the concomitant standard of care reflects this. This more rigorous approach of the courts should ensure that auditors take a correspondingly more rigorous approach and enhance the quality of financial information shareholders receive.

The end result of an audit is to provide "reasonable assurance as to whether the financial report taken as a whole is free from material misstatement".[990] An audit cannot provide absolute assurance, due to inherent limitations in the role of auditors and the procedures they adopt.[991] For example whilst auditors are on the lookout for fraud people engaged in such activity usually take steps to conceal their activities and even a well planned and executed audit may not necessarily uncover it.[992] From a liability perspective it must be remembered that auditors are only obliged to exercise reasonable care, they are not held to a standard of strict liability. Any person can be careful but still make mistakes or not be as thorough as was possible. Therefore an audit does not guarantee the accuracy of the financial statements.[993] For this reason auditors are not regarded as insurers of the accuracy of the financial statements.[994] This point is often forgotten and is the reason the auditing profession coined the phrase "the audit expectation gap" (ie many people wrongly regard an audit as a guarantee of the correctness of the financial statements).[995]

Despite the reality of the audit expectation gap there are nonetheless commentators who are very critical of the role of auditors particularly in light of corporate collapses in the 1980's where the financial statements gave no or little hint of the imminent demise of the

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principal responsibility to prevent and detect fraud etc rests with management by the implementation and continued operation of an adequate internal control structure.

987 *Cambridge Credit Corporation Limited & Anor v Hutcheson & Others* (1983) 8 ACLR 123 & (1985) 3 ACLC 263; *AWA Ltd v Daniels* (1992) 7 ACSR 759 at 834 to 835.

988 Ford, Austin and Ramsay, *Ford's Principles Of Corporations Law* (Butterworths, Sydney, 9th ed., 1999) at [10.570].

989 Just as in medical negligence cases the High Court did not regard itself bound by professional standards in deciding what the appropriate standard of care should be for doctors; see *Rogers v* Whitaker (1992) 175 CLR 479. See also Costello, 'The Auditor's Responsibilities for Fraud Detection and Disclosure: Do the Auditing Standards Provide a Safe Harbour?' (1991) 43 Maine Law Review 265.

990 AUS 202 'Objective and General Principles Governing an Audit of a Financial Report' at paragraph .08.

991 Above at paragraphs .09 to 13; see also AUS 902 'Review of Financial Audits' at paragraph .10 which provides that in 'an audit...the auditor's objective is to provide a high, but not absolute, level of assurance...'.

992 AUS 210 'Irregularities, Including Fraud, Other Illegal Acts and Errors' at paragraphs .12 to .14.

993 This was one of the reasons advanced by Gummow J in *Esanda Finance Corporation v Peat Marwick Hungerfords* (1997) 142 ALR 750 at 798 to deny liability to creditors for the audit report. Discussed further below.

994 *Re London and General Bank Ltd ex parte Theobald (No. 2)* [1895-9] All ER 953 at 957. See Ickeringill, Poke, Sheller and Kent, 'Audit' in *Australian Corporations Law* (Butterworths, Sydney, 1996) at [3.7.0200].

995 Cadbury Committee, *The Financial Aspects of Corporate Governance* (Gee, Great Britain, 1992) at paragraph 5.4 and 5.14; Costello, 'The Auditor's Responsibilities for Fraud Detection and Disclosure: Do the Auditing Standards Provide a Safe Harbour?' (1991) 43 Maine Law Review 265 at fn 8; Epstein and Pava, *The Shareholder's Use of Corporate Annual Reports* (JAI Press, Connecticut, 1993) at 2 to 3.

corporation.[996] Tomasic gives three case studies where this was clearly the case.[997] The principal problems Tomasic identifies are the constraints of market forces, planning problems, fragmentation of the audit work, individual failings and the dominance of the CEO.[998] However it is difficult to see any profound changes that can be made to significantly address most of these problems. The market pressures problem is recognised by the profession themselves in their pronouncement on audit independence (discussed above). In the end it is up to auditors by asserting the need for their independence to address this. Assertion derives from strength of character, which cannot be legislated for. However my proposals to enhance independence should put auditors in a stronger position to exercise these personal characteristics. Planning problems reflect the increased size and sophistication of modern business and there seems no reason why auditors should not be able to adequately plan and ensure a person is charged with effectively monitoring all of the work.

Audit committees are an effective response to the dominant CEO depending on the strength of character of the independent directors relative to the CEO. The incidence of audit committees has risen since the time of Tomasic's article but there is still a strong argument that they should be compulsory. (The role of audit committees is discussed shortly under the sub-heading 'Directors' Obligations Concerning Audit'). One specific reform Tomasic regarded as necessary is to impose on auditors a duty to detect fraud not just plan to detect it, based on a comparison with US auditing standards.[999] However Tomasic's argument seems to be based on a misreading of the US standards.[1000] Some commentators regard these requirements as imposing an affirmative duty on auditors to detect fraud.[1001] However taken on its own this statement of duty overstates the legal position. The US standard obliges directors to plan and perform the audit in order to detect fraud in almost identical terms to AUS 210.[1002] The standard goes on to

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996 The financial crises at the State Bank of South Australia, WA Inc and within the Adsteam group of companies highlight this problem, all of which are discussed in Sykes, *The Bold Riders* (Allen & Unwin, New South Wales, 1994) at chapters 4, 13 and 15; Markovic and Langton, 'Directors and Misleading Financial Statements: Another Perspective' (1995) 8 Corporate and Business Law Journal 27 at 27 to 28; Tomasic, 'Auditors and the Reporting of Illegality and Financial Fraud' (1992) Australian Business Law Review 198; Costello, 'The Auditor's Responsibilities for Fraud Detection and Disclosure: Do the Auditing Standards Provide a Safe Harbour?' (1991) 43 Maine Law Review 265 at 266.

997 Tomasic, 'Auditors and the Reporting of Illegality and Financial Fraud' (1992) Australian Business Law Review 198. The case studies are the collapses of Nugan Hand Bank, Trustees Executors and Agency Co Ltd and Rothwells Ltd.

998 Above at 225 to 227.

999 Tomasic, 'Auditors and the Reporting of Illegality and Financial Fraud' (1992) Australian Business Law Review 198 at 204 to 205 and 228.

1000 At the time of Tomasic's article the relevant US standard was SAS 53, replaced with effect from 15 December 1997 by SAS 82. However as Mancino, 'The Auditor and Fraud' (1997-January) Journal of Accountancy 32 at 32 states:

> SAS no. 82 clarifies, but does not increase, the auditors responsibility to detect fraud. The auditors responsibility is still framed by the key concepts of materiality and reasonable assurance.

However at the time of Tomasic's article the relevant Australian Standard, AUP 16 was not as clearly expressed as the current standard, AUS 210.

1001 Costello, 'The Auditor's Responsibilities for Fraud Detection and Disclosure: Do the Auditing Standards Provide a Safe Harbour?' (1991) 43 Maine Law Review 265 at 278; Gay and Pound, 'The Role of the Auditor in Fraud Detection and Reporting' (1989) 7 Companies and Securities Law Journal 116 at 128.

1002 Statement of Auditing Standard No. 82 "Consideration of Fraud in a Financial Statement Audit" at paragraph 1 provides:

emphasise the auditor's role is in assessing the risk of fraud and planning the audit accordingly[1003] and that the audit does not provide absolute assurance that the financial statements are free from fraud.[1004] This more sophisticated analysis of the US position is also recognised by the commentators.[1005]

In addition there is a danger of drawing broad and extremely critical conclusions based on the minority of bad cases. This is not to deny that there are problems and that these can be improved upon. I have recommended some improvements already and suggest others later in this chapter. But so long as fallible humans are involved in the process then no system is going to be perfect. There will always be audit failures and as a result misreporting of financial information that people will rely on to their detriment. This is inevitable and just one of the harsh realities of the business world. Although it may be too late to totally satisfy individual shareholders, in many ways it is how the system responds to those failures that is a measure of the health of the system. In particular not just the use of penalty sanctions, which seem very under utilised,[1006] but the use of civil liability. The incidence of civil liability for auditors is a major issue for auditors both here and overseas.[1007] However this should be regarded as an indicator of the overall health of the system although not of the state of play in any individual company. I consider issues of liability later in this chapter.[1008]

Historically to ensure audit performance auditors would lodge a bond with the merchant guilds/merchant adventurers/regulated companies that they audited. The owners of the entity would appraise the auditors performance and determine how much of the bond to return.[1009] This was a sharp incentive for the auditor to perform. While today a bond is not required there are other factors which act as an incentive for auditors to perform carefully. Those factors include the potential for personal legal liability of an unlimited amount (since auditors are unable to take advantage of the benefits of incorporation),[1010] a company being generally prohibited from giving the auditors an indemnity from liability[1011] and there being as yet no statutory cap on the amount of damages an auditor may be liable for.[1012]

> An auditor has a responsibility to plan and perform an audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error of fraud.

1003 Above at paragraph 12.

1004 Above at paragraph 10.

1005 Costello, 'The Auditor's Responsibilities for Fraud Detection and Disclosure: Do the Auditing Standards Provide a Safe Harbour?' (1991) 43 Maine Law Review 265 at 278 to 279; Carmichael, 'The Auditors New Guide to Errors, Irregularities and Illegal Acts' (1988-September) Journal of Accountancy 40 at 41.

1006 Markovic, 'Auditors Criminal Liability: Another Approach' (1996) Australian Journal of Corporate Law 48 at 49 to 50; Markovic and Langton, 'Directors and Misleading Financial Statements: Another Perspective' (1995) 8 Corporate and Business Law Journal 27. The authors recommend some amendments to improve these penal provisions.

1007 Markovic, 'Auditors Criminal Liability: Another Approach' (1996) Australian Journal of Corporate Law 48 at 49; Tomasic, 'Auditors and the Reporting of Illegality and Financial Fraud' (1992) Australian Business Law Review 198 at 199, 200 and 219 to 220.

1008 Under the sub-heading 'Report to (Whom)?'.

1009 Watts & Zimmerman, 'Agency Problems, Auditing and The Theory of the Firm: Some Evidence' (1983) 26 Journal of Law & Economics 613 at 621.

1010 Since only a natural person and firms, not a company, may be appointed as an auditor.

1011 CL s241. Auditors can be indemnified if either they are liable to a person other than the company unless the auditor acted without good faith (ss(2)) or for costs and expenses incurred in successfully defending proceedings (ss(3)).

1012 Ford, Austin and Ramsay, *Ford's Principles Of Corporations Law* (Butterworths, Sydney, 9th ed., 1999) at [10.660].

Also if auditors are found to be negligent then they will face a loss of their professional reputation.[1013] On the assumption that any professional is keenly interested in their professional reputation because this is their ticket to ongoing credibility in the market for their services then this is a strong incentive to perform adequately.[1014] Although this is a non-legal matter (putting to one side the law of defamation, which protects reputation) it must not be forgotten and is a factor that helps to ensure that auditors are diligent and careful.

Content of Report

The auditor's report is the information that the auditor generates and then communicates to shareholders. Consistent with the role of auditors their report communicates how credible the financial statements are. There are two types of reports an auditor can make; either an unqualified or qualified report. An unqualified report is given where the auditor is "satisfied in all material respects" with the requirements for the financial statements and the auditors duty concerning them.[1015] That is the auditor is satisfied that the financial statements comply with the accounting standards and show a true and fair view of the corporation's financial position. A qualified report is given when an auditor is not so satisfied. The auditor should only express a qualified opinion after taking " all reasonable steps to be in a position to express an unqualified opinion".[1016]

The three forms a qualified report can take are "except for", "adverse" or "inability to form an opinion".[1017] Except for and adverse opinions both arise when an auditor considers "an unqualified opinion is inappropriate because of a disagreement with management, a conflict between applicable financial reporting frameworks or a scope limitation".[1018] Which opinion is used depends on the extent of the effects, or possible effects, of such a problem. An adverse opinion is issued where such effects are "of such a magnitude or is so pervasive or fundamental that the financial report as a whole is, in the auditor's opinion, misleading or of little use to the addressee of the audit report".[1019] An except for opinion is issued when the extent of the problem is not this great or the other form of qualified opinion is not appropriate.[1020] An inability to form an opinion is used only when a scope limitation occurs and:

> (a) sufficient appropriate audit evidence to resolve the uncertainty resulting from the limitation cannot reasonably be obtained; and
> (b) the possible effects of the adjustments that might have been required had the uncertainty been resolved are of such a magnitude or so pervasive or fundamental that the auditor is unable to express an opinion on the financial report taken as a whole.[1021]

1013 *Esanda Finance Corporation v Peat Marwick Hungerfords* (1997) 142 ALR 750 per McHugh J at 781.

1014 See Cadbury Committee, *The Financial Aspects of Corporate Governance* (Gee, Great Britain, 1992) at paragraph 5.3(c).

1015 See AUS 702 'The Audit Report on a General Purpose Financial Report' at paragraphs .02 and .26; see also AUS 306 'Materiality'.

1016 AUS 702 'The Audit Report on a General Purpose Financial Report' at paragraph .43.

1017 Above at paragraph .25(b).

1018 Above at paragraphs .27, .28 and .42. For the circumstances when each of these apply see paragraphs .44 to .50 (disagreement with management), .51 to .52 (conflict between applicable financial reporting frameworks) and .53 to .56 (scope limitation).

1019 Above at paragraph .28.

1020 Above at paragraph .27.

1021 Above at paragraph .30.

In certain circumstances an auditor has an option other than issuing a qualified report. The other option is to issue an unqualified opinion but make a comment in the opinion (called an "emphasis of matter").[1022] The circumstances where this occurs are where there is inherent uncertainty concerning a matter in the financial statements, other information provided with the financial statements is inconsistent with them, a subsequent event occurs and a revised set of financial statements are issued or in the circumstances mentioned in the next paragraph.[1023]

Notably a qualified opinion should always be given if the financial statements depart from an Accounting Standard or a UIG Consensus View.[1024] If the financial statements comply with the Accounting Standards and UIG Consensus Views but additional information is included in the financial statements on the basis that such compliance resulted in the financial statements being potentially misleading, then the auditor will usually issue a qualified report but failing that at least an emphasis of matter.[1025]

This provides a sensible pattern of opinions on an increasing scale based on the nature and extent of the auditor's reservations.[1026] This pattern of opinions also provides a certain consistency between the reports of different auditors which enhances their comparability.[1027] Comparability, brought about by a certain level of uniformity is desirable. The wording of an unqualified report has been standardised.[1028] However within this pattern of opinions the precise content of a qualification to an audit report or an emphasis of matter are not mandated.[1029] This is appropriate because the content of a qualified report or an emphasis of matter must be tailored to the particular reservations the auditor has with the financial statements of that company.

One empirical study has concluded that "the audit report has little effect on investor decisions and attitudes".[1030] One explanation of this is called the "hypothesis of investor conditioning".[1031] This hypothesis "holds that investors have been conditioned through the standardisation of audit report wording and format to expect the report to be of no interest".[1032] As a result a reader of audit reports has "been conditioned to expect no surprises, and so does not read the audit report. Even when the auditors report is modified or qualified, any but the most knowledgeable reader would have to do a line by

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1022 Above at paragraphs .31 to .32 and .39.

1023 Above at paragraph .57 to .64. See also AGS 1028 'Uncertainty'.

1024 AUS 702 'The Audit Report on a General Purpose Financial Report' at paragraphs .45 and .46.

1025 Above at paragraphs .47 and .58 to .59.

1026 Although there is said to be some minor lacuna's in this pattern; see Picker, 'AUS 702: Emphasis...but no Certainty' (1997-March) Australian Accountant 57.

1027 AUS 702 'The Audit Report on a General Purpose Financial Report' at paragraph .07.

1028 Above at paragraphs .23 and .24 and Appendix 1.

1029 Above at appendix 2 provides examples of qualifications. However these limited examples do not cover all the possible situations in which an auditor would be required to issue a qualified opinion.

1030 Estes, *The Auditors Report and Investor Behaviour* (Lexington Books, U.S.A., 1982) at 87. This study was undertaken in the USA and therefore may not be directly applicable in Australia. But the role of auditors is the same in each country and the reporting content is similar so I tentatively suggest that the study is relevant in Australia. There is also empirical evidence that the audit report is the least read part of the annual report; see Anderson, 'The Usefulness of Annual Reports' in Courtis (ed), *Communication Via Annual Reports* (Financial Management Research Centre, Armidale, 1981) 61 at 68.

1031 Above at 91.

1032 Above at 92.

line comparison with the standard wording to find the changes".[1033] This is particularly so given the low incidence of qualified reports.[1034] As a result the author of the study proposes that the audit report should be revitalised by dropping all standardised wording and replacing it with an original statement expressing the auditors individual opinion on the financial statements of each company.[1035] In my opinion this proposal is too radical because it ignores the advantages of uniformity, namely comparability and providing a benchmark. However the argument is valid up to a certain point and is accommodated since a qualification or emphasis of matter will be explained in the auditors own words.

Interestingly the study concluded that an opinion expressing a disagreement with management had "a negative effect on the investors evaluation of management".[1036] The author tentatively concludes that this is because investors expect managers to be able to work cooperatively with the auditors prior to the audit report being issued and hence be able to avoid such a qualified opinion.[1037]

AUS 702 requires disclosure in the audit report of the scope of the audit.[1038] Unfortunately the requirements of AUS 702 and the model reports contained therein have reduced the statement concerning the scope of the audit to a stylised form of words which communicates very little. Rather than telling what the auditor has done in conducting the particular audit the report describes the purpose of the audit and in a very limited way how the audit was done.[1039]

In my opinion the audit report should contain detailed information on the scope of the audit conducted to enable the auditor to form the requisite opinion. Auditors prepare an engagement letter with their client which sets out the scope of the audit.[1040] Auditors also prepare an audit plan that they will discuss with the directors (or the audit committee if there is one) prior to undertaking the audit.[1041] Also during the audit the auditors generate working papers.[1042] In my opinion shareholders if interested should have access to the engagement letter, audit plan, the auditor's working papers and all other pertinent information. In addition there may be confidentiality concerns with this type of

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1033 Above at 91.

1034 Above at 5. The incidence in Australia of adverse reports and expression of an inability to form an opinion are very rare, under 1%: see Green and Simnett, 'Serious Audit Qualifications in Australia' (1993) 64 No. 7 Charter 36.

1035 Above at 93.

1036 Estes, *The Auditors Report and Investor Behaviour* (Lexington Books, U.S.A., 1982) at 77 to 78 and 89.

1037 Above at 89 where the author of the study quotes investors as saying that if managers are unable to avoid a qualified opinion they "can't be too sharp". Also see below under the heading "Report to Whom" about the auditors legitimate role of taking concerns about the results of their audit to managers and directors before taking them to shareholders.

1038 AUS 702 'The Audit Report on a General Purpose Financial Report' at paragraph .17.

1039 For example AUS 702 'The Audit Report on a General Purpose Financial Report' at paragraph .17(f) provides that the report should state that the "auditor's procedures included examination, on a test basis, of evidence supporting the amounts and other disclosures in the financial report, and the evaluation of accounting policies and significant accounting estimates". These words are repeated verbatim in the example opinions in appendices 1 and 2.

1040 AUS 204 'Terms of Audit Engagements' at paragraph .05(c).

1041 AUS 302 'Planning' at paragraph .10 states that the "auditor should develop and document an audit program setting out the nature, timing and extent of planned audit procedures required to implement the audit plan". The engagement letter may also contain details of the plan for the audit; see AUS 204 'Terms of Audit Engagements' at paragraph .06 at (a).

1042 AUS 208 'Documentation'.

information and confidentiality safeguards should be built into any disclosure regime.[1043] The cost of distributing this information may be excessive. Therefore as an alternative this information should be available for inspection by shareholders.[1044]

Such an approach is consistent with the scientific method of publication.[1045] Part of the scientific tradition is to publish the hypothesis, the method of experimentation, the resulting data (ie the results of the experiments) and the scientist's conclusions. In particular publication of the methodology and raw data enable other scientists to repeat the test to independently verify the results. The general scientific community is then able to decide if there is sufficient data for the hypothesis to be regarded as proved and therefore to be viewed as a theory or law of science (rather than just a hypothesis). Shareholders may not want or be able to repeat the audit but giving them access to the auditors methodology and raw data would enable them to independently determine whether the auditor's expressed opinion was warranted. Of course shareholders may not be interested to do this as a matter of routine. This does not mean the proposal is without merit. The very threat that these documents are available may cause auditors to take their job more seriously. Also making this information available leaves an adequate paper trail in the event of audit failure and enables legal liability to be sheeted home to them. This incentive to perform may prevent audit failures, which can only be a good result.

Shareholders should have access to the audit plan and the auditor's working papers because they contain potentially very useful information for shareholders. If provided with this information shareholders would know precisely what the auditors planned to do and what they actually did. Shareholders would then appreciate how thoroughly the company has been audited and therefore how reliable the audit report is. Disclosure of this type of information is particularly important given there are competitive pressures on auditors to reduce their fees. If fees are reduced then auditors will be tempted to, and may have to be, less thorough.[1046] Noticeably the ASIC has the power to require auditors to produce to the ASIC their working papers of an audit.[1047] This power reposed in the ASIC shows that disclosure of such information is a valuable accountability mechanism.

Report to (Whom)?

The auditor's statutory report is addressed[1048] and sent[1049] to shareholders and also laid before them at the annual general meeting.[1050] The auditors have a right to notice of and to attend any general meeting of the company and to be heard at the meeting on any business of the meeting that concerns the auditor in the capacity of auditor.[1051] Shareholders also have the right to ask auditors, if present at the meeting, any "questions relevant to the conduct of the audit and the preparation and content of the auditor's

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1043 See chapters 1, 2 and 3.

1044 Inspection could be made available on the same basis as inspection of registers under the Corporations Law. See CL s173 discussed in chapter 8.3.

1045 Discussed in chapter 2.2.

1046 This danger was recognised by the Cadbury Committee, *The Financial Aspects of Corporate Governance* (Gee, Great Britain, 1992) at paragraph 5.3(c).

1047 *Australian Securities Commission Act* 1989 (Cth) s30 together with the definition of "eligible person" in s5 which definition includes auditors.

1048 CL s308(1).

1049 CL s314(1)(a)(iii) and (2)(c) & (d).

1050 CL s317(c).

1051 CL s249K and s249V. See also AUS 702 'The Audit Report on a General Purpose Financial Report' at paragraph .16.

report".[1052] These paths of communication are consistent with the role of auditors as an independent watchdog who are appointed, and can only be removed, by shareholders. Without derogating from this simple statement several comments are appropriate.

First, if auditors, during the performance of their duties, discover irregularities then they should first report those irregularities to senior management. Failing prompt corrective action by senior management then the auditors should report to the directors.[1053] Only if the board does not take adequate action should the auditor's report to shareholders. If adequate remedial action is taken then shareholder's interests have been protected. This approach recognises the reality that auditors have their day to day working relationship with management and, to a lesser extent, directors. It also recognises that directors are the representatives of shareholders. However if the board refuse to act, the irregularity is a poor reflection on the board itself, or if problem is material and is not disclosed in the financial statements then the auditors should not hesitate to report to the shareholders.[1054]

Second, who can auditors be liable to? Auditors can be liable for false and misleading statements under section 1308 of the Corporations Law (discussed above at 6.2). The ASIC is responsible for enforcing the Corporations Law. But who can auditors be civilly liable to? Consistent with the analysis of the role of auditors then the answer should unequivocally be to shareholders (at least). For shareholders appoint the auditors, may remove them and the auditors report to the shareholders. However the answer is not that simple. The company is a separate legal entity[1055] and courts have made much of this. In the context of directors duties they have stated that directors owe their duties to the company and as a result shareholders generally, albeit subject to exceptions, do not have a right to sue the directors for a breach of duty.[1056] Although the rule in *Foss v Harbottle* is being eaten up by the exceptions and has been trenchantly criticised it nonetheless still represents current law.[1057] A similar approach has generally been adopted about auditors with the result being that they owe their duties to the company and shareholders generally do not have a right to sue them for a breach in performing their duties.

Although this is broadly correct it depends on the juridical basis on which the shareholders endeavour to sue the auditors. There is some support for the view that the company has an action for damages because the auditor has breached his or her statutory duties.[1058] This right of action is underdeveloped and in any event the right of action seems to reside with the company, not shareholders.[1059]

1052 CL s250T.

1053 *AWA Ltd v Daniels* (1992) 7 ACSR 759 at 833; AUS 710 'Communication to Management on Matters Arising from an Audit'; and AUS 210 'Irregularities, Including Fraud, Other Illegal Acts and Errors' at paragraphs .27 to .31.

1054 *Pacific Acceptance Corporation v Forsyth* (1970) 92 WN (NSW) 29 at 58; see also Ford, Austin and Ramsay, *Ford's Principles of Corporations Law* (Butterworths, Sydney, 9th ed., 1999) at [10.590].

1055 CL s119; *Salomon v Salomon & Co. Ltd* [1897] A.C. 22.

1056 *Foss v Harbottle* (1843) 67 E.R. 189.

1057 Sealy, 'The Rule In Foss v Harbottle: The Australian Experience' (1989) 10 The Company Lawyer 52; Stapledon, 'Locus Standi of Shareholders to Enforce The Duty of Company Directors to Exercise the Share Issue Power for Proper Purposes' (1990) 8 C&SLJ 213; Blanchard, 'Honesty in Corporations' (1996) 14 C&SLJ 4 at 9 to 10.

1058 *AWA Ltd v Daniels* (1992) 9 ACSR 383; see generally Ford, Austin and Ramsay, *Ford's Principles Of Corporations Law* (Butterworths, Sydney, 9th ed., 1999) at [10.530].

1059 *AWA Ltd v Daniels* (1992) 9 ACSR 383 at 385.

In terms of contractual liability the auditors contract is with the company and the auditors fees are payable by the company.[1060] In keeping with the doctrine of privity of contract then only the company can sue.[1061]

If the liability is tortious then certainly the duty of care is owed primarily to the company. The issue is whether it can also be owed to individual existing or future shareholders or others. There have been a number of recent decisions of the House of Lords and Court of Appeal which settle the law for the U.K. and which are persuasive in Australia.[1062] Those cases have consistently stated that auditors engaged in the usual way to audit the financial statements of the company owe their duty of care only to the company, not to individual shareholders. The reasoning is that auditors do not have a sufficiently proximate relationship with individual shareholders to establish a duty of care. Particularly in the *Caparo* decision the House of Lords were concerned with auditors being liable for an indeterminate amount of economic loss.[1063] The court acknowledged that shareholders appoint the auditors and the auditors report is addressed to them. The court nonetheless concluded that the relationship between the auditors and shareholders was not sufficiently proximate. Part of the reasoning of Lord Jauncey was:

> There is nothing in Part VII which suggests that the accounts are prepared and sent to members for any purpose other than to enable them to exercise class rights in general meeting. I therefore conclude that the purpose of annual accounts, so far as members are concerned, is to enable them to question the past management of the company, to exercise their voting rights, if so advised, and to influence future policy and management. Advice to individual shareholders in relation to present or future investment in the company is no part of the statutory purpose of the preparation and distribution of the accounts.[1064]

In Australia the law in this area has not been conclusively settled by the High Court. The High Court in *Esanda Finance Corporation v Peat Marwick Hungerfords*[1065] has examined the issue of auditor's liability to a financier. The High Court unanimously held that the auditor did not owe a duty of care to the financier in the preparation of the annual audit report where the only matter pleaded by the financier was forseeability of loss and reliance by the financier on the audit opinion. The touch stone for liability for most of the judges was either an assumption of responsibility or reasonable reliance (meaning more than reliance on the facts).[1066] Neither could be satisfied in the case of a normal annual audit, although if auditors are performing a specialist report, then a duty

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1060 CL s331.

1061 See Ford, Austin and Ramsay, *Ford's Principles Of Corporations Law* (Butterworths, Sydney, 9th ed., 1999) at [10.540].

1062 *Al Saudi Banque and Others v Clarke Pixley (a firm)* [1990] 2 WLR 344; *Caparo Industries Plc v Dickman* [1990] 2 WLR 358; *James McNaughton Papers Group Ltd v Hicks Anderson & Co* [1991] 1 All ER 134. See generally Ickeringill, Poke, Sheller and Kent, 'Audit' in *Australian Corporations Law* (Butterworths, Sydney, 1996) at [3.7.0160]. A duty of care may exist in other circumstances such as an auditor being retained to prepare special reports in defence of a takeover that has commenced: see *Morgan Crucible Co v Hill Samuel Bank Ltd* Court of Appeal (U.K.) October 1990.

1063 *Caparo Industries Plc v Dickman* [1990] 2 WLR 358 per Lord Oliver at 388.

1064 Above at 406.

1065 (1997) 142 ALR 750.

1066 Above per Toohey and Gaudron JJ at 764 and 766, McHugh J at 780, Dawson J at 762; cf the different formulation adopted by Brennan CJ at 757. Gummow J decided the matter on a narrower basis and did not emphatically state what was necessary to be pleaded by a plaintiff in order to successfully found a duty of care; see his judgement at 804.

may arise.[1067] Members of the court also pointed to various policy reasons why such liability should not be imposed on auditors. Those reasons include the problem of indeterminate liability,[1068] financial loss necessarily occurs as a result of commercial competition and imposing liability would stifle competition,[1069] other liability rules and loss of reputation act as incentives for auditors to perform their job properly without the need for civil liability to such plaintiffs,[1070] insurance is not necessarily easily available or adequate to justify the imposition of liability,[1071] courts will be burdened with significant extra work,[1072] such users of the financial statements are sophisticated and have other means to avoid the risks,[1073] creditors already have an indirect remedy via a liquidator,[1074] the liability of the auditors is secondary to that of their client who is responsible for the preparation of the financial statements,[1075] problems of proof (particularly of subjective elements like reliance),[1076] even groundless cases having a settlement value due to the inherent complexities of the issues,[1077] the quantum of liability being disproportionate to the level of fault,[1078] the plaintiffs are trying to evaluate itself above other creditors,[1079] the audit process is a complex process involving professional opinion not just a statement of verifiable fact,[1080] and that liability would amount to courts imposing a guarantee on auditors of the accuracy of the financial statements.[1081]

Whilst not a case involving liability to shareholders all the judges referred to the decision in *Caparo* with (apparent) approval.[1082] Some judges also referred to other cases with (apparent) approval which denied liability of shareholders[1083] and explicitly overruled a New South Wales decision which imposed liability on auditors to shareholders.[1084] In addition McHugh J explicitly made his judgement on the basis that his reasoning applied

1067 From the general principles discussed above. This was applied in *The Duke Group Ltd (in liq) v Pilmer* (1998) 16 ACLC 567 at 704 to 715 to an independent auditor's report concerning the fairness of a takeover price (discussed in chapter 8.3 under the subheading 'Takeovers').

1068 *Esanda Finance Corporation v Peat Marwick Hungerfords* (1997) 142 ALR 750 per Dawson J at 759, McHugh J at 773 and 783 and Gummow J at 797.

1069 Above per Dawson J at 759.

1070 Above per McHugh J at 781.

1071 Above per McHugh J at 781 and Gummow J at 798.

1072 Above per McHugh J at 782 to 783.

1073 Above per McHugh J at 783 and Gummow J at 798.

1074 Above per McHugh J at 784.

1075 Above per McHugh J at 785 and Gummow J at 798.

1076 Above per McHugh J at 785 to 786.

1077 Above per McHugh J at 786.

1078 Above per McHugh J at 787.

1079 Above per Gummow J at 798.

1080 Above per Gummow J at 798.

1081 Above per Gummow J at 798.

1082 Above per Brennan CJ at 756 to 757, Toohey and Gaudron JJ at 765, Mc Hugh J at 776, Dawson J at 762 and Gummow J at 799.

1083 Those cases include *R Lowe Lippmann Figdor & Franck v AGC (Advances) Ltd* [1992] 2 VR 671 (see Dawson J at 761 and McHugh J at 775 and 780), *Haig v Bamford* [1977] 1 SCR 466 (see McHugh J at 778), *Bily v Arthur Young* (1992) 834 P 2d138 (see Mc Hugh J at 780 and Gummow J at 801 (although Gummow J is more equivocal in his support)) and *Blue Chip Stamps v Manor Drug Stores* (1975) 421 US 723 (see McHugh J at 786).

1084 *Esanda Finance Corporation v Peat Marwick Hungerfords* (1997) 142 ALR 750 per Dawson J at 759 and McHugh J at 788; the decision was *Columbia Coffee & Tea Pty Ltd v Churchill* (1992) 9 ACSR 415.

equally to "creditors and investors".[1085] Whilst these observations must be regarded as obiter dictum concerning the potential liability of auditors to investors for their audit opinion attached to annual financial statements they strongly indicate that the current High Court would deny such liability.

In contrast with this judicial approach Statement of Accounting Concept 2 supports the view that a broad approach to who are the legitimate users of the financial statements.[1086] SAC 2 recognises that there will be many users of financial statements.[1087] The financial statements are regarded as general purpose reports. General purpose financial reporting focuses on providing information to meet the information needs of users who are unable to command the preparation of reports tailored to their particular information needs.[1088] This position is unusual but understandable. Unusual because the financial statements are prepared for shareholders so the financial statements in one sense should be tailored to their needs. Understandable because the reality is that many people other than shareholders use the financial statements and the conceptual recognition of this adopts a realistic approach. The conceptual recognition is another argument in favour of the law recognising that other people use the financial statements and the preparers should be liable for any misstatements.[1089] The High Court in *Esanda Finance* considered an argument that the predecessor to SAC 2, AAS 5, was sufficient to ground a duty of care to these other users to the financial statements. None of the members of the High Court were persuaded by this argument.[1090]

As a result of this approach to liability the law seems schizophrenic. Auditors are appointed by shareholders to protect their interests, auditors report to shareholders but if auditors are negligent then the shareholders are unable to sue them. This is not just an issue of who is the proper plaintiff. For the way shareholders are most likely to suffer a loss is by selling their shares at an undervalued price or by acquiring (more) shares at an overvalue basing those valuations on the audited financial statements. As the company is not a party to these transactions the company will not suffer any loss. However these transactions involve shareholders in their investor function supported by the efficient capital market hypothesis. The courts in denying shareholders the right to sue the auditors are denying shareholders have this legitimate role to play.[1091] There are strong arguments that this is totally myopic and unacceptable.[1092] At least part of the reasoning of Lord Jauncey (quoted above) is inapplicable in Australia because the annual and half-

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1085 *Esanda Finance Corporation v Peat Marwick Hungerfords* (1997) 142 ALR 750 at 776, 783 and 787. McHugh's test has been picked up in Canada where the Canadian Supreme Court has recently denied that auditors owe a duty of care to investors in the course of a normal annual audit; see *Hercules Management Ltd v Ernst and Young* (1997) 146 DLR 577 discussed in Phegan, 'Reining in Forseeability: Liability of Auditors to Third Parties for Negligent Misstatement (*Esanda Finance Corporation Limited v Peat Marwick Hungerfords (Reg)* and *Hercules Managements Ltd v Ernst and Young*) (1997) 5 Torts LJ 123.

1086 "Objective of General Purpose Financial Reporting".

1087 SAC 2 at paragraphs 16 to 19.

1088 Above at paragraph 7.

1089 This argument is developed in Gibson and Simnett, 'Is the Duty of Care Owed by Auditors to All Users of General Purpose Financial Accounts?' (1994) Australian Journal of Corporate Law 54 at 58 to 61.

1090 *Esanda Finance Corporation v Peat Marwick Hungerfords* (1997) 142 ALR 750 particularly per Brennan CJ at 755, Dawson J at 759, McHugh J at 772 and 787 to 788 and Gummow J at 804.

1091 Gibson and Simnett, 'Is the Duty of Care Owed by Auditors to All Users of General Purpose Financial Accounts?' (1994) Australian Journal of Corporate Law 54 at 56.

1092 The strength of this argument is recognised by McHugh J in *Esanda Finance Corporation v Peat Marwick Hungerfords* (1997) 142 ALR 750 at 787; see also Baxt, 'The Liability of Auditors-the Pendulum Swings Back' (1990) C&SLJ 249.

yearly statements provided to investors pursuant to ASX listing rules must be based on audited financial statements.[1093] The ASX is clearly concerned with shareholders in their investor function. As a matter of principle shareholders should be able to sue the auditors if they have been negligent and have caused the shareholders to suffer loss. However there are the countervailing public policy arguments addressed above, nearly all of which also apply to investors. Also for every investor who sells at an undervalued price or buys at an overvalued price, the person they acquired from or sold to receives a windfall. If auditors were held liable there seems no sound legal basis for the auditors to recover this windfall from innocent third parties. It would also be practically impossible to unravel all such transactions and any subsequent ones. Although some investors have been harmed there is no net harm to the market. In total this reason and the other policy considerations outweigh the arguments in favour of imposing liability.

Since there is no liability on auditors to shareholders in their investor role then this has an impact on the usefulness of this information. Certainly shareholders use financial information in their investment decisions and the audit report is relevant to the credibility of this information. However this information is legally irrelevant; although it can be used in real life it can not be used in a court room to found a claim against the auditors. So from a legal perspective this information is useless to shareholders in their investor role.

Directors' Obligations Concerning Audit

Companies are obliged to have their annual financial report audited, obtain an auditor's report[1094] and send it to the shareholders.[1095] The Corporations Law visits directors with liability if they "fail to take all reasonable steps to... secure compliance with" the obligation to have the annual report audited.[1096] This view is supported by the personal obligation on directors to lay before the A.G.M the auditor's report.[1097] So the directors have a responsibility to ensure this information is generated and communicated to shareholders. The directors' relationship with auditors is not limited to ensuring an end product which is sent to shareholders. Directors can have a meaningful role during the audit process. As mentioned above if the auditors come across a problem then if they raise this with the executives who fail to properly address it then auditors should communicate with the directors. The directors should then address the problem. It is by this process that auditors endeavour, if necessary, to shape the content of the financial statements to enable them to not give a qualified opinion. The objective of a good working relationship between directors and auditors is to enhance the quality of financial reporting and in particular the credibility of those reports.[1098] To enhance a good working relationship between directors and auditors the directors often delegate their responsibilities to a committee of themselves. This practice has been widespread in the

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1093 Discussed below at chapter 6.8 'Financial Reporting to ASX'.

1094 CL s301(1). Small proprietary companies in normal circumstances do not have to do this; see CL s301(2) & 327(1A).

1095 CL s314(1)(iii).

1096 CL s344 (previously s296(1)).

1097 CL s317(c).

1098 Australian Accounting Research Foundation, Institute of Internal Auditors-Australia and Australian Institute of Company Directors, *Audit Committees: Best Practice Guide* (AARF, IIA & AICD, Sydney, 1997) at 4.

USA[1099] and Canada[1100] for almost twenty years. It is a more recent development in Australia (and the UK) although their incidence is increasing.[1101]

Three justifications for audit committees have been postulated:
- to increase public confidence in the credibility and objectivity of published financial information;
- to assist the directors in meeting their responsibilities for financial reporting; and
- to strengthen the independent position of a corporation's external auditor by providing channels of communication between the auditor and directors other than through those actively managing the corporation.[1102]

There is no defined role that necessarily applies to all audit committees; it depends on the extent and nature of the delegation by the particular board of directors. An extensive delegation would repose in the audit committee the following functions:

(1) nominating the external auditors;
(2) forming an appreciation, with the external auditors, of the total audit plan;
(3) checking the auditor's evaluation of internal controls;
(4) reviewing the assistance given by the company's executives to the external auditors;
(5) checking the effectiveness of the internal audit;
(6) reviewing the results of the audit; and
(7)reviewing the financial statements with the auditors before recommending approval to the full board.[1103]

It is generally regarded that the audit committee should be comprised, if not exclusively then at least principally, of non-executive directors.[1104] If the committee is to be an

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1099 In 1976 the New York Stock Exchange adopted in principle a requirement that every US-listed company must have an audit committee: see Accountants International Study Group, *Audit Committees* (Accountants International Study Group, USA, 1977) at para 16.

1100 Certain Canadian jurisdictions have legislated to require audit committees: see above at para 18.

1101 Stapledon, *Institutional Investors and Corporate Governance* (Clarendon Press, Oxford, 1996) at 171 to 172 who cites a study which found that as at 1994 75% of the top 150 companies had an audit committee. Stapledon and Lawrence, *Corporate Governance in the Top 100: An Empirical Study of the Top 100 Companies' Board of Directors* (Centre for Corporate Law and Securities Regulation, Melbourne, 1996) at iii found that during 1995 all of the top 100 companies (for which relevant information was available) had an audit committee. The role of audit committees is further discussed in chapter 6.5 under the sub-heading "Director's Responsibilities Concerning Audit". Ramsay and Hoad, *Disclosure of Corporate Governance Practices by Australian Companies* (Centre for Corporate Law and Securities Regulation, Melbourne, 1997) at 18 to 21 who note that disclosure in the corporate governance statement (see LR 4.10.3) of audit procedures was high.

1102 Above. For an elaboration of these core reasons see Spira, 'An Evolutionary Perspective on Audit Committee Effectiveness' (1998) 6 Corporate Governance 29 at 29 to 31.

1103 Ford, Austin and Ramsay, *Ford's Principles Of Corporations Law* (Butterworths, Sydney, 9th ed., 1999) at [10.670]; Accountants International Study Group, *Audit Committees* (Accountants International Study Group, USA, 1977) at para 41. Cadbury Committee, *The Financial Aspects of Corporate Governance* (Gee, Great Britain, 1992) at paragraph 4.35(e); Buxbaum, 'Corporate Governance and Corporate Monitoring: The Whys and Hows' (1996) 6 Australian Journal of Corporate Law 309. See also Australian Accounting Research Foundation, Institute of Internal Auditors-Australia and Australian Institute of Company Directors, *Audit Committees: Best Practice Guide* (AARF, IIA & AICD, Sydney, 1997) at 16 to 20.

1104 Australian Investment Managers Association, *Corporate Governance: A Guide for Investment Managers and Corporations* (AIMA, Australia, 2nd ed., 1997) at 22 (comprised solely of non-executive directors the majority of whom are independent); Accountants International Study group, *Audit Committees* (Accountants International Study Group, USA, 1977) at paras 25, 26 &

effective check against management then this is undoubtedly correct. The audit committee should also be able to seek expert advice concerning the discharge of its functions if this is necessary.[1105]

Some people believe audit committees should be compulsory.[1106] In Australia this has not been made a substantive requirement of the law, although many public listed companies have voluntarily adopted them.[1107] AIMA has recommended that Boards have an audit committee[1108] and this is part of the indicative list of corporate governance disclosures required by the ASX.[1109] Also the directors are required to state in the Preliminary and Final Statement to the Stock Exchange whether there is an audit committee.[1110] So shareholders receive information as to their existence. In my opinion audit committees should be compulsory, unless there are compelling reasons to the contrary.[1111]

However what about the effectiveness of audit committees. Spira has reviewed a range of studies which have examined this issue. Spira sets out a range of factors that are claimed to contribute towards effectiveness.[1112] Those factors include the resources available to the committee, their members' independence (and length of tenure), employment background, skills, gender balance, frequency and timing of meetings (an

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44; and Cadbury Committee, *The Financial Aspects of Corporate Governance* (Gee, Great Britain, 1992) at paragraph 4.35.

1105 Cadbury Committee, *The Financial Aspects of Corporate Governance* (Gee, Great Britain, 1992) at paragraph 4.35(d).

1106 Cadbury Committee, *The Financial Aspects of Corporate Governance* (Gee, Great Britain, 1992) at paragraphs 4.35(d) and 5.9. This was the recommendation of the Lavarch Committee, *Corporate Practices and the Rights of Shareholders* (AGPS, Canberra, 1991) at paragraph 5.5.22. This matter is currently being considered by the Commonwealth Government; see Parliamentary Joint Committee On Corporations And Securities, *The Role of Audit Committees in Corporate Governance-A Progress Report*, (Canberra, 1993). The current government recently requested this committee to reconsider this issue; see letter dated 10 July 1998 from the Treasurer, Mr Peter Costello, to the chair of this committee, Senator Grant Chapman. Audit committees are compulsory for companies listed on the New York Stock Exchange; see The American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (St. Paul Minn, USA, 1994) 104, who also recommended audit committees be compulsory in analysis and recommendation 3.05.

1107 In 1992 Arthur Andersen conducted a survey of public listed companies and discovered that 48% had an audit committee. See Arthur Andersen, *Audit Committees in the 1990's* (Arthur Andersen, Australia, 1993). The executive summary of this survey is attachment A to Parliamentary Joint Committee On Corporations And Securities, *The Role of Audit Committees in Corporate Governance-A Progress Report* (Canberra, 1993). More recently a study as at mid-1995 found that all of the top 100 companies for which information was available (89 of the 100 companies) in the study had an audit committee. 84% of the members of these committees were non-executive directors and 51% were independent; see Stapledon and Lawrence, *Corporate Governance in the Top 100: An Empirical Study of the Top 100 Companies' Board of Directors* (Centre for Corporate Law and Securities Regulation, Melbourne, 1996) at iii and 23 to 24.

1108 Australian Investment Managers Association, *Corporate Governance: A Guide for Investment Managers and Corporations* (AIMA, Australia, 2nd ed., 1997) at 21.

1109 Listing rule 4.10.3, appendix 4A at paragraph 7 and the Guidance Note 'Disclosure of Corporate Governance Practices' at paragraphs 28 to 32.

1110 Listing rule 4.10.2 and see appendix 4B (compliance statement 6).

1111 Also in my opinion the same discipline of decision making and recording the information on which directors decisions are made that I recommend in chapter 7.4 should also apply to a committee of the directors. These recommendations are also consistent with the extra information I recommended auditors should make available above under the heading 'Content of the Report'.

1112 Spira, 'An Evolutionary Perspective on Audit Committee Effectiveness' (1998) 6 Corporate Governance 29.

appropriate lapse of time before the full board meeting is important to ensure the committee can appropriately deal with any identified problems), modes of communication and dynamics of relationships (including familiarity, with too much familiarity possibly leading to a committee marked by senility). Spira's thesis is that the effectiveness of committees is evolutionary and moves from immaturity (where the reasons for the committee are implicit and the committee is passive) to maturity (with explicit reasons and marked as active) and possibly to senility. This "cycle of evolution over time" is not necessarily linear and immaturity is not necessarily bad so long as the committee moves to maturity.

On some of these matters there already is disclosure. For example there is disclosure of each directors' identity, qualifications, experience, special responsibilities and the number of directors meetings (including committee meetings) each year and the number attended by each.[1113] Also their independence can be checked against the related party disclosures required in the annual report.[1114] Some additional disclosures could easily be added to enable shareholders to attempt to monitor effectiveness, such as the timing of meetings relative to full Board meetings. However some measures such as modes of communication and dynamics of relationships depends on very personal characteristics. Like those personal characteristics that auditors should possess no disclosure regime can possibly effectively disclose such matters.[1115]

6.6 ANNUAL REPORT

The financial statements, directors' declaration and the auditor's report together with the directors' report comprise what is commonly called the annual report to shareholders. This is the principal financial information shareholders receive on an annual basis. I have already discussed each of these other than the directors' report.

Directors' Report

The directors must report to shareholders each year on a number of matters specified in the Corporations Law.[1116] I pick up on the content of the report under the topics as they arise during the thesis. The directors must resolve to approve their report and a director must sign and date the report.[1117]

For companies with a financial year that ends after 1 July 1998,[1118] the shareholders can elect[1119] to receive a concise annual report rather than a full one.[1120] The concise annual report consists of a concise financial report (in accordance with the appropriate accounting standard),[1121] an auditor's report tailored to that report and the normal

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1113 CL s300(10), see chapter 7.

1114 Se chapter 7.4 under the heading 'Loyalty'.

1115 Hence it is not surprising for an author to conclude that there is little to no disclosure on the effectiveness of corporate governance policies; see McBride, 'Beyond the Numbers: Reporting Non-Financial Information' (1997-September) Australian Accountant 20.

1116 CL ss 298, 299 & 300.

1117 CL s298(2).

1118 The date of commencement of the *Company Law Review Act* 1998 (Cth) (see Schedule 1, ss 1431 & 1412).

1119 CL s316.

1120 CL s314.

1121 AASB 1039 'Concise Financial Reports' which standard is effective for financial years ending on or after 31 December 1998.

directors' report.[1122] The concise report is designed to reduce costs and aimed at less sophisticated investors who do not require the depth of detail contained in a full financial report.[1123] Hopefully the concise report will also be more understandable by unsophisticated investors, although there is not an established practice yet to see if this will be the result.

Timing

The annual report, comprised of the directors' report, financial statements, directors' declaration and the auditor's report, has to be sent to shareholders by the earlier of 21 days before the forthcoming annual general meeting or four months after the end of the financial year.[1124] The AGM must be held within 5 months after the end of the company's financial year.[1125] It is usual practice for companies to dispatch the annual report to shareholders with the notice of the annual general meeting within such time as to satisfy all the statutory and Listing Rule (and any provisions in each company's constitution) requirements. This timing brings into question the timeliness of this information, which is scrutinised in part 9 of this chapter.

Voluntary Disclosures

Included in the document comprising the annual report the directors commonly voluntarily disclose a range of information.[1126] This voluntary information typically includes a chairpersons and CEO's address, information concerning the businesses of the company and how they fared during the year, the company's products and personnel (particularly the senior executives) and some social disclosures.[1127] However given it is voluntary no list is exhaustive or prescriptive.

The purpose of such disclosures is twofold; to further discharge accountability and as a marketing tool.[1128] Concerning accountability, the directors recognise the difficult nature of the financial statements and attempt to describe in prose and by the use of diagrams, graphs, pictures (and it has been suggested by cartoons/schematic faces)[1129] the same

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1122 CL s314(2).

1123 Corporate Law Simplification Taskforce, *Annual Returns and Financial Reporting to Shareholders: Proposals for Simplification* (AGPS, Canberra, 1994) at 2. These aspects of the *Company Law Review Act* 1998 (Cth) have their genesis in the simplification program.

1124 CL s315(1).

1125 CL s250N(2).

1126 Cadbury Committee, *The Financial Aspects of Corporate Governance* (Gee, Great Britain, 1992) at paragraph 4.57.

1127 Courtis, 'Attitudes to Annual Reports' in Courtis (ed), *Communication Via Annual Reports* (Financial Management Research Centre, Armidale, 1981) at 37.

1128 Mkwinda-Nyasulu, *The Australian Corporate Annual Reports: Some Factors Contributing To Low Readability Scores* (Ph.D thesis, University of Adelaide, 1994) at 233 states that "one of the functions of annual reports is to let shareholders, creditors and debenture holders know how their investments are being used. This is done so they can make informed economic decisions. The other purpose is to win their cooperation so that they continue supporting the companies". She goes on (at 233 to 234) to explicitly state that "annual business reports are used for advertising"; that is "companies are involved in rhetoric". See also Simpson, 'Annual Reports: Glossy, Expensive and Useless?' (1997-September) Australian Accountant 16; and Lewis, 'Annual Reports of the Future' (1984-September/October) Communication Arts 24 (who as the head of a graphic design company views marketing as the new corporate priority for annual reports, which are the "primary tool for winning investor favour" (at 24 to 25).

1129 Smith and Taffler, 'Improving the Communication of Accounting Information Through Cartoon Graphics' (1996) 9 Accounting, Auditing and Accountability Journal 68.

information in a simpler way.[1130] For those readers with no accounting background they may entirely rely on such voluntary disclosures.[1131] To some extent this endeavour is commendable and there is some empirical evidence that points to limited success in this objective.[1132] But this objective is subject to two criticisms. First, there are studies which conclude that these disclosures are still not very readable (although more readable than the financial statements themselves). That is, according to the readability tests described in chapter 2, these disclosures rate very poorly according to readability criteria.[1133] The conclusion of such studies is that "there is almost universal agreement that throughout the period 1948-1990 corporate annual reports have proven difficult or very difficult to read because of sophisticated vocabulary and syntactical complexity".[1134] So for a lot of their readership, and particularly those who most need it (ie the unsophisticated investor), they are failing to meet their purpose.[1135] The second criticism is that directors are selective in the information they voluntarily report to cast the company in the most favourable light[1136] and there is discrepancy, a mismatch, between the voluntary information and the statutory required information.[1137] There is a wealth of empirical evidence that supports this conclusion concerning social information, which I describe at length in chapter 9. Given these disclosures are not mandated or audited then this is not surprising.[1138] This propensity is tied to the other purpose of such voluntary disclosures.

1130 Mkwinda-Nyasulu, *The Australian Corporate Annual Reports: Some Factors Contributing To Low Readability Scores* (Ph.D thesis, University of Adelaide, 1994) at 22 to 32; McQueen, 'The Corporate Image-The Evolution of the Annual Report in Australia 1950-1990' (Paper delivered at the Corporate Law Teachers Conference, The University of Melbourne Law School, February 1997, author on file) at 5 to 6.

1131 Still, 'The Readability of Chairmen's Statements' in Courtis (ed), *Communication Via Annual Reports* (Financial Management Research Centre, Armidale, 1981) at 162; Anderson, 'The Usefulness of Annual Reports' in Courtis (ed), *Communication Via Annual Reports* (Financial Management Research Centre, Armidale, 1981) 61 at 68; Anderson and Epstein, 'The Usefulness of Annual Reports' (1995-April) Australian Accountant 25 at 26.

1132 Jones and Shoemaker, 'Accounting Narratives: A Review of Empirical Studies of Content and Readability' (1994) 13 Journal of Accounting Literature 142 at 170; Courtis, 'Readability of Annual Reports: Western Versus Asian Evidence' (1995) 8 Accounting, Auditing and Accountability Journal 4 at 9.

1133 Mkwinda-Nyasulu, *The Australian Corporate Annual Reports: Some Factors Contributing To Low Readability Scores* (Ph.D thesis, University of Adelaide, 1994) particularly at 135 ("annual reports are in the difficult to read range"); Jones, 'Readability of Annual Reports: Western Versus Asian Evidence-A Comment to Contextualize' (1996) 9 Accounting, Auditing and Accountability Journal 86; Adelberg, 'Narrative Disclosures Contained in Financial Reports: Means of Communication or Manipulation?' (1979-Summer) Accounting and Business Research 179.

1134 Jones and Shoemaker, 'Accounting Narratives: A Review of Empirical Studies of Content and Readability' (1994) 13 Journal of Accounting Literature 142 at 173 (and at 169). These authors are not completely uncritical of these conclusions (see at 172 and 175). See also Courtis, 'Readability of Annual Reports: Western Versus Asian Evidence' (1995) 8 Accounting, Auditing and Accountability Journal 4 at 8.

1135 McQueen, 'The Corporate Image-The Evolution of the Annual Report in Australia 1950-1990' (Paper delivered at the Corporate Law Teachers Conference, The University of Melbourne Law School, February 1997, author on file) at 12.

1136 Above at 16 to 17; Smith and Taffler, 'Improving the Communication of Accounting Information Through Cartoon Graphics' (1996) 9 Accounting, Auditing and Accountability Journal 68 at 82.

1137 Australian Shareholders Association, Position Paper 'Inconsistencies Between Summaries and The Detail of Annual Reports'; McQueen, 'The Corporate Image-The Evolution of the Annual Report in Australia 1950-1990' (Paper delivered at the Corporate Law Teachers Conference, The University of Melbourne Law School, February 1997, author on file) at 29; Holliday, 'Annual Reports As Marketing Tools" (1994-August) Bank Marketing 23.

1138 A graphic designer has even praised this form of massaging in the case of one company, see Lewis, 'Annual Reports of the Future' (1984-September/October) Communication Arts 24 at 27.

Voluntary disclosures are also made as part of the company's marketing program.[1139] The managers use the annual report as an opportunity to promote the company and their management of it. The annual report is part of the corporation "imaging" itself.[1140] It is not just in the overt materials that the directors sell their line. These documents often have a subtle subtext.[1141] For example the quality and opulence of the annual report from a design perspective seems to mirror the company's financial successes.[1142] This occurs in many ways, including companies using lower quality paper and changing from colour to black and white photographs in tough economic periods.[1143] The advertising aphorism that "the medium is the message" is utilised. One author argues that television (a medium of entertainment) is so pervasive that annual reports must follow suit if they are to be regarded as credible.[1144] That is annual reports must "emphasise visual design, gloss and novelty".[1145] Photographs are not merely window dressing but part of the rhetoric to support the truth claims of other information in the annual report.[1146] Photographs also have a connotation and when utilised in annual reports the authors are hoping to use this connotation to their advantage.[1147] However this use of graphic design should stimulate interest, which is one of the factors in readability and therefore should be a positive result.[1148] The prevalent use of graphic design is also tied to the broader movement in societies as consumer cultures.[1149] Such self-serving disclosures can

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1139 McQueen, 'The Corporate Image-The Evolution of the Annual Report in Australia 1950-1990' (Paper delivered at the Corporate Law Teachers Conference, The University of Melbourne Law School, February 1997, author on file); Olsson, 'The Changing Role of Annual Reports' in Courtis (ed), *Communication Via Annual Reports* (Financial Management Research Centre, Armidale, 1981) at 14; Meyer, 'Annual Reports Get an Editor in Washington' in Courtis (ed), *Communication Via Annual Reports* (Financial Management Research Centre, Armidale, 1981) at 31; Epstein and Pava, *The Shareholder's Use of Corporate Annual Reports* (JAI Press, Connecticut, 1993) at 4.

1140 McQueen, 'The Corporate Image-The Evolution of the Annual Report in Australia 1950-1990' (Paper delivered at the Corporate Law Teachers Conference, The University of Melbourne Law School, February 1997, author on file) at 21. See also Neimark, *The Hidden Dimensions of Annual Reports: Sixty Years of Social Conflict at General Motors* (Marcus Wiener, New York, 1992) at 100 speaks of the annual report as the document whereby corporations "define themselves".

1141 The most subtle form of which is subliminal advertising, see Key, *Subliminal Seduction: Ad Media's Manipulation of a Not So Innocent America* (Prentice-Hall, New Jersey, 1973).

1142 McKinstry, 'Designing the Annual Reports of Burton Plc from 1930 to 1994' (1996) 21 Accounting, Organizations and Society 89.

1143 Preston, Wright and Young, 'Imag[in]ing Annual Reports' (1996) 21 Accounting, Organizations and Society 113 at 118; for other examples see Graves, Flesher and Jordan, 'Pictures and the Bottom Line: The Television Epistemology of U.S. Annual Reports' (1996) 21 Accounting, Organizations and Society 57 at 66 to 70.

1144 Graves, Flesher and Jordan, 'Pictures and the Bottom Line: The Television Epistemology of U.S. Annual Reports' (1996) 21 Accounting, Organizations and Society 57 at 61, 65 and 75

1145 Above at 59.

1146 Above at 62 to 63 and 83; although cf Preston, Wright and Young, 'Imag[in]ing Annual Reports' (1996) 21 Accounting, Organizations and Society 113 who note some photographs used in annual reports are ambiguous, it being difficult to discern what meaning the corporation is trying to convey (at 127). This is tied to their larger narrative that there are many ways of seeing photographs, not just as conveying messages intended by their authors (particularly at 134 to 135).

1147 Preston, Wright and Young, 'Imag[in]ing Annual Reports' (1996) 21 Accounting, Organizations and Society 113 at 122.

1148 Lewis, 'Annual Reports of the Future' (1984-September/October) Communication Arts 24 at 27.

1149 Preston, Wright and Young, 'Imag[in]ing Annual Reports' (1996) 21 Accounting, Organizations and Society 113 at 114; Neimark, *The Hidden Dimensions of Annual Reports: Sixty Years of Social Conflict at General Motors* (Marcus Wiener, New York, 1992) at 111 to 116.

themselves be regarded as a useful insight into the corporation's "philosophy and personality"[1150] if the person is sufficiently sceptical and not reading the document at face value. However for less sophisticated readers these subtle influences probably have their desired effect.[1151]

Possibly one way to counter this is to have a US style Management Discussion and Analysis ("MD&A") disclosure.[1152] Under U.S. law a MD&A must accompany the financial statements. The purpose of the MD&A is to provide a narrative to enhance a users understanding of the company's financial statements.[1153] Regulation S-K 229.303 requires management to discuss and analyse the company's financial condition, changes in financial condition and results of operations. The three key areas the MD&A concentrates on is the corporations liquidity, capital resources and results of operations.[1154] The MD&A forces directors to disclose any trends in these areas[1155] which assists shareholders to predict "future operating results or of future operating financial condition".[1156] The regulations in this area are reasonably detailed (running to 3 pages) and also the SEC has developed a body of law which fleshes out the meaning of the MD&A requirements.[1157] The MD&A is subject to the anti-fraud provisions[1158] which prohibit misleading statements. These anti fraud provisions have been the basis in recent years for increased enforcement by both the SEC and private parties.[1159] All of this goes a long way to ensure the completeness and accuracy of the MD&A.

In my opinion if a similar approach were adopted in Australia this would go a long way in enhancing the accuracy, credibility and completeness of this information.[1160] Given the information is in narrative form perhaps comparability will necessarily suffer to some extent, but this can not be avoided. As the information is by narrative disclosure then by using plain English this information should be understandable.[1161] However such mandated disclosures do not prevent companies in the US from also sending voluntary

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1150 Meyer, 'Annual Reports Get an Editor in Washington' in Courtis (ed), *Communication Via Annual Reports* (Financial Management Research Centre, Armidale, 1981) at 36.

1151 McKinstry, 'Designing the Annual Reports of Burton Plc from 1930 to 1994' (1996) 21 Accounting, Organizations and Society 89 at 110.

1152 McBride, 'Beyond the Numbers: Reporting Non-Financial Information' (1997-September) Australian Accountant 20.

1153 Regulation S-K 229.303, Instruction 1.

1154 Regulation S-K 229.303(a)(1), (2) and (3).

1155 Regulation S-K 229.303(a)(2) and (3).

1156 Regulation S-K 229.303, Instruction 3.

1157 Brown, *The Regulation of Corporate Disclosure* (Aspen, USA, 2nd ed 1995) at 2.02[2].

1158 Principally Rule 10b-5 of the *Securities Exchange Act* 1934 (US).

1159 Brown, *The Regulation of Corporate Disclosure* (Aspen, USA, 2nd ed 1995) at 2.02[2].

1160 Unfortunately the government removed from the *Company Law Review Act* 1998 (Cth) before it was passed the requirement that a management discussion and analysis (MD&A) be included in the directors' report; see the *Second Corporate Law Simplification Bill* 1996 s299. The government removed the MD&A requirement preferring to leave this to voluntary action by corporations rather than mandatory legislation; Parliamentary Joint Committee on Corporations and Securities, *Report on the Company Law Review Act 1997* (AGPS, Australia, 1998) at paragraph 1.39. Its removal was controversial and criticised; Parliamentary Joint Committee on Corporations and Securities, *Report on the Company Law Review Act 1997* (AGPS, Australia, 1998) at paragraphs 1.38 to 1.43.

1161 Note that the current government has refused to introduce a mandatory comprehensibility test for prospectuses; see Corporate Law Economic Reform Program, *Fundraising; Proposals For Reform: Paper No. 2* (AGPS, Australia, 1997) at 22 to 24.

information in the annual report.[1162] Therefore such a requirement would only be a limited response to this problem. Fortunately voluntary information attached to or included with the annual report currently attracts liability under the general false and misleading provisions in the Corporations Law.[1163]

It is difficult to propose a complete response to this problem. In addition to the MD&A requirement it would be possible to require this information to be audited. This has merit and in my opinion should be implemented. It would also be possible to prohibit any voluntary information in the annual report, which would restrict it to that required by law to be disclosed. However this ignores the positive role of such information. Also this would not prohibit the directors from otherwise communicating voluntary information in other documents to their shareholders. Would a prohibition on such information also have to prohibit sending a separate document in the same envelope as the annual report? Or within a certain time of the annual report (and if so, how long)? This gets into the realm of freedom of expression and the difficult issue of the appropriate role of advertising. To some extent the problem with this information is not so much that it is slanted but that some people are gullible enough to take it at face value. Sophisticated investors seem to pay little heed to such information, instead concentrating on the financial statements themselves and other mandatory disclosures.[1164] As I have already indicated in chapter 5, it is not the role of the company to educate their shareholders, nor should the company be responsible for their level of unsophistication. Perhaps a suitable compromise is to force a prominent warning prior to such disclosures for the benefit of unsophisticated shareholders.[1165] The warning could read "The information in this part of the annual report is voluntarily provided by the directors. It has not been audited and is not necessarily as reliable or complete as those disclosures required by the law". This would at least provide an appropriate alert to unsophisticated investors and clearly signify that they are perhaps out of their depth and responsible for their level of unsophistication. This would alert them that they should obtain professional advice unless they choose to live with their degree of unsophistication.

Annual Return

In addition to providing the annual report to shareholders, every company must, by 31 January each year, lodge an annual return with the ASIC.[1166] As with most documents lodged with the ASIC the annual return may be inspected and copied by any member of the public.[1167] The primary purpose of the annual return lodgement requirement is to provide a public data base of general information concerning all companies. Therefore it

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1162 McQueen, 'The Corporate Image-The Evolution of the Annual Report in Australia 1950-1990' (Paper delivered at the Corporate Law Teachers Conference, The University of Melbourne Law School, February 1997, author on file) at 30.

1163 CL s1308(7).

1164 Hutchins, 'Annual Reports (...Who Reads Them?)' (1994-October) Communication World 18 at 20; Epstein and Pava, *The Shareholder's Use of Corporate Annual Reports* (JAI Press, Connecticut, 1993) at 91 to 94 (whose study concerned individual investors but within this class could discern a difference between sophisticated and unsophisticated investors (at chapter 9)).

1165 Similar to the regulation that applies to tobacco advertising; see *Trade Practices (Consumer Product Information Standards) (Tobacco) Regulations 1994*. A similar warning is proposed as part of the offer information statement which allows small business to raise up to $5 million without a full prospectus; see *Corporate Law Economic Reform Program Bill* 1998 (Cth) s715(g)&(h).

1166 CL s345.

1167 CL s1274(2), which also lists the limited type of documents lodged with the ASIC that are not available for inspection.

is not surprising that the information that must be contained in the annual return[1168] is information that has already been disclosed to shareholders (principally in the directors' report).[1169] Therefore I see no need to describe the contents of the annual return. In the normal course people who are already shareholders in the company will have no recourse to this document. Its only value is as a public data-base. It would be simpler to require corporations to lodge their annual report with the ASIC rather than completing the annual return. This simpler procedure, from the perspective of corporations, is not used seemingly because the information in the annual return is in a standardised format and in electronic form (which does make searching by outside people easier). Either way I do not regard the annual return or issues as to its format as being particularly important.

6.7 HALF-YEARLY FINANCIAL REPORTING

Since 1 July 1994 companies with shares listed on a stock market[1170] must also prepare half yearly financial statements, a directors' declaration and a directors' report.[1171] The information in the financial statements[1172] and the directors' report[1173] is not as extensive as for the full financial year. More frequent reporting ensures more timely disclosure of information to shareholders.

The half-yearly financial statements can, but do not have to, be audited in the traditional sense described above. As an alternative to a full audit the auditors may prepare a different type of report, based on a review of the half yearly financial statements prepared by the company.[1174] The legislation does not identify who chooses whether an audit or just a review occurs. As the audit function is an important protection for shareholders as a matter of principle it is they who should decide. However as a matter of practice this decision appears to have been taken by directors. The auditing profession regards this as a choice for the directors, but it is not explained whether this is the case as a matter of principle or in recognition of the practice.[1175] If the review option is chosen, then the auditors must report whether "the auditor has become aware of any matter in the course of the review that makes the auditor believe that the financial report [does not comply with the Accounting Standards and the regulations (if any) and does not give a true and fair view]".[1176] This is a very limited review. Both the scope of the audit and

1168 CL s348.

1169 With the exception of CL s348 clause 10, which requires disclosure of the company's ultimate holding company. However it is not common for listed public companies to be a subsidiary of another company.

1170 CL s111 AC(1), 111 AD(1) & 111 AE(1); these provisions also apply to other companies and entities, see CL Part 1.2A.

1171 CL s302 to s306 (formerly 283D & s58C).

1172 AASB 1029: 'Half Yearly Accounts and Consolidated Accounts' standards 10 to 13 and commentary (vi).

1173 CL s306. The truncated directors' report only contains:

> (a) a review of the entity's operations during the half-year and the results of those operations; and
> (b) the name of each person who has been a director of the [company] at any time during or since the end of the half-year and the period for which they were a director.

1174 CL s302(b).

1175 Auditing Guidance Statement 1016 'Audit and Review Reports-Half Year Accounts and Consolidated Accounts' at paragraph .11. There is no guidance in AASB 1029: 'Half Yearly Accounts and Consolidated Accounts' or in Auditing Standard 902: 'Review of Financial Reports' at paragraph .13 (which only speaks of the auditor and the entity agreeing on the terms of the engagement).

1176 CL s309(4).

the procedures used are less than in a full audit.[1177] Perhaps the critical difference between a full audit and a review is the degree of assurance as to whether the financial report is free from material misstatement. In a full audit the degree of assurance is "reasonable"[1178] whereas in a review it need only be "moderate".[1179] However the continuing auditor's belief of non-compliance is and should be based on knowledge drawn from the last or previous audits (though this is not applicable in the case of a newly appointed auditor).[1180] In the normal course it would be difficult and extremely opportunistic for directors to report something radically different from the last audited financial statements and those to be audited in approximately 6 months time. So the perceived weakness of the auditor only reviewing the financial statements is mollified since this review occurs during the financial year which is bounded by audited financial statements. All credibility would be lost if the half yearly financial statements reported one state of affairs but shortly afterwards the audited financial statements reported something different. Only if management is brazenly opportunistic with no concern for being caught out within approximately 6 months will this type of manipulation occur. This will be a rare occurrence and if behaviour is this deliberately manipulative there may be no way to prevent it. The reason the half-yearly financial statements are not fully audited is because cost and time involved in an audit outweigh the perceived risks.[1181] On balance this seems correct.

The possibility of mandatory quarterly reporting has been debated but has not gained widespread support at this stage.[1182] The advantage of quarterly reporting is there is more frequent reporting which adds to the timeliness of disclosures. Rather Australia has chosen to have a more rigorous continuous disclosure regime (discussed in chapter 10.2).[1183] Only listed mining exploration and production companies are obliged to provide a form of quarterly report,[1184] although many other companies voluntarily provide them.[1185]

1177 See AUS 902: 'Review of Financial Reports' which explains the nature of a review and how it should be undertaken.

1178 AUS 202 'Objective and General Principles Governing an Audit of a Financial Report' at paragraphs .08 to .13.

1179 AUS 902: 'Review of Financial Reports' at paragraphs .09 to .12.

1180 Above at paragraph .25(a); and AGS 1010 'Audit and Review Reports-Half Year Accounts and Consolidated Accounts' at paragraphs .19 to .21.

1181 AASB 1029 commentary (vi).

1182 Lavarch Committee, *Corporate Practices and the Rights of Shareholders* (AGPS, Canberra, 1991) at paragraphs 4.4.9 and 4.4.14; and also see Cadbury Committee, *The Financial Aspects of Corporate Governance* (Gee, Great Britain, 1992) at paragraph 4.55; Blair, 'Australia's Continuous Disclosure Regime: Proposals for Change' (1992) Australian Journal of Corporate Law 54 at 56; Boreham, 'Corporate Reporting Talks Reinforce Doubts' *Business Review Weekly*, 1992, August 7; and McBride and Peirson, 'Timing and Frequency of Financial Reports: Present Requirements and Proposals for Change (1993) 11 C&SLJ 183.

1183 Blair, 'Australia's Continuous Disclosure Regime: Proposals for Change' (1992) Australian Journal of Corporate Law 54 at 66 to 68. This may be compared with the position in the US which requires quarterly reporting on Form 10-Q. The US also has current reports on Form 8-K but the triggering events that require such a report are specific and much narrower than under the Australian continuous disclosure regime.

1184 LR 5.1 to 5.3.

1185 Blair and Ramsay, 'Mandatory Corporate Disclosure Rules and Securities Regulation' in Walker and Fisse (eds), *Securities Regulation in Australia and New Zealand* (Oxford University Press, Auckland, 1994) at 265.

6.8 FINANCIAL REPORTING TO THE ASX

In addition to the annual and half yearly reports required under the Corporations Law, the Listing Rules require listed companies to lodge with their Home Exchange a Half Yearly Report and Preliminary Final Statement.[1186] Once lodged with the Home Exchange the information is available for dissemination to the market.

The purpose of the report is to provide the securities market financial information concerning the Company and the dividend announcement before the time the annual and half-yearly financial statements have to be sent to shareholders pursuant to the Corporations Law.[1187] It is not surprising to find the format of the Report and Statement is similar to that required under the Corporations Law.[1188] The primary requirement for each is a balance sheet, a profit and loss statement and a statement of cash flows. The financial statements on which these reports are based must be audited (or for the half-yearly report at least subjected to an audit review).[1189]

6.9 DIVIDEND ANNOUNCEMENT

The directors' report must include for the relevant financial year:
- dividends or distributions paid to members during the year;[1190] and
- dividends or distributions recommended or declared for payment to members, but not paid, during the year.[1191]

This is supported by the Listing Rules which require listed companies to notify the ASX of any recommendation or declaration of a dividend or a decision that no dividend will be declared.[1192]

Shareholders as investors are keenly interested in receiving news of the dividend announcement. This is because shareholders as investors want to make money and the dividend announcement tells them how much they have earnt during that financial period (putting to one side capital gains/losses that should be reflected in the share price).

Farrer has criticised bare dividend announcements on the basis that:
- it involves balancing how much profit is retained against how much is paid out and directors and shareholders can have conflicting interests on where the balance should be struck. For example managers in choosing to keep the dividend rate low may simply be empire building or not wanting to expose themselves to the scrutiny of the capital market; and

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1186 Listing rules 4.1 and 4.3 respectively.

1187 The Report and Statement must be lodged within 75 days after the end of the first half yearly period and the end of the financial year respectively. This is well before the time within which the financial statements and other documents required under the Corporations Law must be sent to shareholders (see chapter 6.6). Special rules apply if the Company changes its accounting period; see LR 4.4.

1188 The Half Yearly Report and the Preliminary Final Statement are in a standard form as set out in Appendix 4 B of the Listing Rules.

1189 Above.

1190 CL s300(1)(a).

1191 CL s300(1)(b).

1192 Previously LR's 3A(6) and 3A(7) but now just part of the general duty to disclose pursuant to LR 3.1 (and given as examples of the type of disclosure required under that rule).

- on its own the dividend announcement is an ambiguous signal to the market. For example to increase the rate of dividend could either signal that management is confident of future increased profitability or that management have no profitable uses for the money in the future.[1193]

Farrer's proposed response to this is to require mandatory disclosure of the reasons for the rate of dividend.[1194] This is a sensible proposal and is consistent with my broader proposals concerning the disclosures which should be regularly made by directors under the duty of care (discussed in chapter 7.4).

6.10 QUALITY OF FINANCIAL INFORMATION

Information concerning the financial position and affairs of the company is vitally significant for shareholders. The principal information in this category is the annual audited financial statements and to a lesser extent the new half-yearly financial statements. These snapshots of the company's financial position and performance are a key indicator for shareholders as both investors and monitors. I therefore test this information against the qualities identified in chapter 2.

Before doing so it is worth mentioning the role of liability rules on the quality of financial information. Liability rules apply to both the directors and executives in preparing the financial statements to ensure the financial statements comply with the accounting standards and are true and fair and the auditors to take care in the audit of the financial statements. The presence of these liability rules, subject to the level of compliance with them and enforcement of them by regulators, plus their deterrent effect, adds to the quality of the financial information provided. In particular, liability rules enhance the accuracy, credibility and completeness of financial information. In the context of financial information, the liability rules play a secondary role to that of the auditors in enhancing the credibility of information (although the liability rules that apply to auditors encourage them to undertake their role carefully).

Accuracy

Bearing in mind the philosophical and other concerns with accuracy,[1195] financial statements, so far as possible, should be accurate.[1196] The financial statements comprise information that is factual in nature, such as the amount of sales and the cost of stock. Other items in the financial statements involve sophisticated concepts (such as goodwill, rates of depreciation, etc), where it is impossible to say there is a factual reality. Therefore there is a fundamental problem with accuracy being taken too far. The

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1193 Farrer, 'Australia's Dividend Laws: The Case for Mandatory Disclosure of the Dividend Decision' (1998) 20 Sydney Law Review 42.

1194 Above at 59 and following.

1195 See chapter 2. Hey-Cunningham, *Financial Statements Demystified* (Allen & Unwin, Sydney, 2nd ed, 1998) at 19 states "remember accounting is a human system, not a natural system of nature. As such it is not absolute truth. Indeed it is a representation in dollars of what an organisation has done. Thus it is an analogy used to represent reality. No analogy is perfect".

1196 SAC 3 'Qualitative Characteristics of Financial Information' at paragraph 48 regards reliability as a necessary characteristic of financial information. Reliability is defined in paragraph 5 to mean "that quality of financial information which exists when that information can be depended on to represent faithfully, and without bias or undue error, the transactions or events that either it purports to represent or could reasonably be expected to represent". This concept of reliability is consistent with my definition of accuracy in chapter 2. See also paragraphs 16 to 26 of SAC 3 concerning reliability. SAC 3 ranks reliability and relevance as the primary qualitative characteristics (at paragraph 7).

sophisticated nature of accounting and the vast size of modern business means that absolute accuracy simply is not feasible. Therefore even though the law requires the financial statements to show a "true and fair view" this requirement has over time been effectively criticised and as a result taken on decreased significance in the law. Since this is the case other qualities take on increased importance, principally comparability and credibility.

Accuracy also involves the issues of completeness and information overload. Completeness is difficult to gauge. The financial statements comprise the profit and loss statement, the balance sheet and the statement of cash flows. These are supported by a large amount of accounting rules and practice which flesh the financial statements out in the notes to them. In my opinion the financial statements provide relatively complete information about the financial position and performance of the company. Though once again this is a matter of evolution. It is interesting to note that many of the criticisms directed at a lack of financial disclosure 20 years ago have now been addressed and we take such disclosure for granted.[1197] The evolution continues with continued development of the accounting standards, the role of the Urgent Issues Group (discussed above) and calls for reform by commentators (and those made in this chapter).[1198] Such evolution is normal and to be expected.

One concern with the financial statements is that they represent a historical position whereas shareholders want more forward-looking information.[1199] Shareholders as investors are concerned about future dividend streams[1200] and are therefore interested in information relevant to this, such as budgeted income statements.[1201] At this level the financial statements are not complete.[1202] Whilst not denying the need for such information, some forward-looking information is currently provided. The statement of cash flows points to whether the company is a going concern and in the directors' declaration the directors must certify that the company is solvent.[1203] These at least point

1197 McKeon, 'Communication in Annual Reports' in Courtis (ed), *Corporate Annual Report Analysis* (Dept of Accounting and Financial Management, Armidale, 1978) 5 at 5 to 8 listed a range of improvements he wanted to see introduced. Those improvements, and the responses that are now embodied in the law (in parenthesis), included disclosure of earnings per share (AASB 1027 'Earnings Per Share'), top 20 shareholders (LR 4.10.9., discussed in chapter 8.3), lease commitments (ASRB 1008 'Accounting for Leases'), segment reporting (AASB 1005, discussed in chapter 8.2) and pro forma statements (although the law has just again been altered on this, as discussed above).

1198 For example arguably the separate reporting of free cash flow in the statement of cash flows is one such improvement, see Jupe and Rutherford, 'The Disclosure of 'Free Cash Flow' in Published Financial Statements: A Research Note' (1997) 29 British Accounting Review 231. See also Hey-Cunningham, *Financial Statements Demystified* (Allen & Unwin, Sydney, 2nd ed, 1998) at 280 to 282.

1199 See Chartered Accountants in England and Wales, *The Corporate Report* (Institute of Chartered Accountants in England and Wales, London, 1975) at 6.32 to 6.39; and Jones, 'Whatever Happened to the Corporate Report?' (1995-July/August) Management Accounting 52.

1200 Anderson, 'The Usefulness of Annual Reports' in Courtis (ed), *Communication Via Annual Reports* (Financial Management Research Centre, Armidale, 1981) 61 at 63 (discussed in footnote 1 above). See also Baker and Haslam, 'Information Needs of Individual Investors' in Courtis (ed), *Corporate Annual Report Analysis* (Dept of Accounting and Financial Management, Armidale, 1978) 105.

1201 Anderson and Epstein, 'The Usefulness of Annual Reports' (1995-April) Australian Accountant 25 at 27 to 28. This view is supported by recent empirical evidence, see Yap, 'Cash Flow Statements: How Useful?' (1996-December) Australian Accountant 36 at 37.

1202 Anderson, 'The Usefulness of Annual Reports' in Courtis (ed), *Communication Via Annual Reports* (Financial Management Research Centre, Armidale, 1981) 61 at 63. See chapter 7.3 where I examine the need for management audits which information is more forward looking.

1203 CL s295(4)(c).

to whether the company is viable, but not necessarily to how profitable it may or may not be. In the directors' report the directors must provide information about future likely developments[1204] but only if such disclosure would not unreasonably prejudice the company.[1205] Also some of the information in the financial statements is predictive in nature. An example of the predictive nature of traditional financial statements is given in SAC 3. Paragraph 9 of SAC 3 states that "financial information about the current level and structure of asset holdings will have value to users when they endeavour to assess an entity's ability to take advantage of opportunities in the market place". However there is a fundamental problem with this type of disclosure; who can be confident of predicting the future. As philosophers state "just because the sun rose in the East yesterday is no guarantee that it will rise in the East tomorrow or rise at all".[1206] The risk is that preparers of reports can be overly optimistic if they like and it is very difficult to disprove their claims. For these reasons parliaments have been very cautious about mandating in favour of such disclosures. Whilst the need for future looking information remains contested in the corporate context there are ways that the quality of this information could be addressed. The present facts and ongoing assumptions on which forecasts are made could be revealed.[1207] Also variations could be produced based on identified contingencies or other assumptions to provide different perspectives, perhaps with an indication from management concerning which they think is most likely.[1208] In addition an explicit warning about the nature of such information could be given to alert the less sophisticated investors of its unreliability.[1209] If introduced directors should be forced to revisit their predictions each year to compare their actual performance against that predicted and justify any discrepancy. In this way those who consistently make overly optimistic predictions would lose credibility over time. For these reasons in my opinion more forward-looking information should be required.[1210]

Also a recent survey of individual shareholders demonstrated that a majority of these shareholders would like additional information on pending litigation and unasserted legal claims (ie those where the aggrieved person has not formally sued the corporation yet), which also should be audited.[1211] There is no reason why such information should not be disclosed to shareholders.

The prospect of information overload is to some extent ameliorated in the context of financial statements by the issue of materiality. If an item is not material it need not be disclosed.[1212] This helps to prevent a minutiae of unhelpful information being disclosed

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1204 CL s299(1) provides that the directors' report must:

> (e) refer to likely developments in the [company's] operations in future financial years and the expected results of those operations.

1205 CL s299(3).

1206 Wishart, 'Resuscitating Popper: Critical Theory and Corporate Law' (1996) Canberra Law Review 99 at 100.

1207 McKeon and Craig, 'Forecasts: Misleading or Essential' (1997) 15 C&SLJ 47 at 49. However the current government does not propose to explicitly require disclosure of assumptions believing that such disclosure is already required under the general test of disclosures, see Corporate Law Economic Reform Program, *Fundraising; Proposals For Reform: Paper No. 2* (AGPS, Australia, 1997) at 28.

1208 Above at 49.

1209 This is the approach adopted in the USA if directors want a safe harbour from liability for forecasts, see Kyrwood, 'Disclosure of Forecasts in Prospectuses' (1998) 16 C&SLJ 350 at 362.

1210 A view shared, in the context of prospectuses, by Kyrwood, 'Disclosure of Forecasts in Prospectuses' (1998) 16 C&SLJ 350.

1211 Anderson and Epstein, 'The Usefulness of Annual Reports' (1995-April) Australian Accountant 25 at 27.

1212 Materiality was discussed earlier in this chapter.

and swamping shareholders. Nonetheless a lot of information is disclosed in the annual report and some complain of information overload.[1213] To a large extent the issue of information overload is tied to the sophistication of the user (which is discussed below under the heading "Understandability").

Credibility

Financial information should be credible.[1214] As credibility is inexorably tied to accuracy and there are inherent problems with the accuracy of the financial statements the issue of credibility becomes more important, and at the same time, more difficult.

The significance of the financial statements results in them being the most vulnerable to manipulation by management. If management are prone to distort information to tell a story favourable to them then this is likely to be their first port of call. The annual financial statements being audited and reported on by independent, qualified accountants curb this propensity. This more than any other requirement reduces the risk of manipulation of the financial statements, but does not immunise the financial statements from misrepresenting the economic reality (if such a thing exists). Like any other person auditors cannot guarantee to perform their job free from error. They are required by the law to exercise a reasonable degree of care and skill and can only realistically provide reasonable assurance concerning the correctness of the financial statements. Only if the auditors are negligent is there a remedy and then only a remedy in favour of the company. The role of auditing is therefore similar to Popper's view on the role of science.[1215] The purpose of testing in the scientific method becomes not to try to prove or verify a hypothesis but to attempt to discredit it. Credibility, but not absolute truth, depends on the absence of negative evidence despite attempts to find such negative evidence by a variety of tests.

The auditing process involves shareholders engaging an elite expert to monitor and verify the reliability of the financial statements prepared by management. Someone else monitors for shareholders. This means there is another link in the chain, shareholders are one step removed from the monitoring process. Having experts check the financial statements as a credibility check is appropriate for two reasons. First, the auditors have the necessary expertise which the shareholders generally lack and therefore monitoring by themselves is unrealistic. Second, even if shareholders did it themselves they are just as likely, if not more so, to make errors. However the challenge in engaging specialist monitors is effectively monitoring them. This is particularly difficult where lay people are trying to judge the performance of professionals exercising specialist skills. Certainly some shareholders, notably institutional shareholders, may have the necessary skills. Also the ASIC has a role to play and would also have the requisite skills to make an intelligent assessment. However the ASIC has finite resources and cannot in effect audit every audit. From a different perspective we see the increased use of audit committees. Audit committees of the board are essentially acting as shareholder representatives. They can effectively monitor the audit function to significantly reduce the risk of audit failure. Once again though shareholders are one step removed from the action. The same structural problems arise, most notably how to monitor the monitors. With these links in the chain of accountability the decaying effects of entropy naturally arise. That is the

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1213 Lewis, 'Annual Reports of the Future' (1984-September/October) Communication Arts 24 at 25.

1214 The definition of reliability from SAC 3 (quoted above) insofar as it contains the concept of "without bias" recognises the importance of credibility. This is expanded upon in paragraph 23 of SAC 3 where the role of the auditor in enhancing reliability is emphasised.

1215 Discussed in chapter 2.2.

impact of entropy increases in successive chains of communication resulting in decreased accuracy of information.

As discussed previously, the quality of the audit process and the ability of shareholders to effectively monitor their monitors can be significantly improved by adopting the following measures:

- insist that auditors make available to shareholders detailed information of their audit plan. Shareholders need to be informed of what the auditors actually did. The current stylised form of reporting set out in AUS 702 is inadequate. Auditors should be forced to lodge their letter of engagement, working papers and an explicit audit plan with the company. These papers should be available for inspection by shareholders to satisfy themselves that the auditors have set about doing their job properly. These arguments are consistent with those I raise in chapter 7.4 (under the heading "Duty of Care") concerning the discipline that should be imposed on directors in their decision making process. It is likely that these papers will contain commercially sensitive information and access should be restricted accordingly;
- audit committees should be mandatory. Similarly the audit committee's responsibilities should be made explicit (one of the hallmarks of a mature and effective audit committee) and they should record what they actually did as a committee. The timing of the audit committee meetings relative to the ensuing directors' meeting should also be disclosed. This information should be available for inspection by shareholders subject to confidentiality restrictions. Similarly this is expanded on in Chapter 7.4. As a committee of directors they should be subject to precisely the same decision-making discipline that I recommend for directors;
- giving auditing standards the force of law and adequately funding the ASIC to properly monitor compliance with them; and
- improve auditors independence. The most important improvements would be to get shareholders to approve the auditors remuneration, mandate auditor rotation every few years and separating the roles of accountants and auditors for particular companies.

If all these alterations were made this would significantly improve the credibility of the audit function and therefore of the financial statements themselves.

Comparability

Information should also be comparable with like information both over time in the same corporation and between different corporations.[1216] This enables meaningful comparisons to be made to enable effective monitoring and allocation of scarce resources. The comparability of the financial statements is enlivened by the financial statements having to:

- comply with an increasingly mature body of rules (the Accounting Standards) designed to ensure consistency within and between financial statements. The paramountcy of these standards enhances their enforceability and recognises the

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1216 SAC 3 'Qualitative Characteristics of Financial Information' at paragraph 49 regards comparability as a necessary characteristic of financial information. Comparability is defined in paragraph 5 to mean "that quality of financial information which exists when users of that information are able to discern and evaluate similarities in, and differences between, the nature and effects of transactions and events, at one time and over time, either when assessing aspects of a single reporting entity or of a number of reporting entities". See also paragraphs 31 to 35 of SAC 3.

fundamental problem in seeking absolute accuracy in sophisticated financial information;
- disclose the accounting policies used by the corporation other than those definitively prescribed by the Accounting Standards;[1217] and
- include a comparison of this years financial results with last years.[1218]

These rules significantly restrict the opportunity for creative accounting undertaken to represent favourable outcomes for management.

One drawback to comparability is the recent change to the accounting requirements whereby a standard format for the profit and loss statement and the balance sheet was no longer required (although certain of the contents of these are prescribed). This was a retrograde step where flexibility was wrongly championed over comparability.

Relevance

Information must be relevant.[1219] Are financial information and audit reports relevant? At some levels it is very relevant. For shareholders in their investor role, financial information is relevant because shareholders will be able to tell how profitable the company was or wasn't and most immediately how much dividend they can expect from that financial year's results. They can also determine the company's cash flow position, which a recent study has concluded sophisticated investors find useful.[1220] This in turn will effect share price and hence potential capital gains or losses to shareholders. The auditor's report is relevant in that it goes to the credibility of financial information. For shareholders in their monitoring role, to see if managers have performed by profitably running the company, which is their principal objective, then financial information is a very effective measure of end results. To this extent it is relevant, although financial information is not a complete or direct measure of directors' performance. Whether shareholders would find other information relevant I have already considered under the issue of completeness.

However given that in their investor role shareholders are not able to sue the preparers and auditors of the financial statements for any loss shareholders suffer if they relied on these documents the report is legally irrelevant to them. Certainly the company can sue, but any loss suffered by the company as a result of the auditor's negligence is very different from the losses suffered by shareholders in the secondary market. These losses can be significant, if not ruinous, both absolutely and in the eyes of the investors involved.

Understandability

1217 AASB 1001 'Accounting Policies' at paragraphs 5 and 6.

1218 AASB 1034 'Information to be Disclosed in Financial Reports' at paragraph 14. See also AASB 1018 'Profit and Loss Accounts' at paragraphs 20 to 21 and AASB 1026 'Statement of Cash Flows' at paragraph 13.

1219 SAC 3 'Qualitative Characteristics of Financial Information' at paragraph 48 regards relevance as a necessary characteristic of financial information. Relevance is defined in paragraph 5 to mean:

> that quality of financial information which exists when that information influences decisions by users about the allocation of scarce resources by:
>
> (a) helping them form predictions about the outcomes of past, present or future events; and/or
>
> (b) confirming or correcting their past evaluations;
>
> and which enables users to assess the rendering of accountability by preparers.

1220 Yap, 'Cash Flow Statements: How Useful?' (1996-December) Australian Accountant 36.

Understandability

One critical issue for the financial statements is their understandability.[1221] I fully addressed the issue of understandability of corporate information in chapter 4.6. The conclusion I reached is that wherever possible information should be understandable to the unsophisticated investor. In most categories of information this should be achievable. However it must be recognised that certain information is by its nature complex and sophisticated. This information should be made as simple as possible, but if it is nonetheless difficult to understand by the unsophisticated investor, then this is realistically unavoidable.

I foreshadowed at that time that the financial statements were the prime type of corporate information that by its nature is complex and technical.[1222] Of course at one level financial statements are quite simple.[1223] It is not difficult for almost anyone to establish the profit earnt over a year (if any), the net asset position of the company and whether the company is solvent. At another level the financial statements are incredibly complex and sophisticated documents. The financial statements are based on a complex web of accounting rules, some of which find expression as Accounting Standards but others that do not. Also the financial statements comprise more information than just the bottom line results. An understanding of these rules and an ability to appreciate the significance of all the information in the financial statements takes a significant degree of education and diligent effort.[1224]

A clear recognition of this reality is made in "Statement of Accounting Concepts 3: Qualitative Characteristics of Financial Information". SAC 3 at paragraphs 36 and 37 provides:

> 36 The ability of users to understand financial information will depend in part on their own capabilities and in part on the way in which the information is displayed. General purpose financial reports ought to be constructed having regard to the interests of users who are prepared to exercise diligence in reviewing those reports and who possess the proficiency necessary to comprehend the significance of contemporary accounting practices.
>
> 37 Preparers should present information in the most understandable manner without sacrificing relevance or reliability. In meeting this objective, it may not always be possible to report complex transactions and events in simple or simplified terms. It should be borne in mind that professional advice can be obtained by the users of general purpose financial reports.[1225]

1221 SAC 3 'Qualitative Characteristics of Financial Information' at paragraph 49 regards understandability as a necessary characteristic of financial information. Understandability is defined in paragraph 5 to mean "that quality of financial information which exists when users of that information are able to comprehend its meaning". See also paragraphs 36 to 38 of SAC 3.

1222 Smith and Taffler, 'Improving the Communication of Accounting Information Through Cartoon Graphics' (1996) 9 Accounting, Auditing and Accountability Journal 68 at 69.

1223 See the foreword by Sykes in Hey-Cunningham, *Financial Statements Demystified* (Allen & Unwin, Sydney, 2nd ed, 1998).

1224 There are even books directed to this issue, see for example Roth, *Analysing Company Accounts: A Guide for Australian Investors* (Wrightbooks, Victoria, 1995); Hey-Cunningham, *Financial Statements Demystified* (Allen & Unwin, Sydney, 2nd ed, 1998).

1225 A similar approach is taken in the US in Statement of Accounting Concepts No. 1 at para 34 where it is provided:

The position for unsophisticated investors is not completely hopeless. As discussed above,[1226] companies can now produce concise financial statements. These are designed to address the difficulties unsophisticated investors traditionally have with financial statements. Time will tell how successful these amendments will be. Also as discussed above, it is common practice for the annual report to voluntarily summarise the financial results of company, commonly in the Chairperson's address. There are problems with such voluntary disclosures in that managers use it as a marketing forum and massage such information to suit their ends. These problems could be partially (but not wholly) addressed by such improvements as the use of a US style MD&A requirement, subjecting such disclosures to some sort of readability requirement[1227] and a warning concerning the reliability of such information for the benefit of unsophisticated investors. There is Australian empirical evidence concerning the extent to which unsophisticated shareholders rely on financial statements and the annual report in general as their principal source of information concerning companies in which they invest. Some of this empirical evidence shows that investors rely on the financial statements and annual report;[1228] whilst others conclude that the principal source of information is from professional advisers (followed by the media).[1229] The most recent empirical study undertaken in 1994/95 supported the subordinate use of annual reports.[1230] However this study also concluded that shareholders still regard the annual report as a valuable document.[1231] Similar mixed results are found from overseas studies.[1232] There is some evidence that financial analysts and institutional investors use the annual report more than individual investors who do not as a whole have the appropriate qualifications or background to fully understand these reports.[1233] This evidence generally supports the

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> The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence.

See also AUS 702 'The Audit Report on a General Purpose Financial Report' at paragraph .07 which states that the audit report should possess the quality of understandability. See also Cadbury Committee, *The Financial Aspects of Corporate Governance* (Gee, Great Britain, 1992) which considers that the financial statements should be "understandable by the reasonably informed shareholder" (at paragraph 4.58).

1226 At 6.2 under the sub-heading 'Directors' Report'.

1227 As stated in a previous footnote, the current government has refused to introduce a mandatory comprehensibility test for prospectuses; see Corporate Law Economic Reform Program, *Fundraising; Proposals For Reform: Paper No. 2* (AGPS, Australia, 1997) at 22 to 24.

1228 Anderson, 'The Usefulness of Annual Reports' in Courtis (ed), *Communication Via Annual Reports* (Financial Management Research Centre, Armidale, 1981) 61.

1229 See the two Australian studies summarised in Courtis, 'Attitudes to Annual Reports' in Courtis (ed), *Communication Via Annual Reports* (Financial Management Research Centre, Armidale, 1981) at 37.

1230 Anderson and Epstein, 'The Usefulness of Annual Reports' (1995-April) Australian Accountant 25 at 26.

1231 Above at 27.

1232 See the international studies summarised in Courtis, 'Attitudes to Annual Reports' in Courtis (ed), *Communication Via Annual Reports* (Financial Management Research Centre, Armidale, 1981) at 37; Chang and Most, 'The Use of Annual Reports-An International Study' in Courtis (ed), *Communication Via Annual Reports* (Financial Management Research Centre, Armidale, 1981) at 37; Epstein and Pava, *The Shareholder's Use of Corporate Annual Reports* (JAI Press, Connecticut, 1993) (investors regard annual report as the most useful information); Hutchins, 'Annual Reports (...Who Reads Them?)' (1994-October) Communication World 18 (institutional investors regard the annual report as useful).

1233 Chang and Most, 'The Use of Annual Reports-An International Study' in Courtis (ed), *Communication Via Annual Reports* (Financial Management Research Centre, Armidale, 1981) at 37; Courtis, 'Annual Reports: The Armchair or the Wastepaper-Bin?' in Courtis (ed), approach taken in SAC 3 although given the inherent tension involved in making the complex understandable then the degree of inconclusiveness in this evidence is also not surprising.

Ultimately the position adopted in SAC 3 is appropriate.[1234] Whilst every endeavour should be made to make the financial statements as understandable as possible this can only be taken so far. The financial statements are necessarily sophisticated documents and if people choose to invest in companies they should either endeavour to receive appropriate training to understand the financial statements, obtain professional advice (as many do) or appreciate that they are out of their depth and bear the risks associated with it.

As mentioned above, the current government has introduced the option for corporations to send concise financial reports to shareholders.[1235] This option was established in response to the difficulty unsophisticated investors have with complex financial statements and the cost to companies in sending full financial statements to people who do not use them.[1236] The success of this reform will unfold over time depending on practices adopted by publishing corporations. It is at least consistent with the simpler documents that can be used when corporations are raising funds (discussed in chapter 8.3).

Accessibility

Since the financial statements are sent to each shareholder and released to the ASX there is no problem of accessibility. In addition the totality of information included in the annual report makes this a very convenient document. If all of this information was not included in the annual report it would take a lot of effort by shareholders to track it down and this may not be completely successful.[1237]

The raw data from which the financial statements are prepared are not released to shareholders. However such raw data is not released for pragmatic reasons. To allow shareholders access to this information on a regular basis would be too disruptive to the affairs of the company, and would inundate shareholders with a huge amount of information (ie information overload). It is possible to imagine a corporation where all information was in an electronic format and to allow shareholders to access this would involve no disruption to the company (subject to suitable confidentiality safeguards). However such a situation awaits the future, although given the rate of technological development it may not be too far away. But generally shareholders would have no interest in receiving such information; the financial accounts themselves satisfy their needs. However the release of this information would be consistent with the scientific method of releasing raw data so that others can test claims made on the basis of such

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Corporate Annual Report Analysis (Dept of Accounting and Financial Management, Armidale, 1978) 1 at 2.

1234 A view shared by others; see McKeon, 'Communication in Annual Reports' in Courtis (ed), *Corporate Annual Report Analysis* (Dept of Accounting and Financial Management, Armidale, 1978) 5 at 7. For a similar conclusion about the understandability of information set out in prospectuses see Blair and Ramsay, 'Mandatory Corporate Disclosure Rules and Securities Regulation' in Walker and Fisse (eds.), *Securities Regulation in Australia and New Zealand* (Oxford University Press, Auckland, 1994) at 268 to 269.

1235 CL s314.

1236 Corporate Law Simplification Taskforce, *Annual Returns and Financial Reporting to Shareholders* (AGPS, Canberra, 1994) at 2.

1237 McBride, 'Beyond the Numbers: Reporting Non-Financial Information' (1997-September) Australian Accountant 20 at 20.

data. That is release of this raw data would be useful not in itself but in order to assist in testing credibility of the financial statements. However testing credibility is the role of the auditors and I have already made suggestions to improve this, for example by allowing shareholders access to the auditor's working papers. At this stage in my opinion the pragmatic reasons to not require regular disclosure of this information outweigh the need for its disclosure. It should be borne in mind that particularly interested shareholders could access this information by gaining court assisted access to information and if my proposals for reform are accepted then by this regime as improved by utilising FOI principles (discussed in chapter 10.3).

Finally, as stated in the introduction to this chapter much of the information discussed in subsequent chapters according to their pertinent topics is financial information. The accessibility of this information is considered in these subsequent chapters.

Confidentiality

The financial statements themselves do not comprise confidential information. As I have noted, if the work of the auditors and the audit committee are made available to shareholders then some of this information will be confidential and appropriate restrictions would have to be put in place. In my opinion if my proposals for reform are adopted then the AASB should formulate an accounting standard to deal with this issue of non-disclosure of confidential information in these documents.

Timeliness

The timeliness of the financial information I consider according to the components of timeliness established in chapter 2, namely the interval of reporting and the period it covers.

The interval of reporting has traditionally been done annually. However there now are the half-yearly reporting requirements, so the interval has been halved. Quarterly reporting has been debated but not seen as generally necessary because of the continuous disclosure regime of reporting to the ASX.[1238] Conventional wisdom regards this as best that can be achieved within the existing framework of periodic disclosure. However I disagree. Most companies produce monthly management accounts. To my mind there seems no reason why this "raw" information should not be made available to shareholders. Certainly monthly management accounts have not been audited (or even reviewed by an auditor) but management themselves consider it reliable enough to use. Surely shareholders are knowledgable enough to appreciate the difference between audited and unaudited financial information (and if some of them are not then the information could include an appropriate warning). It may be too costly to post this information to all shareholders so alternatively it could be released to the ASX and made available electronically. The release of this information in these ways could be notified in the annual report so shareholders who are sufficiently interested know about the release of this information and can choose to access it. I can see no compelling reasons against having such disclosure.

Putting aside the prospect of monthly reporting, delay in reporting is an issue for the annual financial statements since by the time they are published they represent a position

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[1238] Discussed in chapter 10.2. Also see my proposal in chapter 10.2 to abolish the "document prepared for internal management purposes" exception to the continuous disclosure regime which would result in any monthly financial statements prepared for management purposes to be disclosed to the market.

that is dated by approximately 4 months.[1239] Largely this is inevitable due to the necessary time it takes to properly prepare and audit the reports.[1240] There is some empirical evidence that an audit qualification will delay the release of the annual report principally due to auditor/client negotiating time.[1241] Added to this is the time it takes to print and disseminate this information. Two matters ameliorate the timing problem with the financial statements:

- the directors' report must include post financial year information;[1242] and
- dissemination of the periodic reports to the ASX which occur slightly before the company is required to formally report to shareholders under the Corporations Law.

Existing computer technology which enables reporting via the Internet hold the promise of further improving time delays in reporting to shareholders by effectively eliminating the printing and posting stage of reporting.

The reporting period is one year for the annual financial statements and six months for the half yearly reports (and would be one month if monthly reporting was introduced).

Cost

The preparation and dissemination of financial information involves costs which must be weighed against the benefits.[1243] The cost of preparing and auditing the financial statements are significant. This includes the cost of implementing information systems, executive and director time and the fees of professional auditors. Also the costs of publishing the annual report are significant.[1244] However this information is so crucial to shareholders in "for profit" enterprises that no one seriously questions the appropriateness of incurring these costs. These costs could also be reduced by the use of computer technology. On a minor point the desirability of having the half yearly financial statements reviewed or audited depends on a cost benefit analysis (but the shareholders should make this choice).

1239 SAC 3 at paragraphs 39 to 41 recognises this problem and the tension between timeliness and relevance. Courtis, 'Annual Reports: The Armchair or the Wastepaper-Bin?' in Courtis (ed), *Corporate Annual Report Analysis* (Dept of Accounting and Financial Management, Armidale, 1978) 1 at 3.

1240 Garsombke, 'The Timeliness of Corporate Financial Disclosure' in Courtis (ed), *Communication Via Annual Reports* (Financial Management Research Centre, Armidale, 1981) 204 at 212 and 216; Whittred, 'Audit Qualification and the Timeliness of Corporate Annual Reports' in Courtis (ed), *Communication Via Annual Reports* (Financial Management Research Centre, Armidale, 1981) 238 at 239.

1241 Whittred, 'Audit Qualification and the Timeliness of Corporate Annual Reports' in Courtis (ed), *Communication Via Annual Reports* (Financial Management Research Centre, Armidale, 1981) 238 at 254.

1242 CL s299(1)(d) provides that the directors' report must:

> give details of any matter or circumstance that has arisen since the end of the year that has significantly affected, or may significantly affect:
> (i) the [company's] operations in future financial years; or
> (ii) the results of those operations in future financial years; or
> (iii) the [company's] state of affairs in future financial years.

1243 This is recognised in SAC 3 at paragraphs 42 to 45 which ultimately regards this weighing process as a matter of "professional judgement" (there being "no universally acceptable methodology" for doing so).

1244 Simpson, 'Annual Reports: Glossy, Expensive and Useless?' (1997-September) Australian Accountant 16 at 16 states that an annual report costs between $5 to $20 a copy, depending on the number of shareholders and therefore the economies of scale the company can utilise.

6.11 CONCLUSION

Disclosure of financial information to shareholders is justified on the basis of their role as investors and monitors. The existing law and practice concerning the disclosure of financial information to shareholders is reasonably adequate and to a reasonable extent ensures the quality of information provided to shareholders. The law has a long history of ensuring disclosure of financial information based on the view that this is the most important information provided to shareholders. If the law is amended as I have suggested in this chapter this position would nonetheless be significantly improved. The most significant of these changes are to:

- shore up the position of auditors including their independence, increasing and improving the information they report to shareholders, making audit committees compulsory and clarifying liability rules;
- have a warning concerning reliability attached to the voluntary information included with the annual report for the benefit of unsophisticated shareholders;
- include more forward looking information although warn about the inherent danger of such information. Directors should have to revisit this information each reporting period and compare the prediction with the ensuing reality; and
- improve timeliness by releasing monthly management accounts.

However at the end of the day there can never be an absolute guarantee of the quality of financial information. Given that managers prepare the financial statements and they have an agenda that is different from shareholders, there is inherent risk of misreporting. There are safeguards in place and although these can be improved upon, the desire for a perfect system is too idealistic. Auditors call this the audit expectation gap, which will remain even if my proposals are implemented. Ultimately the judge of reliability will be history. If misreporting occurs this will ultimately become evident because the economic realities will soon display the flaws in the financial statements. This certainly is the pattern set by the cases where auditors have been held liable at law. Possibly there is no escaping this pattern, although the measures I have suggested may have a deterrent effect. The important question when financial statements ultimately prove to be wrong becomes establishing why the financial statements were unreliable. Part of that inquiry will be whether there has been any fraud or negligence for which the auditors or directors are legally liable. The measures I have suggested above should make this inquiry easier.

CHAPTER 7

MANAGEMENT INFORMATION NEEDS OF SHAREHOLDERS

7.1 INTRODUCTION

This chapter is about the information shareholders receive concerning the management of their company. The chapter is divided into three parts. The first part concerns information shareholders receive about the identity and qualifications of individual directors and executives and board composition generally. The second part considers direct information about the performance of management functions. The third part examines the information shareholders should and do receive about compliance by directors and executives with their duties of honesty, care and loyalty.

Some of the current disclosures appear as notes to the financial statements. Whilst not directly appearing in the profit and loss statement, balance sheet or statement of cash flows, this information can be regarded as secondary financial information but on the broad topic of management.

In chapter 4 I explained the role of directors in managing the businesses conducted by the company. I noted that modern business has become increasingly complex and sophisticated which in turn has led to a split between the roles of shareholders and managers (which I described) and increased professionalisation of the role of managers. This led to the conclusion that shareholders have a role in monitoring the managers. In this capacity shareholders clearly have need and right to receive information concerning the identity and qualifications of the managers, direct evidence of their performance as managers and with their compliance with relevant laws (further explanation under each sub-heading below). Hence the management function is a legitimate topic to examine what disclosures to shareholders are currently required and whether this is adequate.

7.2 IDENTITY AND QUALIFICATIONS OF INDIVIDUAL DIRECTORS, SENIOR EXECUTIVES AND BOARD COMPOSITION

Justification for disclosure of identity and qualifications

Shareholders have a direct role in voting on the election of directors, as part of their citizenship in the corporate democracy. This aspect of their role as corporate citizens justifies information on the identity of their directors and their suitability (including qualifications) for office. As the freedom of speech material in chapter 5.4 spelt out, citizens "need to know about the candidates". Directors are not faceless androids; they are or should be selected so as to bring their particular skills and perspective to their task. Information about their identity and qualifications is therefore justified. Whether disclosure of the identity and qualifications of the senior executives is justified is analysed under the next sub-heading. Information on Board composition is the holistic side of information about individual directors and is therefore also justified.

Analysis

As I explained in chapter 4, shareholders have the power to appoint and remove directors, although directors may make interim appointments to fill a casual vacancy or as an addition to the board. Therefore it goes without saying that the shareholders will generally know, or ought to know, who their directors are. Nonetheless shareholders are informed each year in the directors' report of the identity of the directors.[1245] Also the company must notify the ASIC the identity of the company's directors and secretary within one month of incorporation and within one month of any change to these positions.[1246] The notice to the ASIC contains each persons name, any former names, date and place of birth and address. These requirements are adequate. Shareholders know who their appointed directors are.

For public companies, the directors' report must also disclose the directors' qualifications, experience and special responsibilities (if any).[1247] However any disclosure about the qualifications and experience of directors will almost necessarily be unsatisfactory to some extent. There are no compulsory formal education qualifications for directors. The role of directors has become increasingly professionalised and there are courses that have recently become available which aim to help people to acquit themselves as directors. But completing such a course is not a prerequisite to acting as a director, unlike other professionals such as doctors, lawyers and accountants. So the role of directors is increasingly professionalised but not formally a profession with a supporting education qualification. Whilst this remains the situation disclosure under this requirement will necessarily be general and vague. For many directors their competence to act as a director derives not from formal qualification but from hands on experience as business people and being directors of other companies. Prior to 9 December 1995,[1248] directors had to disclose any directorships they held in any other public company or their subsidiaries.[1249] This requirement addressed directors' qualifications and experience but has now been abolished. This requirement was dropped as part of simplifying the number of registers which corporations had to keep, with the register of directors etc abolished. It is not clear why abolishing this register necessarily entailed dropping this disclosure requirement from the directors' report, nonetheless that is what happened. It may well be that companies will still disclose other directorships held by their directors under the general requirement of disclosing their qualifications and experience. However vague requirements allow directors to be selective in the information they disclose which is not a desirable situation. This is exacerbated by there being no informal disclosure because of a lack of a permanent, active opposition and a relatively ineffective media.

Unfortunately there is no requirement to disclose the identity of the senior executives of the company, unlike in the U.S.[1250] Given that often these people actually now manage the company's business they remain the hidden face of the company. Many annual

1245 CL s300(1)(c). See also AASB 1017 'Related Party Disclosures' at 10.

1246 CL s242. Directors and secretaries are separately obliged to provide the company with the necessary information so that the company can comply with CL s242; CL s236(1)(c) and 236(4). In addition Listing Rule 3.16.1 separately obliges listed companies to immediately notify the ASX of any change of director, CEO or Secretary. Listing Rule 3.16.3 is the equivalent provision covering a change in the company's auditor.

1247 CL s300(10).

1248 The date of operation of the *First Corporate Law Simplification Act* 1995 (Cth).

1249 Previously CL s242(2).

1250 In the U.S. disclosure of the identity of each director and executive and their principal occupation occurs in the annual report which is sent to shareholders for their annual meeting to elect directors: *Securities Exchange Act* 1934 (U.S.) Rule 14a-3(b)(8).

reports nonetheless voluntarily disclose who the senior executives are but it is unsatisfactory to leave this as a matter of choice.

The issue involves more than identity though. Annual reports generally do not disclose information about the executives' qualifications, experience, how they reached their current position and their suitability to hold that position. This may be defensible on the basis that the shareholders appoint the directors who are charged with the responsibility of appointing the CEO who in turn appoints the senior executives. So there is a chain of command. Arguably all shareholders need to know is that the directors have adequate mechanisms in place so they are able to and actively monitor the CEO's appointment and promotion of senior executives (and also their performance). If this is correct then shareholders need information to assure them that this is occurring. Perhaps the role of the nomination committee could be expanded and directors obliged to report on the deliberations of this committee. Shareholders currently receive no such information. The counter and broader argument is that shareholders are concerned with the overall performance of the company and it is principally the executives who are responsible for that performance on a day to day basis. Therefore shareholders are directly interested in who the executives are, their qualifications, experience and suitability for office (and ultimately their performance). I lean towards preferring this broader view. These two arguments are subtle but significantly different ways to view the information requirements of shareholders. I prefer the broader view but despite whichever view is preferred shareholders do not currently receive either type of information. To give one glaring example there is no requirement concerning the division of responsibilities between, and the appropriate role of, directors and executives. If this discipline was required[1251] and disclosure was mandated, then shareholders could assess whether their company had adopted an appropriate management structure. On either view the information needs of shareholders could be satisfied by an audit of management, although the form of that audit would vary depending on the preferred view. As stated earlier, I consider management audits later in this chapter.

From the qualities in chapter 2 the information provided is simple factual information and therefore should be able to be accurate. The problem is that the current disclosure obligations are not complete. The other qualities on this straight-forward issue are not relevant.

Chapter 4.3 pointed out that the composition of the board of directors is an important issue in the corporate governance debate. In particular it is important to have a majority of independent, non-executive directors and for the chairperson to be non-executive. How such people were nominated and in particular whether there was a nomination committee was also seen as important. There are no compulsory disclosure rules concerning this. However the Listing Rules require corporations to disclose in their annual report a "statement of the main corporate governance practices" of the corporation.[1252] The Listing Rules also provide an indicative list of such corporate governance practices, which include Board composition.[1253] Being only an indicative list, corporations are not compelled to disclose any particular item of information. A recent study of 268 listed corporations' corporate governance statement revealed that 60% had on their board a majority of non-executive directors but only 7% disclosed

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1251 Australian Investment Managers' Association, *Corporate Governance: A Guide for Investment Managers and Corporations* (AIMA, Sydney, 2nd ed., 1997) at paragraph 3.9 recommends an annual review of the respective roles of directors and executives.

1252 LR 4.10.3.

1253 Appendix 4A to the Listing Rules at paragraph 1.

whether these people were independent.[1254] The figures were similar but slightly lower concerning whether the chairperson was an independent, non-executive director. Only 22% revealed that they had a nomination committee.[1255] However another recent empirical evidence indicates that:

(a) most listed companies have a majority of non-executive directors but evidence to support their independence is less clear;

(b) over 80% of listed companies had an independent chairperson; and

(c) only 17% had nomination committees.[1256]

Therefore it seems there is a difference between actual corporate governance practices and those reported to shareholders (principally on the issue of independence).[1257] Given that disclosure is not mandatory then this is not necessarily surprising. However on independence there are disclosures under the duty of loyalty concerning this (discussed later in this chapter). This enables readers of the annual report to piece together an understanding of independence but this raises the issue of accessibility of information, particularly for unsophisticated investors.

7.3 MANAGEMENT PERFORMANCE

Justification for disclosure on management performance

The need of shareholders for information on management performance is principally justifiable from the perspective of shareholders as monitors. As monitors obviously shareholders have an interest in receiving information that directly (not inferentially from corporate results) measures the performance of directors. In chapter 6.2 I established that the disclosure of financial information is also justified from the perspective of shareholders as monitors since financial information indirectly measures management performance. If an indirect measure of management performance is justified then direct measures of their performance is also necessarily justified.

Information on management performance is also a valuable tool for shareholders in their investor role. One way to value company shares is to assess a company's ability to produce a future stream of income.[1258] Some suggested forms of reporting management performance involves measuring how the company is being managed so as to produce the capability to maximise wealth (discussed below). If adopted this would give shareholders a surer method of predicting a company's future income stream.[1259] It is certainly a more

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1254 Ramsay and Hoad, *Disclosure of Corporate Governance Practices by Australian Companies* (Centre for Corporate Law and Securities Regulation, Melbourne, 1997) at 11 to 13.

1255 Above at 13 to 14.

1256 Stapledon, *Institutional Investors and Corporate Governance* (Clarendon Press, Oxford, 1996) at 171 to 172; cf Stapledon and Lawrence, *Corporate Governance in the Top 100: An Empirical Study of the Top 100 Companies' Board of Directors* (Centre for Corporate Law and Securities Regulation, Melbourne, 1996) at 4 to 12 whose study in 1995 of the top 100 listed companies found that the relevant percentages were (a) 40%, (b) 45% and (c) 19%.

1257 As noted in Ramsay and Hoad, *Disclosure of Corporate Governance Practices by Australian Companies* (Centre for Corporate Law and Securities Regulation, Melbourne, 1997) at 11.

1258 See chapter 4.6. See also Francis, 'Measuring, Predicting, And Enhancing Corporate Performance', paper presented at the conference Measuring And Enhancing Corporate Performance: An Agenda For Corporations And Investors organised by the Business Council Of Australia and The Australian Investment Managers Group, Sydney, 12 November 1993 at 5.

1259 Francis, 'Measuring, Predicting, And Enhancing Corporate Performance', paper presented at the conference Measuring And Enhancing Corporate Performance: An Agenda For Corporations And Investors organised by the Business Council Of Australia and The Australian Investment predictable method of forecasting than by extrapolating from historical results.[1260] Also as discussed in chapter 4.6, the takeovers market is dependent on information that accurately pinpoints ineffective managers; direct information on management performance will better serve this need than inferences drawn from disclosures about the company's financial position and performance.

Given the broad information rights of shareholders as citizens such disclosures are also justifiable from this perspective. Only if shareholders receive information about the performance of directors will shareholders be able to rationally make decisions on how to exercise their rights as citizens to vote on the election (including re-election) or removal of directors.

Analysis

The financial statements provide very pertinent information but within a very narrow range. They provide a historical snapshot of a company's financial performance and cash flows over a certain period and its assets and liabilities as at a certain date. Traditionally this was, and overall still is, regarded as the only information needed to assess the performance of the managers. However there is an increasing body of literature that questions this.[1261] These authors argue for a broader range of information to be regularly published in order to better and more directly assess the performance of not just the company but of its managers. Certainly management performance can and is rightly linked to the financial performance of the company. After all it is the directors' role to maximise wealth for shareholders. This is particularly so when viewed from the perspective of shareholders interested in short term gains.[1262] However there are a myriad of factors which influence the profitability of a company. Those factors include the number (if any) and quality of competitors in the same market, the state of the labour market, the government's taxation policy and the general health of the economy. These factors can combine to produce either a good or a bad financial result for the company regardless of the quality of management performance. This gives poor managers the scope to be able to both take the credit for a good result and blame extraneous factors for a bad result. There is also anecdotal evidence of managers manipulating performance and information to ensure a steady increase in profitability over several years when greater increases were always available.[1263] In addition dividend payment rules entitle directors to pay dividends from profits retained from previous years.[1264] Therefore even

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Managers Group, Sydney, 12 November 1993 at 5. See also Brancato, *New Corporate Performance Measures* (The Conference Board, New York, 1995) at 9 to 10.

1260 Francis, 'Measuring, Predicting, And Enhancing Corporate Performance', paper presented at the conference Measuring And Enhancing Corporate Performance: An Agenda For Corporations And Investors organised by the Business Council Of Australia and The Australian Investment Managers Group, Sydney, 12 November 1993 at 4.

1261 For example see Brancato, *New Corporate Performance Measures* (The Conference Board, New York, 1995); Sherer & Kent, *Auditing And Accountability* (Pitman, London, 1983); Kocourek, 'Board Performance Criteria-Who Defines It, Who Monitors It?' paper presented at a conference 'Corporate Governance: Critical Board Issues" organised by the Australian Institute of Company Directors in Sydney on 24 May 1993 (author on file); Australian Institute of Company Directors, *Measuring Board Performance*(AICD, Sydney, 1993); and Drucker, 'Reckoning With The Pension Fund Revolution' (1991) Harvard Business Review 106 and the materials referred to therein.

1262 Kocourek, 'Board Performance Criteria-Who Defines It, Who Monitors It?' paper presented at a conference 'Corporate Governance: Critical Board Issues" organised by the Australian Institute of Company Directors in Sydney on 24 May 1993 (author on file) at 110.

1263 Burrough and Helyar, *Barbarians at the Gate* (Arrow, Great Britain, 1990) at 458 to 459.

1264 Table A cl 89; *Marra Developments Ltd v B W Rofe Pty Ltd* [1977] 2 NSWLR 616; Lipton and Herzberg, *Understanding Company Law* (Law Book Company, Sydney, 1998) at 289.

in years where there is not an adequate profit, or no profit at all, directors have the ability to nonetheless pay dividends from these reserves. To some extent this is in shareholders interests because they have a steady and predictable stream of income. Although a careful reading of the financial statements will reveal how such dividends are being funded, many unsophisticated investors would not necessarily pick up on this. On the other hand if it is appropriate to pay these dividends to shareholders why retain them in the first place? Certainly this practice is likely to deflect criticism of directors for a poor result in a year; shareholders with their normal dividend are less likely to complain than shareholders without a dividend. Also shareholders have an interest in more than just short term profitability but also the ongoing viability and health of their corporations.[1265] Hence there is a need for information that directly measures management performance.

Looked at from a slightly different perspective as previously discussed, the financial statements measure results but not how those results were achieved. This limits the ability to prospectively monitor the performance of management as results only reflect a historical position. An assessment of poor management can only be made after poor results have been published and any blame shifting to extraneous circumstances by management is no longer believed. Even if this point is reached investors may still be in the dark about how the losses arose. Therefore some commentators argue that shareholders should be told how the company and management operate so that effective monitoring can occur.[1266] That is managers should explain how they manage their companies in order to maximise wealth. More specifically these commentators argue that to enhance wealth managers must have regard to such "intangibles" as:

- quality of output;
- customer satisfaction/retention;[1267]
- employee turnover and training;
- research and development investments and productivity;
- new product development;
- market growth/success;
- environmental competitiveness; and
- other measures specific to each company.[1268]

These items do not traditionally appear in the financial statements but are relevant to how companies generate wealth and therefore information on these topics should be provided to shareholders.

1265 Kocourek, 'Board Performance Criteria-Who Defines It, Who Monitors It?' paper presented at a conference 'Corporate Governance: Critical Board Issues" organised by the Australian Institute of Company Directors in Sydney on 24 May 1993 (author on file) at 111. There is empirical evidence which supports the view that shareholders take a long term view of the corporation and do not just have a short term investment horizon; see Anderson and Epstein, 'The Usefulness of Annual Reports' (1995-April) Australian Accountant 25 at 26.

1266 Sherer & Kent, *Auditing And Accountability* (Pitman, London, 1983) at 118.

1267 This item is the focus of a form of business analysis described in Harry and Lawson, *Six Sigma Producibility Analysis And Process Characterisation* (Addison-Wesley, U.S.A., 1992). This was the business system used by Motorola Inc to turn their declining fortunes around in the 1980's, which culminated in Motorola receiving a U.S. national quality award in 1988.

1268 Brancato, *New Corporate Performance Measures* (The Conference Board, New York, 1995) at 10. See also Drucker, 'Reckoning With The Pension Fund Revolution' (1991) Harvard Business Review 106 at 113 to 114. Similar measures exist in the public sector, see Sharp, Stanwick and Baulderstone, 'An Organisational Culture Consistency Meter in Evaluation of Organisational Learning' paper presented at a conference 'Evaluation: Equipping Communities and Government' conducted by the Australasian Evaluation Society, Adelaide, Australia, 1 to 3 October 1997.

One commentator, Dr. Ivor Francis, has developed this concept further than just saying investors should receive information on how their companies are managed.[1269] Francis argues that managers must use a systemic approach in order that they understand how their business creates value.[1270] That is, how the various component functions of the company operate and interact so as to produce the capability to maximise wealth. If this is adopted then managers can systematically manage to enhance future performance.[1271] Shareholders can use this style of management as the basis or blueprint for systematically monitoring management performance.[1272] The result is enhanced accountability. As Francis states:

> Individual managers, including the CEO, and perhaps even the board itself, can now be held accountable for the health *of the system, functions, or processes* over which they have at least some degree of authority.
>
> This is the most profound point of all, for this defines good management as maintaining the health of the system and holding people to account for delivering their systemic improvements, not for making grand acquisitions, massive restructurings, launching new mission statements, high profile productivity or quality drives, or new deals with unions.[1273]

Since the capability of the company is measured, the potential for performance is made known, not just past results.[1274] If managers do not deliver what the company is capable of then shareholders will be adequately informed, be able to identify who is responsible and be able to sheet home responsibility (including dismissal) to under performing managers.[1275] Francis is not the only commentator to argue for such a system.[1276]

Given that more direct measures of management performance are appropriate the issue becomes how to provide investors with this type of information. There is evidence some companies voluntarily provide this information in their annual report.[1277] However I have already previously effectively criticised such disclosures from a quality perspective; such information cannot be relied upon.[1278] Most commentators consider that the

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1269 Francis, 'Measuring, Predicting, And Enhancing Corporate Performance', paper presented at the conference Measuring And Enhancing Corporate Performance: An Agenda For Corporations And Investors organised by the Business Council Of Australia and The Australian Investment Managers Group, Sydney, 12 November 1993.

1270 Above at 4 & 7.

1271 Above at 5.

1272 Above at 5.

1273 Above at 22.

1274 Above at 7.

1275 Sherer & Kent, *Auditing And Accountability* (Pitman, London, 1983) at 118.

1276 See also Kaplan and Norton, 'Using the Balanced Scorecard as a Strategic Management System' (1996-Jan-Feb) Harvard Business Review 75. While the authors principally use their balanced scorecard as a management system they also state (at 80) "we believe that as senior executives gain confidence in the ability of the scorecard measures to monitor strategic performance and predict future financial performance, they will find ways to inform outside investors about those measures without disclosing competitively sensitive information". For an appraisal system restricted to the Board level see Conger, Finegold and Lawler, 'Appraising Boardroom Performance' (1998-Jan-Feb) Harvard Business Review 136.

1277 Holliday, 'Annual Reports As Marketing Tools' (1994-August) Bank Marketing 23; Ramsay and Hoad, *Disclosure of Corporate Governance Practices by Australian Companies* (Centre for Corporate Law and Securities Regulation, Melbourne, 1997) at 14 to 15.

1278 Chapter 6.6.

company should submit to a business management audit.[1279] As a matter of principle an audit is justified. An audit is appropriate where there are no other structural mechanisms in place to ensure the accountability of those in power in an organisation and hence the credibility of the information they publish. As I demonstrated earlier in this thesis in the corporate context there is an absence of other structural mechanisms to ensure the reliability of information. Principally there is no active opposition and relatively weak media coverage of corporations. This is part of the reason why the financial statements are audited. If the financial statements are audited there is a stronger argument to support an audit of management performance. The financial statements measure the consequences of managers performing their job. A business management audit more directly measures how and how well or poorly managers are performing. If there is a risk of managers manipulating the information in the financial statements surely that risk is greater where their performance is being directly measured.

A management audit for investors is an extension of the work performed by internal auditors[1280] and similar work undertaken by business consultants and accountants on an ad hoc basis at the request of directors.[1281] The latter type of management audit may occur for a variety of reasons including at the time of a takeover, merger or reorganisation or because the company is in serious financial difficulties.[1282] The primary difference of the proposed business management audit is that it occurs regularly and an independent auditor is responsible for the audit and reports to shareholders.

Blueprints for such audits exist.[1283] Auditors have promulgated their methodology in Auditing Standards on performance auditing[1284] and their planning.[1285] The standard on performance auditing defines a performance audit as:

> an audit of all or a part of an entity's or entities' activities to assess economy and/or efficiency and/or effectiveness. It includes any audit directed to:
>
> > (a) the adequacy of an internal control structure or specific internal controls, including those intended to safeguard assets and to ensure due regard for economy, efficiency, and effectiveness;
> > (b) the extent to which resources have been managed economically and efficiently; and
> > (c) the extent to which activities have been effective.[1286]

As can be seen the effectiveness of managers is intimately connected with their handling of the business under their control, which is appropriate. The auditing standards go on to explain in some detail how such an audit should be undertaken, including establishing the terms of the engagement[1287] and the criteria against which performance is to be

1279 Sherer & Kent, *Auditing And Accountability* (Pitman, London, 1983) Chapter 11; Drucker, 'Reckoning With The Pension Fund Revolution' (1991) Harvard Business Review 106 at 113 to 114; Francis, 'Measuring, Predicting, And Enhancing Corporate Performance', paper presented at the conference Measuring And Enhancing Corporate Performance: An Agenda For Corporations And Investors organised by the Business Council Of Australia and The Australian Investment Managers Group, Sydney, 12 November 1993 at 25.

1280 Sherer & Kent, *Auditing And Accountability* (Pitman, London, 1983) Chapter 10.

1281 Craig-Cooper and De Backer, *The Management Audit* (Pitman Publishing, U.K., 1993).

1282 Above at chapter 2.

1283 Above at chapter 5. See also Herbert, *Auditing the Performance of Management* (Lifetime Learning Publications, California, 1979).

1284 AUS 806 'Performance Auditing'.

1285 AUS 808 'Planning Performance Audits'.

1286 AUS 806 'Performance Auditing' at paragraph .02. See also Herbert, *Auditing the Performance of Management* (Lifetime Learning Publications, California, 1979) at 6 to 7.

1287 AUS 806 'Performance Auditing' at paragraphs .15 to .17; AUS 808 'Planning Performance Audits' at paragraphs .04 to .05.

judged.[1288] The terms of the engagement can be narrow or broad; the criteria can be specific or vague. To have value as an accountability tool for shareholders the audit should be comprehensive and judged against specific and relevant criteria.

So the business management audit is a comprehensive examination of the management of the company by an outside auditor.[1289] The auditor examines the efficiency and effectiveness of management and reports to shareholders accordingly. The management auditor must have all the hallmarks of the financial auditor, most notably be appropriately qualified,[1290] independent[1291] and have unrestricted access to the company's information and personnel. One further advantage of an outside auditor is that 'the management auditor will invariably be able to use his experience of different organisations to assess the performance of management from a broader perspective'.[1292]

Managers are likely to resist having their performance examined under a microscope by an outsider. It may well be that the business audit will only come about, on other than a piecemeal basis, if companies are compelled to do so by legislative warrant. On the other hand, Drucker regards the business audit as being of crucial significance and will therefore be popularised by market forces. He also places management's likely aversion to business audits in historical perspective. Drucker states:

> Thus it may not be too fanciful to expect that in ten years a major pension fund will not invest in a company's shares or fixed-income securities unless that company submits itself to a business audit by an outside professional firm. Managements will resist of course. But only 60 years ago, managements equally resisted - in fact, resented demands that they submit themselves to a financial audit by outside public accountants and even more to publication of the audit's findings.[1293]

Only time will tell if this confident prediction of a voluntary shift in culture will occur.[1294] The difficulty with having a voluntary shift is that the first who may wish to undertake it may perceive they are giving their competitors an advantage and therefore not implement their wishes.[1295] Certainly managers in some companies are undertaking

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1288 AUS 806 'Performance Auditing' at paragraphs .23 to .25; AUS 808 'Planning Performance Audits' at paragraphs .27 to .36. If management have implemented their own performance criteria and so long as these are appropriate the auditor could simply use those criteria.

1289 Herbert, *Auditing the Performance of Management* (Lifetime Learning Publications, California, 1979) at 3.

1290 The consulting divisions of accounting firms originally and still do this type of work (Drucker, 'Reckoning With The Pension Fund Revolution' (1991) Harvard Business Review 106 at 114). Clearly accountants and auditors have claimed this role. However arguably there is room for people with management training (such as MBA's) to undertake, or be involved in, this type of work.

1291 AUS 806 'Performance Auditing' at paragraph .08(a); Sherer & Kent, *Auditing And Accountability* (Pitman, London, 1983) at 113 to 114; Francis, 'Measuring, Predicting, And Enhancing Corporate Performance', paper presented at the conference Measuring And Enhancing Corporate Performance: An Agenda For Corporations And Investors organised by the Business Council Of Australia and The Australian Investment Managers Group, Sydney, 12 November 1993 at 25.

1292 Sherer & Kent, *Auditing And Accountability* (Pitman, London, 1983) at 114.

1293 Drucker, 'Reckoning With The Pension Fund Revolution' (1991) Harvard Business Review 106 at 114. Noticeably over half of Drucker's time has elapsed with no sign of universal business audits in sight.

1294 Although a similar prediction was made nearly 30 years ago; Burton, 'Management Auditing' (1968-May) The Journal Of Accountancy 41 at 45.

1295 Boreham, 'Corporate Reporting Talks Reinforce Doubts' 1992, August 7 *Business Review Weekly* 88 at 89 in the different context of quarterly reporting of financial information.

performance measurements to be used internally for management purposes.[1296] However this is very different from being audited on such matters and this being reported to shareholders and the wider world.[1297] When talking of the future everyone is speculating but in my opinion Drucker is overly optimistic. In my opinion the management audit is sufficiently important so that Parliament should make them mandatory sooner rather than later. There certainly is some empirical evidence that points to shareholders wanting this type of information.[1298]

As the business management audit is only a proposal then it is not possible to assess the quality of the information against the criteria identified in chapter 2. Although credibility would be enhanced, given an audit of management information is proposed. Concerning the other qualities then such an audit should strive to achieve them, which is supported by the relevant auditing standard.[1299] Just as over time the financial statements and auditing of them has evolved and improved then similar improvements over time in the management audit would be expected. The reporting of a management audit would have to be subject to legitimate confidentiality concerns.[1300] The final issue is the prickly issue of cost. Once again whether new information is warranted given the cost involved is difficult to definitively answer. The cost of this information will be significant given independent auditors are involved. The costs will be particularly high at the outset whilst both the company and the auditors are on a steep learning curve. Over time these costs should level out but will still be significant. In my opinion the benefit of the management audit warrants the costs involved.

7.4 DISCLOSURE OF COMPLIANCE WITH LEGAL STANDARDS

In this part I consider the justification for reporting about the fiduciary and statutory duties that apply to directors, the content of those duties, the reporting requirements there currently are about directors and executives' conformance with them and whether any improvements should be made.

Justification for disclosure about directors' compliance with legal standards

In chapter 4 I observed that since shareholders have delegated powers to directors they have placed themselves in a position of reliance and relative weakness. This is also the

1296 Brancato, *New Corporate Performance Measures* (The Conference Board, New York, 1995) includes case studies of companies from the United States, United Kingdom and Australia which do this.

1297 Above at 11 expresses the concern of many managers about the release of such information because this "will reduce their competitive advantage".

1298 Anderson and Epstein, 'The Usefulness of Annual Reports' (1995-April) Australian Accountant 25; Epstein and Pava, *The Shareholder's Use of Corporate Annual Reports* (JAI Press, Connecticut, 1993) at 131.

1299 AUS 806 'Performance Auditing' at paragraph .07 states that the objective of a performance audit "includes the provision of relevant and reliable information about performance".

1300 See chapter 2. One alternative has been suggested in Francis, 'Measuring, Predicting, And Enhancing Corporate Performance', paper presented at the conference Measuring And Enhancing Corporate Performance: An Agenda For Corporations And Investors organised by the Business Council Of Australia and The Australian Investment Managers Group, Sydney, 12 November 1993 at 25. Francis recognised the concern that information produced as a result of a management audit may be damaging in the hands of the company's competitors. He therefore suggested that "one short answer to that question is that the investor should know that the company has the *capabilities* to execute its many necessary functions, not necessarily the details of the decisions reached as a *result of executing* those functions, but that it has the *capability* of doing so."

situation where directors have in practice taken the initiative over the use of many of the powers that shareholders have formally retained (eg the nomination and appointment of new directors). The law recognises this dynamic by imposing on director's fiduciary duties, one of the most stringent form of duties known to the law. Those duties can be broadly categorised as duties of honesty, care and loyalty. There are complementary and overlapping statutory duties as well. Fiduciary duties are imposed on directors in recognition of their separate role from shareholders and their divergent interests and are therefore a mechanism of accountability.[1301] From this point it is uncontroversial to say that shareholders have an interest in and responsibility to monitor their delegates and that directors should be accountable to the shareholders. Given the extraordinary breadth of the power of management delegated to directors but the very potent powers retained by shareholders and their ultimate powers over the company, directors should be accountable for all of their functions. Given that pertinent information is a linchpin of accountability, shareholders should receive information on the compliance by directors with the very duties put in place in recognition of the relative positions of directors and shareholders.[1302] There is scant recognition of this as a matter of principle in Australia. In a different context (medical negligence), two justices of the High Court support this kind of logic. Justices Gaudron and McHugh in *Breen v Williams* stated:

> If there was a general fiduciary duty to act in the best interests of the patient, it would necessarily follow that a doctor has a duty to inform the patient that he or she has breached their contract or has been guilty of negligence in dealings with their patient.[1303]

In the corporate context there is a duty on directors to act in the best interests of the company/shareholders and therefore the necessary implication of reporting a breach of duty logically follows. Also as I concluded in chapter 4.4, Australian law and practice embraces a modestly idealistic view of corporations. As a result shareholders as monitors are necessarily interested in the directors and executives' compliance with the relevant laws which effect them. Disclosure of this information is also justifiable from the perspective of shareholders as citizens; citizens are interested in whether their elected representatives are obeying the law.[1304] Such disclosures add to the complete package of information provided to shareholders. Whilst there is not a lot of support at a theoretical level for such disclosures, as becomes apparent shortly there are a range of mandatory disclosure rules that exist in this area.

Analysis

Broadly speaking the directors are subject to duties of honesty, care and loyalty. I analyse each in turn.

1301 Eisenberg, 'The Structure of Corporation Law' (1989) 89 Columbia Law Review 1461 at 1473; Easterbrook and Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, USA, 1991) at 90 to 93.

1302 Also given the broad powers of management which directors are entrusted with they should be accountable for the exercise of these powers. Direct information on this topic would assist the operation of the takeover market which relies on bidders being able to identify poorly managed companies (discussed in chapter 4.6).

1303 (1995-1996) 186 CLR 71 at 113.

1304 In the US disclosure of breaches of fiduciary duty are required as part of the proxy solicitation process for the re-election of directors; see Cary and Eisenberg, *Corporations: Cases and Materials* (Foundation Press, USA, 6th ed, 1988) at 299 to 303.

Honesty

The directors[1305] and executives[1306] are under a duty to act honestly.[1307] There are currently no disclosure requirements about whether this duty has been breached. The closest the law comes to this is the requirement for the auditors to detect fraud and opportunities for fraud.[1308] This is a useful provision but misses the mark in that the obligation to make such disclosures should be principally cast upon the directors and fraud is only one type of dishonesty (especially as honesty in corporations includes the proper purposes test).[1309] If litigation commences concerning a breach of duty then the media may report this (as it might for the other duties). So such matters may come to the attention of shareholders. But shareholders should not have to rely on this avenue of information, which is not necessarily reliable. The argument is that the company should be obliged to so report.

If someone is being dishonest they are not about to shout it from the rooftops. Therefore at one level it is not surprising to find there is no reporting requirement concerning this.[1310] However detection of dishonest behaviour will be haphazard at best unless there are control and reporting systems in place designed to detect it. Directors should be responsible to have adequate mechanisms in place to prevent and detect dishonesty. If dishonesty is detected then it is reasonable to require a report to the shareholders. However dishonesty is a delicate issue bound up with our inviolable principle of a person being innocent until proven guilty which is backed up by the laws of defamation and sub judice contempt. Any reporting requirement would have to be sensitive and subject to these laws. For disclosure before trial (if there ever is one), it would be possible to disclose details of the dishonesty but not the identity of the perpetrator. Even this has its limitations because from within a small group of directors and executives it may be easy to identify the perpetrator by inference. If reporting were to occur in the annual report then this type of delay should alleviate such concerns as matters of dishonesty usually are dealt with quickly once they come to light. If the matter goes to court then it is a matter of public record and reporting the progress of these proceedings is uncontroversial.[1311]

1305 *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407 at 426; *Mills v Mills* (1938) 60 CLR 150 at 175 (per Starke J) and at 185 (per Dixon J).

1306 *Green v Bestobell Industries* [1982] WAR 1 at 3 (Burt CJ), 10 (Wickham J) & 18 (Kennedy J); *Canadian Aero Service Ltd v O'Malley (1973) 40 DLR (3d)* 371 at 381 to 382. See also CL s232(1).

1307 Both at common law and pursuant to section 232(2) of the *Corporations Law*.

1308 AUS 210 'Irregularities, Including Fraud, Other Illegal Acts and Errors'; *re Thomas Gerrard & Sons Ltd* [1968] Ch 455; and *Arthur Young & Co v WA Chip and Pulp Co Pty Ltd* (1988) 13 ACLR 283 at 289. See also Ford, Austin and Ramsay, *Ford's Principles Of Corporations Law* (Butterworths, Sydney, 9th ed., 1999) at [10.550]; and Ickeringill, Poke, Sheller and Kent, 'Audit' in *Australian Corporations Law* (Butterworths, Sydney, 1996) at [3.7.0155]. Discussed also in chapter 6.5.

1309 This is the strained interpretation as a result of *Australian Growth Resources Corporation Pty Ltd (Recs and Mgrs apptd) v Van Reesema & Ors* (1988) 13 ACLR 261 at 268-272; and *Southern Resources Ltd & Ors v Residues Treatment & Trading Co Ltd & Ors* (1990) 3 ACSR 207 at 226-228. The current government is also proposing to replace the statutory duty of honesty with the two tests of "bona fide in the best interests of the company" and "proper purposes"; see *Corporate Law Economic Law Reform Program Bill* 1998 (Cth) ss181 & 184(1).

1310 Loss, 'Disclosure as Preventive Enforcement' which is in chapter IV of Hopt and Teubner (eds), *Corporate Governance and Directors' Liabilities* (Walter de Gruyter, Berlin, 1984) at 332 to 333.

1311 For example it is a defence to a claim of sub judice contempt that the person was publishing a fair, accurate, uncoloured and contemporaneous report of legal proceedings; see *ex p Terrill; re Consolidated Press Ltd* (1937) 37 S.R.(N.S.W.) 225 per Jordan CJ at 257.

Sometimes the dishonesty will not be of an individual but virtually endemic throughout an organisation. If this is the case then there is virtually no hope of disclosure being made during the time the culture of dishonesty prevails. However the legal requirement of disclosure could remain and when a different culture prevails, usually by new people being in a position to control the company, then disclosure could be made. In many ways this is an unsatisfactory result because many years of dishonesty may have elapsed and irreparable harm done to the company. Realistically though this seems to be the best result available. There could be an added attraction to such a requirement. If the obligation to disclose dishonest behaviour was itself a civil penalty provision this may not prevent collective dishonesty but would be a clear fingerprint of dishonesty that legal regulators could use to easily prosecute such people.

In my opinion the law should require directors to report annually to shareholders that:

- there are adequate mechanisms in place to prevent and detect instances of dishonesty (giving a description of these mechanisms);
- in the opinion of the directors these mechanisms are functioning satisfactorily; and
- to the best of their knowledge there have been no instances of dishonesty or if there have been detected cases of dishonesty then make appropriate disclosures. Such disclosure should include what remedial steps the directors have taken or propose to take. The disclosure obligation should be subject to the principle of 'innocent until proven guilty' and the law of defamation.

Care

The directors and executives when performing their functions must act carefully.[1312]

Whether the directors and executives are acting carefully cannot be totally divorced from financial performance. If the managers have been negligent then this may result in a poor, bad or disastrous financial result for the company. In this way the care directors take can be linked to the company's performance. However the directors may not be acting particularly carefully but fortunately for them no bad outcomes have (yet) resulted, or vice versa. Anyway if financial performance is the only measure of care shareholders receive they will only learn of carelessness after the company's fortunes have been adversely affected. Timely and relevant information can, if acted upon, have a preventative effect. Clearly the financial statements are not a clear or direct measure of the care taken by officers. Therefore this section considers whether there are more direct indicators of the measure of care managers bring to their tasks.

The board of directors is a body which acts collectively and makes decisions by majority vote.[1313] In chapter 5 I discussed how the board is a unitary body and how an analogy with cabinet, another collective decision making body, is appropriate (although the analogy can not be taken too far).[1314] Another useful analogy is to sporting teams. The role of sporting teams is to perform as well as possible and to try to win their matches and competition. The team relies on each individuals performance but ultimately all the individuals must work together to try to win. Similarly boards of directors are a team who must work together to enable the company to maximise its performance. Directors are a team because they act collectively and make decisions by majority vote. This is why principally their collective performance should be assessed.

1312 *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407; CL s232(4).

1313 Table A, cl 70(1).

1314 Although I concluded that this alone does not warrant exemption of their decision making process from an FOI style regime of disclosure.

How directors as a collective body can act carefully or negligently can be divided into four parts, namely their duty:

- to monitor their delegate, where directors have delegated some of their responsibilities;
- of inquiry if suspicion of mismanagement or illegality is aroused;
- to make informed decisions; and
- to make reasonable decisions.[1315]

I now examine four ways that directors actions can be analysed to see if they have been careful, consider what information shareholders currently receive on this topic and whether this can be improved. Finally I consider whether there is any scope to systematically assess the care taken by individual directors or whether any additional role can be carved out for the chairperson for assessing the care taken by his or her fellow directors and report to shareholders accordingly.

Delegation — Monitoring the Delegate

Directors often delegate a lot of management functions to the executives. Where a delegation occurs then directors act less as managers and more as overseers; they take on a monitoring role. However it is not monitoring in the sense of direct observation, looking over managers' shoulders; that is unrealistic. Directors should install appropriate internal controls and information systems from which it can be established that the company is being properly run.[1316] The duty to monitor has been explicitly endorsed by an Australian court.[1317]

In monitoring their delegates the directors will be interested in executives' performance and conformance with the law. As the company's activities are the sum of the activities of the people who are employed by it then ultimately the directors monitoring their delegates extends to monitoring the performance of the company and the company's conformance with the law.[1318] Measuring and reporting on performance was discussed previously in this chapter. However the law does not seem to oblige directors as part of this duty to monitor to have in place a legal compliance program. A legal compliance program is a system designed to enable all of the company's officers and employees to know of and comply with the law and a reporting system designed to detect any instances where laws have been breached. There is no direct Australian authority on this point. A duty to have a legal compliance program in place was explicitly rejected in the United States in the 1960's,[1319] although a recent authority questions this result.[1320] As I argued in chapter 4.4, an obligation to report on compliance with the law is consistent with a modestly idealistic view of the company. In my opinion disclosure of manager's

1315 This four stage analysis of the duty of care is derived from Eisenberg, 'The Duty of Care of Corporate Directors and Officers' (1990) 51 University of Pittsburgh Law Review 945.

1316 Institute of Internal Auditors, *Australian Control Criteria: Effective Internal Control to Achieve Business Objectives Within an Acceptable Degree of Risk (Exposure Draft)* (Institute of Internal Auditors, Sydney, 1998).

1317 *Daniels v Anderson* (1995) 13 ACLC 614 at 662.

1318 Tricker, 'Corporate Governance-Australian Experience in the '90s' paper presented at a conference 'Corporate Governance: Critical Board Issues' organised by the Australian Institute of Company Directors in Sydney on 24 May 1993 (author on file) at 98.

1319 *Graham v Allis-Chalmers Manufacturing Co* 188A 2d 125 (Del 1963); discussed in Clark, *Corporate Law* (Little Brown & Co., New York, 1986) at 130 to 133.

1320 *In Re Caremark Int'l Inc* Civ A No 13670 WL 549894 (Del Ch Sept 25, 1996); discussed by Veasey, 'The Defining Tension in Corporate Governance in America' in Ramsay (ed), *Corporate Governance and the Duties of Directors* (Centre for Corporate Law and Securities Regulation, Melbourne, 1997).

compliance with fiduciary duty and the company's conformance with laws are justified as a matter of principle.

As a matter of practice systematic information about compliance with the law would compel the directors to adopt a certain management practice and the shareholders would have to be willing to bear the costs. It is difficult to gauge whether this discipline and cost is justified and people will legitimately have different views on the matter.[1321] In my opinion both the discipline and cost are justified if the reality of modern business requires delegation of management functions and the duty to monitor is taken seriously.[1322]

More generally speaking currently the shareholders receive no information about what functions have been delegated to the executives, what systems are in place to enable the directors to monitor the executives (discussed further below) and whether the results of that monitoring were satisfactory. In my opinion this type of information should be available to shareholders.

Inquiry

Where the directors have delegated functions to the executives then there is always the possibility those delegates are not performing adequately or may even be defrauding the company or otherwise behaving illegally. If the directors have reason to suspect this is occurring then they should promptly take remedial action. In an ideally structured scheme of negligence liability the duty of inquiry would complement the duty to monitor. However until recently the courts set a very low standard of when directors suspicions should be aroused. The traditional exposition stated that suspicion would be aroused only when the directors:

> ...were cognisant of circumstances of such a character, so plain, so manifest, and so simple of appreciation, that no men with any ordinary degree of prudence, acting on their own behalf, would have entered into such a transaction as they entered into.[1323]

It was thought by many that this standard was too low.[1324] This standard virtually says that directors are only put on notice if something slaps them in the face. Many thought that directors should be obliged to pick up on much more subtle messages of trouble in the company and pursue them.

However in the *AWA* appeal[1325] the majority judges rejected the traditional approach and adopted a much more rigorous approach. The majority cited with approval the US case of *Rankin v Cooper* where it was said:

> If nothing has come to the knowledge of directors to awaken suspicion that something is going wrong, ordinary attention to the affairs of the institution is sufficient. If, on the other hand, directors know, or by the exercise of ordinary care should have known, any facts which would awaken suspicion and put a

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1321 Blair and Ramsay, 'Mandatory Corporate Disclosure Rules and Securities Regulation' in Walker and Fisse (eds.), *Securities Regulation in Australia and New Zealand* (Oxford University Press, Auckland, 1994) at 265.

1322 I pursue an aspect of this issue further in chapter 9 concerning the company's compliance with social laws.

1323 *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407 at 429; *AWA Ltd v Daniels trading as Deloitte Haskins & Sells* (1992) 7 ACSR 759 at 868.

1324 For example the Royal Commission into the Tricontinental Group of Companies, August 1992.

1325 *Daniels v Anderson* (1995) 13 ACLC 614.

> 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, in justice to those who deal with the [company], shut their eyes to what is going on around them.[1326]

So a more appropriate legal standard has now been recognised.

Unfortunately as with the previous category there are no compulsory disclosure obligations concerning this function of the directors. The previous suggestion that directors should report on the results of their monitoring and have a legal compliance program in place substantially covers the reporting obligations under this category. The only additional reporting that is necessary is directors should report whether they have taken action pursuant to their duty of inquiry and the consequences of taking any such action.

Informed Decisions

Australian cases have consistently recognised that directors are under a duty to properly inform themselves before they make a decision.[1327] This is another application of the pervasive view in our society that people act rationally, or should act rationally.[1328]

However the law does not impose any obligations on directors to disclose information on how they reached informed decisions. To address this issue the law should insist that the directors as a collective decision making body:

- record and keep copies of the information on which they based their decision;
- make a positive statement that in their opinion such information was reliable and the reasons for their opinion;
- give their opinion that they do not require any additional information in order to make a sound decision in the circumstances;
- state what the viable alternatives to their decision are and the reasons they are not preferred;[1329]
- express the reasons for taking the particular decision; and
- record any dissenting views and the reasons for those views.[1330]

If this discipline is imposed on directors it makes them responsible, as they should be, for the collective nature of their decision. I submit that it is unacceptable when a decision of the directors is subject to review for there to be significant disparity between the directors, not only as to why they reached a particular decision but also what they decided.[1331] It is also unacceptable for judges to excuse this and to state that the

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1326 Above at 663 to 664.

1327 *In Re Australasian Venezalana Pty Ltd* [1962] 4 FLR 60; *AWA Ltd v Daniels trading as Deloitte Haskins & Sells* (1992) 7 ACSR 759 at 864-865, 873; *Daniels v Anderson* (1995) 13 ACLC 614 at 668; see also *Smith v Van Gorkom* 488 A 2d 858 (Del 1985).

1328 Discussed in chapters 1 and 4.6 (in the context of the ECMH, which posits rational investment decisions).

1329 Note that this style of information must be provided to shareholders if they are asked to approve contentious matters in general meeting; see *Fraser v NRMA* (1995)15 ACSR 590 discussed in chapter 10.4.

1330 The last two points are justified more by the need for reasonable decisions, which is discussed under the next heading. However given they flow from the previous points it is logical to present them at this stage, although it does some chronological violence.

1331 *AWA Ltd v Daniels* (1992) 7 ACSR 759 at 780 to 789.

executives have the responsibility of reducing to writing the directors decision.[1332] I am strongly of the opinion that this is wholly inappropriate; directors should take responsibility for the collective nature of their decisions.

Certainly this will impose a more formal discipline upon directors in their decision making process. But it is warranted in that it forces the directors to consider whether they are exercising the necessary degree of care when making a decision. It also provides the type of information to enable the decision making process to be open to scrutiny by those affected by it.

This type of disclosure obligation would bring to the corporate context a similar discipline to that imposed on administrators who are obliged on application to provide the reasons for their decisions. As I argued in chapter 5, this type of disclosure regime is appropriate for companies. It is subject to the confidentiality rider previously discussed in that chapter, for these documents are likely to contain commercially sensitive information which is confidential to the company. As I stated earlier one option is to delay disclosure for a short period of time until confidentiality is lost or is less critical.

Requiring directors to provide reasons for their decisions is not totally foreign to corporate law. Directors must give reasons for their recommendations when companies are proposing a compromise or arrangement with members[1333] and when responding to a takeover concerning whether shareholders should accept or reject the offer to buy their shares.[1334]

Reasonable Decisions

So far those aspects of the duty of care I have examined principally concern how the Board operates and how decisions have been made and whether these processes were undertaken carefully. The last issue is whether there is a requirement that the decision itself must be reasonable. Of course a careful decision making process is more likely to lead to a better, reasonable decision but this result can not be guaranteed. If the decision itself must be reasonable, then the courts will be assessing the quality of the decision.

Unfortunately courts have consistently said they will not review the merits of a decision. This view has been expressed by both the High Court[1335] the Privy Council[1336] and the U.S. Supreme Court.[1337] It is also proposed to give this statutory recognition by adopting an explicit business judgement rule.[1338] At first glance this judicial attitude seems outrageous. Courts examine the merits of doctors' decisions to see if they are reasonable, they examine lawyers' decisions to see if they are reasonable. Why not directors' decisions?

1332 Above at 867.

1333 CL s412(1)(a), regulation 5.1.01 and schedule 8, part 3 clauses 8301(a)(i). See chapter 8.4. Prior to 1 July 1998, directors also had to give the reasons for proposing to give financial assistance for the acquisition of its own shares; CL s205(10)(c). The current provision, CL s260B, no longer requires this.

1334 CL s750 Part B clause 1 and Part D clause 1.

1335 *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483.

1336 *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821; see also re *City Equitable Fire Insurance Co Ltd* [1925] Ch 407 at 429.

1337 *Shlensky v Wrigley* 237 N.E.2d 776 at 780 (Ill. App. 1968). See Clark, *Corporate Law* (Little Brown & Co, New York, 1986) at 124.

1338 *Corporate Law Economic Law Reform Program Bill* 1998 (Cth) s180(2).

There seems to be three justifications for this approach.

(1) Courts say they are ill equipped to reassess business decisions. They lack the necessary business nous. This seems to be tied to some notion of the appropriate role of the court. They don't see it as their job to be an appellate board of directors. Otherwise the courts fear that a disgruntled party with a different management philosophy may appeal any business decision they dislike.

(2) Business decisions of their necessity involve risk taking.[1339] There is never a sure bet in business. Some managers are more conservative, others are more entrepreneurial and prepared to take bigger risks. A conservative may judge the amount of risk an entrepreneur is willing to take as unreasonable, but that doesn't mean a court of law should call the entrepreneur negligent. After all some entrepreneurs are spectacularly successful and make themselves and shareholders a lot of money. Some must inevitably fail, but that doesn't necessarily mean they have been negligent.

(3) There is a difference between a bad decision and a decision which turns out badly. A decision may be reasonable based on all the information available at the time it was taken. A bad result may eventuate simply because the business climate changes, a new competitor enters the scene or new technology is invented which renders the company's obsolete. But that doesn't mean the original decision was bad when it was taken. However there is the risk of hindsight bias (exaggerating the ability to predict a result when the result is already known) which affects any court decision.[1340]

These justifications are not persuasive. If a plaintiff can establish that the decision is unreasonable then the court should not bury its head in the sand — they should review it and call it unreasonable.

Nonetheless just because the court will not review the quality of directors' decisions does not mean shareholders should not receive information concerning this topic. In fact quite the opposite. If legal review is not available then if information is not available to enable shareholders themselves to assess the quality of a business decision the directors are effectively immunised from review. Many shareholders, particularly institutional shareholders, have the business expertise to assess the quality of the directors' decisions. They also have a range of self-help remedies, notably the power to remove directors,[1341] they can use without resort to the courts. For these reasons and complementary with the reforms suggested in the previous part, in my opinion directors should provide a positive statement that in their opinion the decision they took is the best decision for the company and the reasons they hold that opinion.

Individual Performance

Certainly directors act by majority and are a collective decision making body. However this section considers whether shareholders can or should receive systematic information about the performance of, and care taken by, individual directors. This is relevant for

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1339 Arkes and Schipani, 'Medical Malpractice v The Business Judgement Rule: Differences in Hindsight Bias' (1996-Spring) Defense Law Journal 59 at 94 to 95. These authors suggest other reasons as well but in my opinion the ones I have listed are the most important in Australia.

1340 Arkes and Schipani, 'Medical Malpractice v The Business Judgement Rule: Differences in Hindsight Bias' (1996-Spring) Defense Law Journal 59.

1341 Public companies CL s227; proprietary companies CL s226E (replaceable rule) and Table A cl 62, discussed in chapter 4.

two reasons. First, shareholders vote on the election of directors individually.[1342] Also directors are expected to bring their independent judgement to their role as a director.[1343] Second, although directors act collectively if a matter goes to court their liability is assessed individually.[1344] If directors make similar contributions then their liability will be similar. But for example a minority director who considers his or her colleagues are acting negligently and warns them accordingly and votes against the transaction will not be regarded as having breached the duty of care. Therefore is it appropriate for shareholders to be systematically provided with meaningful information on the individual performances of directors?

The only current disclosure obligation is that the Directors' Report must contain for the relevant financial year the total number of directors' meetings (and meetings of committees of directors) in the year and the number of meetings each director attended.[1345] Although this is a welcome recent development it is only a first, tentative step. It tells us how often a bum was in a seat, but nothing of the quality of an individuals contribution to the collective decision making process.

The difficulty is that it is very hard (and expensive) for an outsider to effectively assess the quality of an individual director's performance. Certainly in the case of directors who do very little then arguably a requirement that extensive minutes of directors meetings, if not tape recording or videoing, could counter this. The problem is these measures may be counter-productive; they may stifle open debate and jeopardise confidentiality. A more fundamental objection is that such measures may not squarely address the issue. A director may be actively exercising an individual judgement but merely expressing that in the vote. It is impossible to monitor the thought process. Second such measures only monitor the formal meetings. Anyone who has experience of collective decision making bodies knows that a lot of discussion occurs behind the scenes, often even before a proposal is formally put before the Board. The value of this cannot be under-estimated and is immeasurable by an outsider. Recording the proceedings of formal meetings may result in more informal discussions which would undermine its own purpose.

In my opinion there are no effective mechanisms that can be put in place to enable outsiders to monitor the quality of an individual directors contribution.[1346] As mentioned above, if directors are sued for breach of the duty of care their liability is assessed individually. However at this time the court has the advantage of compelling people to give evidence under oath which is tested by cross examination. It is not appropriate to translate the procedures of assessing liability involving great expense and time into a cost justified, periodic reporting requirement.

However is it possible that an insider to the Board could effectively monitor the performance of individual directors and report to shareholders accordingly?

1342 CL s225.

1343 This principle is supported by the fiduciary duty that prohibits directors from fettering their discretion; see *Thorby v Goldberg* (1964) 112 CLR 597.

1344 Note the individual assessment of each individual-director's performance and the different judgements of liability as between the nonexecutive directors and the CEO in *AWA Ltd v Daniels trading as Deloitte Haskins & Sells* (1992) 7 ACSR 759.

1345 CL s300(10)(b) & (c).

1346 However note that there is beginning to emerge a call for self and anonymous peer assessment of individual directors performance; see Conger, Finegold and Lawler, 'Appraising Boardroom Performance' (1998-Jan-Feb) Harvard Business Review 136 at 144 to 145. However this call is not directed to outsiders monitoring such performance.

Chairperson's Role

One of the Chairpersons roles is to ensure the Board is well balanced and composed of people with a broad range of expertise so it can function effectively.[1347] Clearly if one or more board members are not making a quality contribution then this will affect the overall performance of the Board and the Chairperson is likely to be aware of this. In this situation does the role of the Chairperson extend to take positive steps to deal with this situation and, if so, how far should or can the Chairperson go?

There is no doubt that the Chairperson could informally speak to the director in question. This may or may not occur in practice. If the director responds favourably, well and good. But if the director does not lift his or her performance, then what?

The Chairperson's position then becomes very difficult. Directors are peers. The Chairperson is merely one of them, indeed elected by them to fulfil a specific role.[1348] He or she is not in an employer/employee relationship in which there is a superior/subordinate relationship. In the employment relationship the employer has the right to discipline and ultimately dismiss a recalcitrant employee. Certainly neither the directors collectively nor the Chairperson alone have the power to remove their fellow directors. In my opinion to preserve the independence of directors and to ensure they are the representatives of shareholders the chairperson should not have the power to remove directors. But could the chairperson simply report to shareholders concerning the performance of individual directors, either with or without a recommendation concerning re-election or removal?

Referring back to the sporting team analogy, the coach has a role to assess individual performance and if a player is not performing adequately or simply does not fit the team then the coach, usually in conjunction with a panel of selectors, can drop the player from the team. However this type of discipline relies on replacement players waiting in reserve and being ready, willing and able to immediately enter the team. This scrutiny of performance enables the best team to be assembled on an ongoing basis. Can the chairperson be equated with the coach? As stated above, directors are peers and the chairperson has no power to remove his or her fellow directors. If a chairperson had such power there is the risk that the power could be used capriciously whenever there are factions on the board or even an individual who is consistently expressing strong opinions contrary to that of the chairperson. This risk is greater on a board of directors than in a sporting team. On a sporting team the performance of individual players is transparent to the teams management and fans and a capricious decision would appear to be so and therefore much harder to justify. As I have already demonstrated, it is impossible for the outside constituents to independently assess the performance of individual directors. Even the power to report could be used capriciously and the targeted director could face an insurmountable barrier of prejudice against his or her re-election. In my opinion the value of directors being independent and being able to freely voice their opinions is jeopardised by equating the chairperson with a coach and therefore no additional role for the chairperson should be made.[1349] Also as a matter of human

1347 Pease and McMillan, *The Independent Non-Executive Director* (Longman Professional, Melbourne, 1993) at 64; Ford, *Guidelines for Directors in Australia* (Institute of Directors in Australia, Australia, 2nd ed., 1986); Cadbury, *The Financial Aspects of Corporate Governance* (Gee & Co, Great Britain, 1992) at para 4.7; Cadbury, *The Company Chairman* (Director Books, UK, 2nd ed, 1995) at 14 to 18.

1348 Table A, cl 75(1).

1349 Cadbury, *The Company Chairman* (Director Books, UK, 2nd ed, 1995) sees no such role for chairpersons either.

nature it is very difficult for peers to "dob on their mates", particularly to the extent of taking action that may lead to their removal. If this form of peer assessment was introduced, then this would undermine the unity of the Board which would be extremely counter productive. Indeed it would entirely undercut the chairperson's position as an insider of the board; the chairperson would no longer be one of a group of peers.

I submit that the desire for systematic information on individual director's performance is not that critical an issue to warrant the introduction of reform to enable this to occur. Although shareholders vote on directors individually they are ultimately interested in and concerned about the performance of the Board as a collective body and in turn the performance of the company. Therefore the performance of individual directors is not critical. Boards act as collective bodies and can probably tolerate a substandard contribution from one or two directors (depending on the size of the Board). Although not ideal, a Board can get away with one or two freeloaders.

Loyalty

There is a range of situations where, because of the nature of the decision being undertaken, directors have an inherent conflict between their personal interests and the interests of the company (or a conflict of duties). The common law traditionally took a very strict approach and absolutely prohibited any such conflict,[1350] although some moderately recent cases have taken a more pragmatic and lenient position.[1351] There are also two statutory regimes for dealing with conflicts of interest which takes a more pragmatic view.[1352] The caveat to this strict position is that the shareholders can always modify this strict position if they so agree. This is commonly achieved by express terms in the constitution.[1353]

These situations of conflicting personal interests with duties to the company fall into distinct categories which can be separately analysed. Different commentators categorise the various situations in different ways and with any categorisation there will be significant overlap between the categories. However I prefer the categorisation adopted by Lipton and Herzberg in their textbook which I use below.[1354] Those categories are interests in company contracts, personal profits (including remuneration), transactional conflicts, competing with the company, interests in shares and options and then the statutory provisions of related party provisions and s232A.

Contracts

Sometimes a director is a contracting party with the company. Clearly in this situation the directors' personal interest is to negotiate the best terms (including price) from his or her perspective. However whilst acting as a director he or she should be negotiating for the best terms for the company; for the opposite result. The conflict is obvious. The common law strictly prohibited such conflicting interests in corporate contracts.[1355] However corporate constitutions usually allow directors to have an interest in a contract

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1350 *Aberdeen Railway Co v Blaikie Bros* [1843–60] All ER Rep 249; *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378.

1351 *Queensland Mines v Hudson* (1978) 52 ALJR 399; *Woolworths Ltd v Kelly* (1991) 9 ACLC 539.

1352 CL s232A and CL chapter 2E.

1353 See for example Table A, clauses 63, 65(e), 71 & 80.

1354 Lipton and Herzberg, *Understanding Company Law* (Law Book Company, Sydney, 7th ed., 1998) at 392 to 418. See also Austin, 'Fiduciary Accountability for Business Opportunities' in Finn (ed), *Equity and Commercial Relationships* (Law Book Company, Australia, 1987).

1355 *Aberdeen Railway Co v Blaikie Bros* [1843–60] All ER Rep 249.

so long as they disclose that interest to their fellow directors and do not vote on the resolution about that contract.[1356]

The Corporations Law requires disclosure in the directors' report of particulars for each director of any personal interest in a contract or proposed contract with the company.[1357] However there is no disclosure as to price, terms or whether a better contract could be obtained from an arms length party (or whether such an attempt had been made, for example by a tender process). Disclosure of such contracts is also required under related part disclosures (discussed below) and possibly the continuous disclosure regime (discussed in chapter 10.2).[1358]

In addition to these general disclosure obligations the law requires certain transactions between the company and related parties involving significant assets[1359] and contracts where a conflict of interest permeates the whole Board[1360] to be approved by shareholders. In these situations shareholders will receive more detailed information with the notice of meeting which convenes them to consider the matter.[1361]

Personal Profits (Including Remuneration)

Directors are not entitled to personally profit from their office as director.[1362] This rule may seem like a throwback to a more genteel age but it nonetheless still represents current law. This strict position can be modified by the corporate constitution.

To match this legal requirement the directors' report must include details of any benefit which the director has received or is entitled to receive under a contract with the company (mentioned above).[1363] This broad requirement is generally adequate except that it does not explicitly require the value of the benefit to be disclosed. This is ameliorated to some extent by other rules which require more detailed disclosure. First, if the personal profit arises out of a transaction the director has with their company then disclosure is required under AASB 1017 (discussed below under the heading 'Related Party Transactions'). Second, there are more detailed rules about disclosure of directors'

1356 Table A, clauses 65(e) & 71. See also CL s232A discussed below.

1357 CL s300(11)(d).

1358 Listing Rule 3.1 (where an example of the types of continuous disclosure required is "an agreement between the entity (or a related party or subsidiary) and a director (or a related party of the director)". Previously Listing Rule 3C(3)(d) required disclosure in the annual report of 'any material contracts involving directors interests'. However subsequent provisions of this Listing Rule seemed to limit its scope to loans to directors This Listing Rule generally required disclosure of the amount of the loan, the interest rate, the terms as to payment of interest and repayment of principal and the security provided. This detail of disclosure was not required if the loans were to full time employees in which case disclosure of just the number and total amount of all such loans and their range in value was required. This Listing Rule was supported by Listing Rule 3L(5) which required disclosure to the stock exchange without delay of any material contract involving directors interests. The disclosure had to include particulars of the contract and the directors interest in the contract. These disclosure requirements did not require the value of the contract to be disclosed and whether it was on arms length terms or favourable terms (and if so the reasons for the favourable terms).

1359 Listing Rules 10.1 to 10.3.

1360 Corporations Law 232A requires shareholders to approve any transaction where the directors as a group are unable to consider the matter because of a conflicting material personal interest.

1361 See chapter 10.4.

1362 *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378; *Green and Clara Pty Ltd v Bestobell Industries Pty Ltd* [1982] WAR 1; *Guinness Pty Ltd v Saunders* [1990] 1 All ER 652.

1363 CL s300(11)(d).

remuneration, which is the most common way in which directors' profit from their office (which I discuss next).

Directors' remuneration is the most controversial and high profile issue in this category.[1364] Remuneration as a personal profit stems historically from the position of directors holding honorary positions with no remuneration paid (or only a modest honorarium and perhaps expenses).[1365] In the modern era properly approved remuneration is an exception to the general prohibition against making a profit only because the constitution permits such remuneration when approved by the shareholders.[1366] Therefore shareholders are aware of the level of the directors' remuneration at the time they approve it in general meeting.

For financial years ending on or after 1 July 1998,[1367] the directors' report must include:

(a) discussion of broad policy for determining the nature and amount of emoluments of board members and senior executives of the company; and

(b) discussion of the relationship between such policy and the company's performance; and

(c) details of the nature and amount of each element of the emolument of each director and each of the five named officers of the company receiving the highest emolument.[1368]

This new provision will ensure adequate disclosure of the remunerations of the directors and the top executives. Paragraph (a) is similar to an item in the indicative list of corporate governance practices under the listing rules. This item includes a suggestion that the statement disclose "the main procedures for establishing and reviewing compensation arrangements" for the executives and directors (including details of the remuneration committee, if there is one).[1369] A recent study found that most companies made a disclosure under this item and the most companies had a remuneration

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1364 Hill, *Remuneration Disclosure in Australia* (Australian Investment Managers' Association, Sydney, 1996) at 2.

1365 *Re George Newman and Co* [1895] 1 Ch 674 per Lindley LJ at 686.

1366 Table A, cl 63; see also CL s236A - replaceable rule. LR 10.17 also requires shareholders to approve any increase in directors remuneration (discussed in chapter 4).

1367 CL ss 1412 & 1431.

1368 CL s300A; see also ASIC, *Practice Note 68: New Financial Reporting and Procedural Requirements*, 1 November 1998 at paragraphs 54 to 71. The section only applies to listed companies incorporated in Australia (CL s300A(2)). The provision in the Corporations Law was inserted as part of the *Company Law Review Act* 1998 (Cth) only at the insistence of the Labour Party and the Democrats in the Senate. The amendments were agreed to and passed by the government but less than 2 weeks later the government asked the Parliamentary Joint Committee on Corporations and Securities to examine it (although not explicitly saying the government opposed the amendment, as it did with some others); letter from the Treasurer Mr Peter Costello to the chair of the Parliamentary Joint Committee on Corporations and Securities date 10 July 1998.

Paragraph (c) seems to have derived from a recommendation of AIMA (now IFSA) concerning executive remuneration, namely:

> The Board should disclose in the company's annual report its policies on and the quantum and components of remuneration for all directors and each of the 5 highest paid executives. The disclosure should be made in one section of the annual report in tabular form with appropriate explanatory notes.

Australian Investment Managers' Association, *Corporate Governance: A Guide for Investment Managers and Corporations* (AIMA, Sydney, 2nd ed., 1997) at paragraph 3.10; see also Hill, *Remuneration Disclosure in Australia* (Australian Investment Managers' Association, Sydney, 1996) at 28.

1369 LR Appendix 4A at paragraph 5.

committee.[1370] However the study also found that beyond this the "level of disclosure varied widely".[1371] Once again, given the non-mandatory nature of such disclosures this is not surprising. The new measure is mandatory so in future all companies will have to comply with it.

In addition to this new requirement, the Accounting Standards require disclosure on a regular basis of the amount of directors[1372] and executives[1373] income. The need for disclosure is regarded as more important than the directors and executives' right to privacy in this information.[1374] The financial statements must disclose the aggregate income of all the directors and the number of directors whose income falls within different levels (bands of $10,000). The same disclosure is required of executives who earn over $100,000.[1375] Income is broadly defined[1376] and interpreted[1377] although there are some exceptions to disclosure. Those exceptions are out of pocket expenses incurred for the benefit of the company,[1378] certain payments made by foreign entities to people not resident in Australia,[1379] and remuneration paid to executives who worked outside Australia.[1380]

To some extent these requirements are sufficient. It is irksome that precise amounts are not identified nor who earns what. Generally it is possible to piece together which directors earn what (the CEO invariably earns the most, sometimes the chairperson earns more and the rest of the directors roughly the same). It is more difficult to work out which executives earn the amounts disclosed depending on how many earn over $100,000 and the extent of voluntary disclosure of their identity (a problem mentioned earlier in this chapter). If shareholders have a legitimate interest in the identity of the executives, their functions and their performance then you would expect explicit disclosure of who earns how much. This would help shareholders to ascertain whether executives are being properly remunerated given their responsibilities in the company. It seems that Parliament has decided that the issue of executive remuneration is important but has left the pie half-uncooked. Shareholders should not be left in the unenviable, if not impossible, position of trying to piece together the identity of the executives and how much each is paid. That is, it is preferable that the directors and executives are identified

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1370 Ramsay and Hoad, *Disclosure of Corporate Governance Practices by Australian Companies* (Centre for Corporate Law and Securities Regulation, Melbourne, 1997) at 16 to 18.

1371 Above at 17.

1372 AASB 1017 'Related Party Disclosures' paragraph 4.2 (formerly clause 25 of schedule 5 to the CL Regulations).

1373 AASB 1034 'Information to be Disclosed in Financial Reports' at paragraph 12 (formerly clause 29 of schedule 5 to the CL Regulations).

1374 *Re Australian Newsprint Mills Ltd* (1988) 6 ACLC 1205; ASIC Policy Statement 43 'Accounts and Audit Relief' at paragraphs 28 to 33.

1375 AASB 1034 'Information to be Disclosed in Financial Reports' at paragraph 12.1(a) (formerly Clause 29(2)(a) of schedule 5 to the CL Regulations).

1376 AASB 1017 'Related Party Disclosures' paragraphs 4.5 and 4.6; AASB 1034 at paragraph 12.3.

1377 UIG Abstract 14 'Directors' Remuneration' has clarified some potential interpretation difficulties involved with AASB 1017 and resolves those potential inconsistencies generally in favour of increased disclosure.

1378 AASB 1017 'Related Party Disclosures' paragraph 4.6(a); AASB 1034 at paragraph 12.3(c).

1379 AASB 1017 'Related Party Disclosures' paragraph 4.6(b) and (c); AASB 1034 at paragraph 12.3(d).

1380 AASB 1024 'Consolidated Accounts' at paragraph 12.3(a). This exception has been criticised; see Hill, *Remuneration Disclosure in Australia* (Australian Investment Managers' Association, Sydney, 1996) at fn 79. See also column 2 to the attachment to UIG Abstract 14 'Directors' Remuneration'.

by name and the amount of their remuneration is precisely disclosed.[1381] This will occur for the top 5 executives under the new reporting requirement in the directors' report but not the other executives. It is also as yet unclear whether these accounting standards will be amended to dovetail more closely with the new reporting requirement, which would seem sensible.

A more stinging criticism traditionally related to performance based remuneration. Performance based remuneration is seen as a way to align the interests of shareholders and directors. This type of remuneration structure is a key indicator in the corporate governance puzzle.[1382] Therefore shareholders have a legitimate interest in receiving information on the components of remuneration and details on any that is performance based.[1383] Traditionally whether the remuneration of directors and executives is performance based and if it is, details of it, is not disclosed to shareholders at all.[1384] This was seen as a glaring omission.[1385] This has now been addressed by the new requirement in the directors' report. Such disclosures by all companies will enable comparability between the level and type of remuneration in different companies.[1386]

In addition to this regular flow of information, 10% of the shareholders or shareholders who own 5% of the company's issued shares have a statutory right to request an audited statement of directors remuneration.[1387] This is a curious provision and it is difficult to understand how the threshold was arrived at.[1388]

As part of their remuneration directors and executives commonly participate in an employee incentive scheme involving the issue of shares or options over shares in the company. However I defer considering this aspect of conflicting interest until later in this chapter.[1389]

Part of remuneration is the benefits the person will receive upon retirement. There are substantive requirements concerning the amount of retirement benefits which can be given to directors and executives, backed up by certain disclosure obligations. The Corporations Law requires shareholders to approve certain prescribed benefits for loss of,

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1381 Hill, *Remuneration Disclosure in Australia* (Australian Investment Managers' Association, Sydney, 1996) at 15 to 16; Greenbury Committee, *Directors' Remuneration* (Gee Publishing, UK, 1995) at [5.8] to [5.11].

1382 Jensen and Murphy, 'CEO Incentives-It's Not How Much You Pay, But How' (1990) May Harvard Business Review 3.

1383 Hill, *Remuneration Disclosure in Australia* (Australian Investment Managers' Association, Sydney, 1996) at 9 to 11.

1384 It is possible to, and some companies do, structure performance based remuneration on non financial measures as discussed in the next part of this chapter; see Brancato, *New Corporate Performance Measures* (The Conference Board, New York, 1995) at 46 to 49.

1385 Australian Investment Managers Group, 'Newsletter No 2', July 1994 at 6; Hill, *Remuneration Disclosure in Australia* (Australian Investment Managers' Association, Sydney, 1996) at 18.

1386 Hill, *Remuneration Disclosure in Australia* (Australian Investment Managers' Association, Sydney, 1996) at 12 and 18 to 19.

1387 CL s239.

1388 The 5% threshold is the same in the statutory right for members to convene a shareholders meeting (CL s249F) and to requisition the directors to convene a meeting (CL s249D). However this may be compared with the statutory right to inspect books where there is currently no threshold requirement (CL s247A, discussed in Chapter 10.3).

1389 See below under the sub-heading "Interests in Shares and Options".

or retirement from, office.[1390] Once again shareholders will receive information at the time of their general meeting to approve such benefits. Also and on a regular basis disclosure must be made, as a note to the annual financial statements, of the actual payment of a prescribed benefit to the directors (but not other executives!)[1391] or their respective superannuation funds.[1392] But this leaves gaps in the information which shareholders receive. They do not receive information about prescribed benefits that do not require shareholder approval, which the directors have agreed will be given to themselves or the executives. The amount of such benefits can be significant.[1393] So once again insufficient detail is provided to shareholders about exactly what has been given (or agreed to be given) and to whom. This additional information should be provided.

Another criticism is that the disclosure obligations are spread amongst a range of reporting rules which leads to a scattering of information in a variety of places.[1394] This clearly affects the quality of the information disclosed, notably its accessibility and hence its comparability and understandability. In my opinion detailed changes should be introduced so complete disclosures are made so that all of the criticisms made above are met.

Transactional Conflicts

Many conflicts of interest arise out of particular transactions that present themselves to the company. These situations are categorised by Lipton and Herzberg as involving bribes and other undisclosed benefits, misuse of company funds, misuse of corporate confidential information[1395] and taking up a business opportunity.[1396] These headings are self-descriptive and I offer no further elaboration. Some instances of personal profits also involve transactions with the company and such cases can also be considered in this category.[1397] All of these transactional conflicts are more often than not one-off instances of a breach of the duty of loyalty but sometimes the problem may be of repeated or systemic breaches. However often these transactions involve contracts between the director and the company and so long as the procedure prescribed in the constitution and section 232A of the Corporations Law are followed there will not be a breach of duty. Nonetheless instances of such procedures being used should be reported together with appropriate details of the underlying transactions.

1390 CL s237. In addition Listing Rule 10.19 provides that shareholders must approve service contracts which provide for termination benefits that exceed in aggregate 5% of the equity interests of the company.

1391 See the definition of "prescribed office" in CL s237(19).

1392 AASB 1017 'Related Party Disclosures' at paragraphs 4.7 to 4.9; AASB 1034 'Information to be Disclosed in Financial Reports' at paragraph 12.3(b).

1393 One of the exceptions to CL s237 allows the last three years remuneration for directors and the last 7 years for executives to be given without shareholder approval; CL s237(6) (The exception is not as straight forward as this, but broadly speaking this is accurate). See chapter 4.3.

1394 Hill, *Remuneration Disclosure in Australia* (Australian Investment Managers' Association, Sydney, 1996) at 21 to 22; Greenbury Committee, *Directors' Remuneration* (Gee Publishing, UK, 1995) at [5.4] recommends that such disclosures should also occur in one place.

1395 This category is backed up by a statutory prohibition on misuse of confidential information contained in CL s232(5).

1396 Lipton and Herzberg, *Understanding Company Law* (Law Book Company, Sydney, 7th ed., 1998) at 406 to 413.

1397 *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378; *Green and Clara Pty Ltd v Bestobell Industries Pty Ltd* [1982] WAR 1; *Guinness Pty Ltd v Saunders* [1990] 1 All ER 652.

In these breach of loyalty situations possibly no rules will prevent the breaches from occurring and they are usually accompanied by a degree of covertness. I demonstrated that the same characteristics existed in the duty of honesty and in my opinion they both should be treated in the same way. That is directors should be obliged to provide information to shareholders of the systems they have in place to prevent and detect such breaches of loyalty. Also directors should report any instances of breaches of loyalty and what action they have taken as a consequence. Some of these transactional conflicts will involve a transaction between the director and the company. Others will not, for example taking a bribe from a party who is dealing with the company and all cases of corporate opportunities. Those conflict situations that involve a transaction between the director and their company is subject to the disclosure regime set out in AASB 1017 (discussed below).

Closer examination of one of these types of transactional disloyalty is necessary. Corporate opportunities involve a business opportunity that comes to the company in circumstances where the opportunity is properly regarded as the company's opportunity and not any of its officers. If an officer simply usurps the opportunity there is no reason to treat this type of disloyalty any differently than other types of transactional disloyalty. However sometimes the Board of Directors will either revoke the opportunity or explicitly consent to the director personally taking up the opportunity. If this occurs the law says that the director has not breached the duty of loyalty.[1398] As a matter of principle this may well be correct and certainly represents current and accepted authority. Given this state of the law in my opinion shareholders should receive information whether the board has revoked any such opportunity[1399] or consented to an officer personally exploiting a corporate opportunity (including a description of the opportunity) and give their reasons.

Competing With the Company

It would be consistent with the strict rule of not allowing a conflict of interest and duty to prohibit a director from working for one of the company's competitors. Arguably there is no greater potential for conflict. However the law in this area is not particularly clear but certainly the law has not said that directors are comprehensively prohibited from competing with their company. The law seems to be different for non-executive and executive directors.

There are old and recent authorities which clearly say that non-executive directors are not prohibited from acting as directors of a rival company.[1400] The reasoning seems to be that the responsibilities of non-executive directors are of an intermittent nature. They are only part-timers, it is up to them how they spend the rest of their time. Nonetheless the courts insist that the directors do not disclose any confidential information of one

1398 *Queensland Mines v Hudson* (1978) 52 ALJR 399; *Peso Silver Mines Ltd (NPL) v Cropper* (1966) 58 DLR (2d) 1; *Canadian Aero Service Ltd v O'Malley* (1973) 40 DLR (3d) 371.

1399 Boards may argue that they do not take up many business opportunities and do not know (and perhaps do not particularly care) whether officers take the opportunity themselves. They would not want to be saddled with this type of extra disclosure obligation. However such a disclosure obligation is warranted given the importance to shareholders of this type of information. Shareholders are particularly vulnerable to abuses arising from a breach of loyalty and human nature suggests officers are particularly tempted by such opportunities. Such a disclosure obligation is consistent with the disclosure obligation proposed under the duty of care and in fact would not impose any additional obligation on the directors.

1400 *London and Mashonaland Exploration Co Ltd v New Mashonaland Exploration Co Ltd* [1891] WN 165; *Rostex Company Pty Ltd v Licata* (1994) 12 ACSR 779 at 782-783; *On the Street Pty Ltd v Cott* (1990) 3 ACSR 54.

company to the other. So such directors must still comply with that aspect of the duty of loyalty. This approach also accords with the commercial realities; non-executive directors act for competing companies.

However this conflicts with the reasoning used in some cases. In *Imperial Mercantile Credit* the reasoning in the Court of Appeal was that "the company have a right to the services of their directors, whom they remunerate by considerable payments; they have a right to their entire services...".[1401]

As a matter of principle these two approaches cannot be reconciled. Just because a director is a part-timer does not mean he or she is entitled to be disloyal by working for a competitor. Certainly directors could act for companies in a different line of business; no problem at all. The bottom line though is that the law is not consistent in this area.

The position of executive directors seems to be different. It is an implied term of their contract of employment that they do not compete with their company. These people are expected to work full-time for their company. This proposition comes from the general law of employment which provides that where employees have specialist skills they are said to owe a duty of fidelity.[1402]

As mentioned previously, prior to 9 December 1995[1403] directors had to disclose any directorships they held in any other public company or their subsidiaries.[1404] This requirement went to the qualifications directors held for their position[1405] but also highlighted any competing directorships. Unfortunately the disclosure requirement did not go to any other form of relationship the director may have had with a competitor such as a consultant, adviser or even employee. Also there were no disclosure obligations imposed on the executives. In these ways the previous law was inadequate but was certainly better than no such disclosure, which is the current position. The current position is clearly inadequate.

Interests in Shares and Options

Although not one of Lipton and Herzberg's categories, directors owning shares in the company also raises a potential conflict of interest. The problem arises because directors have the power to issue shares and other securities.[1406] The risk is that the directors will issue shares to themselves on advantageous terms or to an inappropriate extent.[1407] For example the purchase price (or exercise price for options) may be at a sharp discount to the prevailing market price or the terms may otherwise be unduly favourable. Favourable terms can include the issue of partly paid shares or providing loans to managers to fund the purchase.[1408]

1401 *Imperial Mercantile Credit Association v Coleman* (1871) LR 6 Ch App 558.

1402 *Hivac Ltd v Park Royal Scientific Instruments Ltd* [1946] 1 All ER 350; *On the Street Pty Ltd v Cott* (1990) 3 ACSR 54; *Green and Clara Pty Ltd v Bestobell Industries Pty Ltd* [1982] WAR 1 at 19; but cf the result in *Peninsular and Oriental Steam Navigation Co. Ltd v Johnson* (1938) 60 CLR 189.

1403 The date of operation of the *First Corporate Law Simplification Act* 1995 (Cth).

1404 Previously CL s242(2).

1405 See chapter 7.2 above.

1406 Table A, cl 2.

1407 This risk is recognised in paragraph (xxvi) of AASB 1017 'Related Party Disclosures'.

1408 In which case substantive related party rules apply; CL chapter 2E (loans to directors were formerly dealt with by CL s234).

On the other hand it is generally regarded as good for managers to own shares in their company.[1409] If they own shares then their interests are more closely aligned with other shareholders.[1410] So the issue can not be put in black or white terms; it is a question of degree, but in an area where there is clearly a high risk of excess.

Section 235 of the Corporations Law provides a disclosure regime about the interests directors have in shares in their company. Section 235(1) provides:

> A director of a listed company must notify the [ASX]....of the following interests of the director:
>
> (a) relevant interests in shares of the company or of a related body corporate
>
> (b) relevant interests in debentures of, or interests in a registered scheme made available by, the company or of a related body corporate
>
> (c) rights or options over shares in, debentures of, or interests in a registered scheme made available by, the company or of a related body corporate
>
> (d) contracts to which the director is a party or under which the director is entitled to a benefit and that confer a right to call for or deliver:
>
> (i) shares in; or
>
> (ii) debentures of; or
>
> (iii) interests in a registered scheme made available by;
>
> the company or of a related body corporate.

The notice to the ASX for paragraphs (a) and (b) must "give details of the nature and extent of the relevant interest".[1411]

For financial years ending after 1 July 1998, as part of the directors' report, disclosure is required of details for each director of their relevant interests in shares, debentures and options of, and interests in a registered scheme made available by, the company.[1412] There is also an overlapping but slightly different requirement set out in AASB 1017.[1413] AASB 1017 requires a similar disclosure as notes to the financial statements but only about directors interests in shares, units, options and other equity investments (but not of debentures or prescribed interests). Under AASB 1017 details must be given of such directors' interest as at the balance date for the financial year.[1414] Also under AASB 1017, "the nature of the terms and conditions" of transactions involving such interests must be disclosed "if on terms and conditions more favourable than those which it is reasonable to expect the [company] would have adopted if dealing with the holder at arm's length in the same circumstances".[1415] This qualification is fair enough as the concern is with transactions on favourable terms. Nonetheless only having to disclose

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1409 Farrer and Ramsay, 'Director Share Ownership and Corporate Performance - Evidence From Australia' (1998) 6 Corporate Governance: An International Review 233 undertook empirical research on this issue in Australia. Their qualified conclusion was that the "results, although to some extent inconclusive, suggest there may be a link between director shareownership and performance".

1410 Stewart, 'Remaking the Public Corporation From Within' (1990) 4 Harvard Business Review 126 at 127 to 129; Ramsay, 'Directors and Officers Remuneration' [1993] Journal of Business Law 351 at 359 to 360 and 362; Eisenberg, 'The Structure of Corporation Law' (1989) 89 Columbia Law Review 1461 at 1493 to 1495.

1411 CL s235(2). Also in the directors report issued each year the disclosures made under section 235(a) must be repeated; CL s300(11).

1412 CL s300(11).

1413 AASB 1017 'Related Party Disclosures' at paragraphs 4.15 to 4.16.

1414 AASB 1017 'Related Party Disclosures' at paragraph 4.16.

1415 AASB 1017 'Related Party Disclosures' at paragraph 4.15(c).

the nature of the terms and conditions may leave directors with room to manipulate the disclosure made to hide if not camouflage favourable terms. Neither disclosure requirement explicitly requires price or value to be disclosed. This is a significant shortfall in the disclosure regime.[1416] It remains to be seen if the accounting standard will be amended to more closely mesh with the new reporting requirement in the directors' report.

I have previously mentioned one way directors and executives commonly obtain such interests. They commonly participate in an employee incentive scheme involving the issue of shares or options over shares in the company as part of their remuneration. The establishment of these schemes[1417] and each time directors (but not executives) participate in the scheme[1418] must be approved by shareholders. Therefore at this time shareholders will receive adequate information.

These requirements provide moderately adequate disclosure but only on a bare bones basis. None of these rules explicitly requires the purchase price or other (potentially advantageous) terms to be disclosed. Sometimes price can be worked out because the purchase is made under an employee or executive share plan. But shareholders should not be forced to act as detectives. In my opinion the price and other terms of all interests directors have in securities of the company should be disclosed to shareholders. Also there are glaring gaps in the disclosures, most notably there is no disclosure of executive interests at all. This is inappropriate given this will often be an important part of their remuneration package. Particularly when it is an identified concern "how many shares are issued to them, at what price and whether this excessively dilutes the holdings of existing shareholders".[1419]

Related Party Transactions

The previous categories describe the general law duty of loyalty reinforced by section 232(5) & (6) of the Corporations Law. There is a parallel[1420] statutory regime called the related party provisions which attempts to deal with some aspects of the duty of loyalty in a black letter law way. This regime was introduced with effect from 1 February 1994 due to perceived serious abuses by directors of their company's funds and assets in the 1980's, despite the strict general law duty of loyalty and sections 232(5) and (6). Directors were still transferring funds away from their companies and into their own hands. The government responded by introducing "related party provisions" into the Corporations Law.[1421]

The basic prohibition is in section 243H which provides that a public company or any of its child entities must not give a financial benefit to a related party. Financial benefit is defined extremely broadly.[1422] Also related party is broadly defined.[1423] The directors of the company or its parent entity are related parties as are those directors' spouses or

1416 Hill, *Remuneration Disclosure in Australia* (Australian Investment Managers' Association, Sydney, 1996) at 17 and 28.
1417 LR 7.37, mentioned above under the sub-heading "Personal Profits".
1418 LR 10.14.
1419 Above in chapter 4.3.
1420 CL s243ZI(3) makes it clear that chapter 2E operates in addition to any other duty imposed by law.
1421 At the time this was the new Part 3.2A, now chapter 2E.
1422 CL s243G.
1423 CL s243F.

defacto spouses, their parents and children and any entity these people control.[1424] Notably the executives are not related parties. A number of transactions are exceptions to the general prohibition, the most notable being:

- reasonable remuneration to a director or officer;[1425] and
- financial benefits to related parties on no more favourable terms than can be agreed with a party at arms length.[1426]

The only other way financial benefits can be given to related parties is if the shareholders approve it.[1427] At this time shareholders receive adequate information.[1428]

The Corporations Law itself does not require any particular disclosure of related party transactions. However AASB 1017 'Related Party Disclosures' requires certain disclosures. I have already mentioned some of these specific disclosures relating to the identity of the directors, their remuneration and retirement benefits and their share and share option holdings. There are more general disclosure requirements in this standard, the broadest of which relates to any transaction the directors enter into. This requirement provides:

> ...[W]here there have been transactions during the financial year with directors of the [company]...the financial report must disclose the following in respect of those transactions;
>
> (a) each different type of transaction;
>
> (b) the nature of the terms and conditions of each different type of transaction; and
>
> (c) for each combination of type of transaction and nature of terms and conditions:
>
> > (i) the names of the directors concerned; and
> >
> > (ii) the aggregate amount recognised.[1429]

This catch all standard is backed up by other standards requiring disclosures about loans to directors[1430] and about certain items appearing in the profit and loss statement or balance sheet that relate to transactions with directors.[1431] Detailed disclosure is required unless the transaction is on no more favourable terms than an arms length transaction, involves trivial amounts or is of a domestic nature and will not either adversely affect users of the financial statements or the discharge of accountability by the directors if disclosed by general description.[1432] This relaxation of the standard, although involving some fuzzy terms, is acceptable given the size and nature of the amounts involved and the requirement of it being on no more favourable terms than an arms length transaction. After all the concern under the duty of loyalty is that directors will engage in transactions on favourable terms with themselves. Shareholders are still informed of the transaction but not in the same detail. This is a concession to the problem of information overload. The only difficulty with relaxing the disclosure requirement is that in the first instance

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1424 Remoter relatives and friends of the directors are not related parties.

1425 CL s243K.

1426 CL s243N. This is different than the general law approach under conflict of interest rules (and under the duty of care) where the courts do not examine the fairness of the transaction. Under this exception the courts will have to compare this transaction with other transactions

1427 CL s243Q. Noticeably if the related party owns shares in the company they are unable to vote upon the matter (CL s243ZF).

1428 See chapter 10.4.

1429 AASB 1017 'Related Party Disclosures' at paragraph 4.17.

1430 AASB 1017 'Related Party Disclosures' at paragraphs 4.10 to 4.14.

1431 AASB 1017 'Related Party Disclosures' at paragraph 4.18.

1432 AASB 1017 'Related Party Disclosures' at paragraph 4.19.

the directors themselves decide whether the conditions are satisfied to warrant disclosure just by general description. Inevitably there will be borderline cases and directors may err on the side of providing information only by general description. One way around this dilemma to allow disclosure by general description but to insist that fuller details or the documents which record these transaction be made available for inspection. These documents would also be subject to the confidentiality requirements previously discussed. Of course, given disclosure occurs in the financial statements, the auditors may disagree with the proposed disclosures to be made by directors and insist on greater disclosure. There is guidance for auditors to assist them in auditing relevant related party information.[1433]

Under these broadly drafted standards adequate general disclosure of related party transactions now occurs. However I object to the introduction of the vague qualifying words of "the type of transaction" and "the nature of the terms and conditions". I appreciate that these qualifications were introduced so that the financial statements do not become unduly prolix. But such vague qualifications give directors latitude to manipulate the disclosure made and may enable them to camouflage or hide particularly favourable terms. A suitable compromise would be to retain the qualifications but insist on the same disclosure mentioned in the previous paragraph. That is make the documents which record the transaction available for inspection (subject to confidentiality requirements). Also there is no explicit disclosure requirement of price or value which for the same reasons as stated elsewhere is a serious flaw in the disclosure regime.

Section 232A

Section 232A of the Corporations Law prohibits a director of a public company who has a material personal interest in a matter that is being considered at a board meeting from voting on the resolution or being present while the matter is being discussed. There are two exceptions to this prohibition. Exceptions to the prohibition are the personal interest a director has as a shareholder in common with other shareholders[1434] and in a contract for directors' professional liability insurance.[1435] If the directors' meeting is inquorate because some or all of the directors are subject to the prohibition then the shareholders can approve that item of business at a general meeting.[1436] At this time shareholders would receive appropriate information.[1437]

In my opinion the directors should disclose to shareholders the occasions when section 232A operates and details of the transaction involved (including the value of the transaction). Shareholders would then be able to have an opinion on the wisdom of the transaction, for there is the risk it was approved by the other directors out of a sense of cronyism. Also too substantial or too frequent declarations may suggest the person should no longer be a director.[1438]

1433 AUS 518 'Related Parties'.
1434 CL s232A(2).
1435 CL s232A(3).
1436 CL s232A(5).
1437 See chapter 10.4.
1438 This point was made by Kirby P to justify a strict approach to the general law duty of loyalty in *Woolworths Ltd v Kelly* (1991) 9 ACLC 539 at 546. The same reasoning supports the type of disclosure I have recommended.

Ratification

One situation in which the common law requires shareholders to approve a matter is the ratification of certain breaches of directors' duty.[1439] If this occurs then shareholders will receive adequate information at the time of their meeting.[1440] Although in terms of the underlying breach of duty this may have occurred some time ago and from this perspective disclosure is not timely. There is little that disclosure rules can do to address this difficult substantive issue.

Conclusion

Disclosure of directors and executives' conformance with their fiduciary and other duties is warranted as a matter of principle. Unfortunately with the duties of honesty and care there are no current disclosure requirements (except for the minor disclosure required pursuant to CL s307(2)). This is unacceptable and I have suggested appropriate reforms to change this.

There are disclosures concerning the breach of loyalty. Particularly AASB 1017 casts a very broad net which generally satisfies the quality of completeness. Such disclosures also generally enable readers to assess whether non-executive directors are independent which is an important hallmark of good corporate governance.[1441] However there are some significant shortcomings in the disclosures made which are best analysed in the context of the various qualities of information.

Accuracy is always a principal concern with information. A concern with the current disclosures, and the ones I have recommended, is that it is asking directors and executives to provide information on their conformance with the law. Such a disclosure system effectively requires them to dob themselves in for breaching the law and to provide the information that could later be used in evidence in any court case concerning the breach of duty. This clearly goes against both self-interest and the civil right against self-incrimination. The response to this is to argue that a Board of Directors that is concerned with complying with the law has nothing to fear. If one of them or of the executives breaches their duty then the Board as a whole has no interest in not disclosing. Only if the breach of duty pervades the whole company is there room for concern, but this concern is illegitimate and should not be a basis to deny the disclosure requirement.

A subset of accuracy is completeness and information overload. As I have demonstrated clearly the information provided is not complete. The most telling examples of incompleteness are:
- the pervasive refusal to disclose price or value of the transactions involved;
- gaps in the disclosure of retirement benefits;
- no disclosure of competing positions or offices held; and
- no disclosure of executives' interests in securities of the company.

These deficiencies should be addressed. Of course there are some appropriate concessions to the spectre of information overload. However where details are omitted from the report they should be available for inspection elsewhere if shareholders are sufficiently interested.

1439 For a general discussion of ratification see Yeung 'Disentangling the Tangled Skin: The Ratification of Directors Actions' (1992) ALJ 343.

1440 See chapter 10.4.

1441 See chapter 4.3.

The concern with accuracy is addressed by the need for an independent audit. Since many of these disclosure rules, in particular AASB 1017, requires disclosure in the annual financial statements then these disclosures will be scrutinised by the auditors which enhances their credibility (and hence accuracy).

Some of the disclosures, such as directors' remuneration and interests in shares, have a standard format and therefore comparability is satisfied. In other areas it is and necessarily will be more difficult because the underlying events and transactions that give rise to the loyalty problem can be extraordinarily varied. However, this is not assisted by the fuzzy law approach adopted in some of the disclosure requirements, particularly AASB 1017. These disclosure rules could be tightened to require specific details of a generic nature, notably the price or value of the matter in question. In addition the format of such disclosures could be laid out in appendices to the various disclosure rules.[1442] This would greatly enhance their comparability.

The disclosures that are made and the improvements I have suggested to them are directly relevant to shareholders scrutinising whether directors and executives have conformed to their duties.

There is no reason these matters can not be described in plain English and therefore at a certain level there should not be a problem with understandability. However some of these items necessarily involve sophisticated concepts, such as sophisticated equity interests and complex performance based pay arrangements. Once again these items should be explained as simply as possible but there is a limit on how far this can be taken.

Existing disclosures occur in the annual report and this is also the most suitable place for my proposed disclosures. As can be seen the disclosure obligations arise from a variety of legal rules which stipulate different places where items should be disclosed in the annual report. This involves shareholders having to hunt around the annual report in order to piece together the complete picture. There is much to be said for requiring like disclosures to be made in the same place. The clearest example of this is to have a separate part of the report devoted to remuneration issues. Also if my proposals were adopted a separate section could be created and headed 'compliance with law'.

Generally timeliness will also not be an issue. This information is not as critical as the financial information, particularly from an investment perspective, and therefore disclosure a few months after the event will not be a problem. As shareholders are interested in this information principally in their role as monitors, then so long as the information is provided while the offender is still in office, and steps can be taken against him or her (if the other directors have not already done so), the information is sufficiently timely.

The issue of cost is real. For my proposed disclosures there will be significant costs. Particularly the costs would be significant of a legal compliance program and to lesser extent the increased discipline associated with making informed and reasonable decisions. In my opinion these costs are justified in legitimating the activities of companies and making those who control the company accountable to the shareholders. Another problem associated with cost is the argument that a focus on conformance to legal obligations (and my proposals for quality reporting on this) distracts managers from

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1442 See for example the standard format appendices on directors remuneration required in the US which are attached to Hill, *Remuneration Disclosure in Australia* (Australian Investment Managers' Association, Sydney, 1996).

performing commercially.[1443] That is it takes away from management resources which obviously have a cost. This may be a danger but the reality is that directors have legal responsibilities (as we all have) and my proposals force them to take them seriously. There is no reason why managers cannot successfully both conform and perform.[1444]

There are confidentiality concerns for some of this information and where appropriate I have suggested appropriate restraints to disclosure.

7.5 CHAPTER CONCLUSION

In this chapter I have examined three substantive areas where shareholders receive, or should receive, information. Those three areas are the identity and qualifications of managers, management performance and conformance with legal duties. Disclosure on these topics is justified on the basis of shareholders as either monitors, investors or citizens.

There are adequate disclosure requirements identifying who are the directors but not of their qualifications and experience. But there are no formal disclosure requirements on the identity of the executives, their qualifications or suitability for office. There should be such disclosures.

The business management audit is a way to directly measure the performance of the managers. The manager's principal function is to manage the company's business efficiently and effectively in order to generate wealth. Shareholders currently do not receive any information about how managers go about this task. Certainly shareholders receive the financial statements which indirectly, albeit imperfectly, measures the performance of the directors by means of end results. The financial statements measures the consequences of the managers performance together with a host of other extraneous factors such as the current state of the economy. But there is currently no mandatory disclosure that directly measures how managers perform in order to generate a particular financial result for the company.

Conformance with legal standards involved considering the three fiduciary duties of honesty, care and loyalty. There is virtually no disclosure requirements which directly measure conformance by directors with the duties of honesty and care. I argue that it is not possible or desirable to attempt to measure the performance of individual directors, either by outsiders or by giving the chairperson a reporting role on this topic. Rather the law should concentrate on the collective actions of the Board as a whole to see if the directors as a group have acted carefully. I use a four pronged analysis to consider whether the directors are acting carefully and note there are currently no disclosure requirements attached to any of these four aspects of the duty of care. There are a range of disclosure requirements linked to the various aspects of the duty of loyalty. However I have pointed out significant problems with the quality of this information.

In all of these areas where I have indicated there is inadequate disclosure I have suggested reforms so that shareholders are provided with pertinent information. If the reforms suggested in this chapter were adopted then there would be key information available to shareholders in order for them to assess how the directors are performing their management role and whether in conformance with their fiduciary duties. If these

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1443 Tricker, 'Corporate Governance-Australian Experience in the '90s' paper presented at a conference 'Corporate Governance: Critical Board Issues' organised by the Australian Institute of Company Directors in Sydney on 24 May 1993 (author on file) at 99.

1444 Which is the bottom line of Tricker anyway; see above at 98.

reforms were in place then the shareholders would be in a significantly stronger position to hold the directors accountable for their actions.

In this conclusion I have talked of providing shareholders with information about the performance and conformance with legal duties of directors. Yet as I have already established it is often the executives who manage on a day to day basis in large modern companies, with directors taking on the role as overseers. As stated during the chapter, the law certainly regards the executives as being subject to these general duties, although the related party provisions of the Corporations Law do not apply to them. In my opinion all of these disclosure requirements should extend to the activities of the executives. In a few places I have indicated where the law already does this (for example the remuneration of the executives must be disclosed). All of the disclosures I have discussed about conformance with legal standards can apply to the executives with the possible exceptions of the duties of monitoring and of inquiry which are a part of the duty of care. This is because these duties relate to directors' ultimate oversight function. Nonetheless if adequate information on these two aspects of the duty of care are disclosed concerning the activities of directors then given they are monitoring the executives there will necessarily be disclosure about the executives. Also a broad business management audit will cover the performance of the executives. This disclosure of the activities of the executives may be unduly prolix and costly to appear regularly in a published report. If this is so then at least these documents should be open to inspection by shareholders.

CHAPTER 8

CORPORATE INFORMATION NEEDS OF SHAREHOLDERS

8.1 INTRODUCTION

This chapter examines three loosely related topics and the information shareholders receive on them. The three topics are:
- the businesses run by the company;
- the capital structure of the company and identity of the people who own that capital; and
- information about the separate entity that is the company.

Note that the issue of information about the business activities of the company is different from the discussion in the previous chapter about management information. The distinction is that management information looks at how managers perform whereas this section looks to the businesses of the corporate entity. There is obvious overlap though since managers are managing these businesses. Each of the three topics I consider in turn and each has its own introduction, hence there is no need to say any further here.

8.2 BUSINESS ACTIVITIES

Justification for disclosure of information about businesses run by corporations

Investors buy shares in companies which then conduct certain businesses. Often investors will select their investment based on the businesses being run and the expected rate of return balanced against the perceived risk involved. They are therefore interested in the actual businesses being run by the company and should receive pertinent information accordingly.

As described in chapter 4, shareholders have delegated broad powers to directors, most significantly the power to manage the affairs of the corporation (eg to manage businesses). Shareholders can not monitor directors in a vacuum; the directors are managing businesses and therefore it is artificial and illogical to separate the two out and argue that shareholders have no claim to information concerning the businesses of the company. Also as explained in chapter 4, shareholders have the claims of last resort on the assets of the company and therefore have a strong connection to the company's businesses. Therefore shareholders as monitors should receive information concerning these businesses.

Analysis

The information disclosed in the financial statements about the profits and losses, assets and liabilities and cash flows of the company necessarily relates to specific businesses run by the company. But numbers do not describe and explain businesses. However directors usually voluntarily disclose in the annual report a general description of the businesses they run.[1445] This voluntary disclosure seeks to explain and translate the numerical results in the financial statements to the businesses run by the company. However as noted in chapter 6.6, such voluntary disclosures are often biased and unreliable. Therefore it is important to analyse the relevant mandatory disclosure rules.

The law to some extent also recognises that investors are interested in more than just the profit figures but also the businesses being run. This recognition occurs in various information requirements which are:

- the Listing Rules which require some significant transactions to be approved by shareholders;
- the Directors Report which must include information concerning the company's activities, review of operations, after balance date activities and future prospects; and
- segment reporting.

I will discuss each of these requirements in turn. Before doing so it is worth mentioning that under the continuous disclosure regime disclosures about the company's business may have to be made.[1446] This regime is discussed in chapter 10.2.

Transactions Requiring Shareholder Approval

Listing Rule 11.2 stipulates that shareholders must approve a sale or disposal of the company's main undertaking.[1447] Unfortunately Listing Rule 11.2 may have no application to a large company which operates several diversified businesses because none of those individual businesses can be regarded as the company's main undertaking.[1448]

In addition Listing Rule 11.1 provides that if the company proposes a significant change to the nature or scale[1449] of its activities then the ASX can insist that the shareholders approve the change. But approval by shareholders is not mandatory; the issue is at the discretion of the ASX. In my opinion it would be preferable if this was a mandatory rule rather than being left to the discretion of the ASX. The primary obligation on the company is to provide the ASX with information about the proposed change. In support

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1445 Blair and Ramsay, 'Mandatory Corporate Disclosure Rules and Securities Regulation' in Walker and Fisse (eds.), *Securities Regulation in Australia and New Zealand* (Oxford University Press, Auckland, 1994) at 265.

1446 See LR 3.1 and the examples of matters that should be disclosures listed thereunder.

1447 LR 11.2 also contains restrictions on voting (see also LR 14.11.1).

1448 A criticism of the previous listing rule (3S(2)) was that the Listing Rule applied to a sale or disposal of the company's main undertaking and therefore it did not seem to apply to a sale by a subsidiary of a group of companies' main undertaking; see Black and Minns, 'Commentary on the ASX Listing Rules' in *Australian Corporations Law* (Butterworths, Sydney, 1996) at [10.1.0860]. This criticism no longer seems available since listing rule 11.2 utilises the concept of "entity" rather than of "the company".

1449 The previous listing rule (3S(3)) only applied to a company which was contemplating "changing its activities". Arguably therefore the old listing rule did not catch a major expansion in the same industry, which often proved disastrous. For example the acquisition by the State Bank of South Australia of interests in the Equicorp group of companies; see Sykes, *The Bold Riders* (Allen & Unwin, New South Wales, 1994) at chapter 15; *State of South Australia v Marcus Clark* (1996) 19 ACSR 606. Often these acquisitions which have less than optimal returns are made because the company has excess cash-flow which it is unwilling to return to shareholders; see Jensen, 'Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers' (1986) 76 The American Economic Review 323. However listing rule 11.1 applies to a proposed change by a company to the nature or scale of its activities. Therefore an expansion in the same industry now seems to be covered.

of this information requirement the ASX can suspend trading in the company's shares until the ASX is satisfied that the listing rule has been complied with.[1450]

The policy behind these Listing Rules is clear. The policy recognises that shareholders select their investments based on the businesses being run by the company at that time.[1451] Any significant change to those businesses may well significantly effect the prospects of the company and in any event changes the nature of the investors previous decision. For these reasons it is thought appropriate for shareholders to prospectively consent to a change to the nature of their investment decision by the company entering into such transactions. Unfortunately the Listing Rules have been too narrowly drafted and do not catch all the transactions covered by the policy.[1452] These Listing Rules must therefore be regarded as relatively minor incursions into the directors' broad power of management and reflects a non-interventionist approach by regulators. The attitude is clearly one of deference to the business acumen of directors.

But where the Listing Rules apply shareholders receive information with the notice of meeting seeking their approval.[1453] Also shareholders receive information on these topics after the event in the directors report, by specific disclosure requirements to the ASX and under the continuous disclosure regime (discussed in chapter 10.2). The only criticism of these disclosures is the timing of them (after the event).

Directors' Report

The directors' annual report must:

- state the company's principal activities and any significant changes in the nature of those activities;[1454]
- contain a review of operations and the results of those operations;[1455]
- give details of any significant change in the company's state of affairs;[1456]
- give details of any matter or circumstance that has arisen since the end of the year that has significantly affected or may significantly affect the company's operations, the results of those operations or the company's state of affairs in future financial years;[1457] and
- refer to likely developments in the company's operations in future financial years and the expected results of those operations.[1458] However this information can be omitted if disclosure would unreasonably prejudice the company (but the report must mention the omission).[1459]

1450 LR 11.3.

1451 I recognise that some investors, such as venture capitalists, make their investments based on the identity of those managing the company and have confidence in their ability to successfully run any business. But this certainly is not the case for all investors and I suspect those investors who place their faith in individual managers are the minority of investors.

1452 These Listing Rules may be compared with the position in New Zealand where any major transaction must be approved by shareholders (discussed in chapter 4 above). For the position in other jurisdictions see Hadden, 'Corporate Governance By Institutional Investors? Some Problems From an International Perspective' at 91 in Baums, Buxbaum and Hopt (eds), *Institutional Investors and Corporate Governance* (Walter de Gruyter, Berlin 1993).

1453 See chapter 10.4.

1454 CL s299(1)(c).

1455 CL s299(1)(a).

1456 CL s299(1)(b).

1457 CL s299(1)(d).

1458 CL s299(1)(e).

1459 CL s299(3).

Financial Statements - Segment Reporting

A very common position today is to have a group of companies operating a variety of businesses. A group of companies which is operating as a diversified group are generally obliged to report as a single economic entity by preparing consolidated financial statements.[1460] This is because investors have bought shares in the group holding company and want to know the performance of the overall group. However as I have established shareholders are interested in the performance of individual businesses within the group (or of different divisions of a diversified single company). AASB 1005 'Segment Reporting' recognises this by requiring financial reporting by segments.[1461] The purpose of AASB 1005 is to "require disclosure of information about the material industry segments and material geographical segments in which a company operates".[1462] One justification is that "[s]ince the progress and prospects of a diversified enterprise are composites of the progress and prospects of its several parts, financial statement users regard financial information on a less-than-total-enterprise basis as also important".[1463]

Another justification for segmented reporting is that it will improve management performance.[1464] Management performance is improved because segment reporting:

> will reveal in more detail how well management has performed. Management will not be able to hide its failures behind its successes. Both will be disclosed and investors will be able to better judge the performance of directors. In addition, disclosure of segment results may encourage management to be more careful in making investment decisions and more decisive in correcting mistakes.[1465]

AASB 1005 requires disclosure of financial results for different types of businesses operating in different locations (usually different countries). AASB 1005 achieves this by utilising the concepts of industry segment and geographic segment.[1466] The company must disclose whether it has such segments and if so, identify them.[1467] For each material segment the financial statements must disclose:

(a) segment revenue, distinguishing between revenue derived from customers outside the company or group of companies and revenue derived from other segments;
(b) segment results;
(c) the carrying amount of segment assets; and

1460 CL s295(2)(d) and AASB 1024 'Consolidated Accounts'.

1461 Segment reporting is only required for the end of year financial statements but not for the half yearly financial statements required under the Corporations Law. This has been criticised: see Reilly, 'Accounts' in *Australian Corporations Law* (Butterworths, Sydney, 1996).

1462 AASB 1005 'Segment Reporting' at .03.

1463 Financial Accounting Standards Board, 'Statement of Financial Accounting Standards No. 14: Financial Reporting for Segments of a Business' (FASB, Connecticut, 1976) at paragraph 60 which is quoted in Henderson and Peirson, *Issues in Financial Accounting* (Longman Cheshire, Melbourne, 5th ed., 1992) at 175. There are counter arguments against segment reporting which are set out in Henderson and Peirson, *Issues in Financial Accounting* (Longman Cheshire, Melbourne, 5th ed., 1992) at 175 to 177. Clearly these arguments are not persuasive in Australia.

1464 Henderson and Peirson, *Issues in Financial Accounting* (Longman Cheshire, Melbourne, 5th ed., 1992) at 174.

1465 As above.

1466 Defined in AASB 1005 'Segment Reporting' at .06.

1467 AASB 1005 'Segment Reporting' at .20 to .23.

(d) the basis of inter-segment pricing.[1468]

This information is relatively brief. If it was more detailed it may undermine the purpose of consolidated financial statements. Nonetheless, this snapshot of segment results enables investors to ascertain (somewhat crudely) the performance of different segments of the company. Studies have shown that segment reporting "enable investors to make earnings forecasts superior to those which they would have made relying on consolidated data".[1469]

Conclusion

Arguably the substantive rules governing the division of power between shareholders and directors over significant business decisions is too narrowly defined so that the policy behind the rules that are in place is not given full effect. The apparent policy is that any transaction that significantly affects the businesses being run by the company should be approved by the shareholders. But this is the state of the current law.[1470] The obvious criticism available from viewing the current rules as too narrow is that there may be adequate disclosure but after the deal is completed and it is too late to prevent the transaction from occurring. However this argument is softened since shareholders have the ability to quit their investment and this is one of the key reasons to give investors information.[1471]

Overall there is adequate disclosure to shareholders on these topics in the directors report. The problem is that these disclosure obligations are cast in general terms which gives the managers considerable discretion about what to report. At one level this is difficult to avoid since disclosure by description necessarily involves a degree of vagueness. However there are real and legitimate concerns about the quality of the information provided; is it accurate, credible, complete, comparable and understandable? In my opinion the bare bones and fuzzy law approach in Australia can be improved on to ensure the quality of the information provided. This would be achieved by implementing a MD&A requirement, which I recommended in chapter 6.6. The MD&A requires discussion and analysis not just of financial performance but also of results of operations which necessarily involves the businesses being conducted.

In my opinion if a similar approach were adopted in Australia this would go a long way in enhancing the accuracy, credibility and completeness of information about the businesses of the company. Given the information is in narrative form perhaps comparability will necessarily suffer to some extent, but this can not be avoided. As the information is by narrative disclosure then by using plain English this information should be understandable. The requirement of accessibility is satisfied because the information would be sent to all shareholders in the annual report. Timeliness would be somewhat of a problem because it would be sent to shareholders only once or twice (if required to be included in the half-yearly report) a year. But the continuous disclosure regime should fill the gaps to an acceptable extent imbetween the time of these reports. Disclosure

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1468 AASB 1005 'Segment Reporting' at .24. Various terms in this paragraph are defined in the standard at .06.

1469 Seligman, 'The Historical Need for a Mandatory Corporate Disclosure System' (1983) 9 Journal of Corporate Law 1 at fn 22.

1470 It is not within the scope of this thesis to extensively examine this issue, but see the general discussion about the balance of power between shareholders and directors in chapter 4.2.

1471 See chapter 4.6.

should be subject to confidentiality concerns.[1472] The cost of such disclosure should not be significant. The managers should already understand their business and a full description to shareholders is merely reducing this knowledge to writing.

Finally it should be borne in mind that if the business management audit which I argued in favour of in the previous chapter is introduced then such disclosure dovetails with and enhances disclosures about the businesses. If this occurs then shareholders would be left in little doubt about the businesses being conducted and how well they are being managed.[1473]

8.3 CAPITAL

Justification for disclosure of equity capital

Shareholders are those people who collectively contribute the equity capital to the company. This is how they bring themselves into relationship with the company and others involved with the company such as directors, executives and the auditors. Since shareholders own the equity capital naturally enough they are the ones most interested in, and have a right to, information concerning their capital.

Shareholders' interest in knowing the identity of their fellow shareholders is not just a matter of idle curiosity given there is a market for corporate control.[1474] The issue is particularly acute for those investors who decide they wish to own a controlling parcel, majority or all of a company's issued share capital. The information needs of potential takeover bidders is addressed at this level by open access to the register of members and option holders and the range of other information that must be disclosed to shareholders either in the directors report or by other means.

If a takeover is commenced then the existing shareholders are presented with an offer for their shares and are faced with a decision to hold or sell their shares. Clearly at such time shareholders as investors are justified in receiving appropriate information concerning that investment decision. Similarly when a company proposes to issue new shares, shareholders and potential shareholders are faced with an investment decision and have right to pertinent information. Both of these situations are also addressed below under the analysis.

Shareholders' interest in receiving information about their capital is not just a matter of idle curiosity for another reason. Studies have shown there is a correlation between the type of ownership structure that is in place with the performance of the company, the likelihood of different self interested transactions by those in control and wealth transfers from smaller shareholders to larger shareholders.[1475] Investors aware of this will choose to invest in those companies which they perceive have the best ownership structure in

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1472 This is recognised in the U.S. where merger negotiations do not have to be disclosed under the MD&A: see *Securities Exchange Act* 1934 (US) Release No. 26,831 (May 18 1989) quoted in Brown, *The Regulation of Corporate Disclosure* (Aspen, USA, 2nd ed 1995) at 2.02[2].

1473 See chapter 7.3 and in particular the types of additional information Francis considers should be disclosed to shareholders.

1474 Discussed in chapter 4.6. See also Eisenberg, 'The Structure of Corporation Law' (1989) 89 *Columbia Law Review* 1461 at 1500 to 1505.

1475 Ramsay and Blair, 'Ownership Concentration, Institutional Investment and Corporate Governance: An Empirical Investigation of 100 Australian Companies' (1993) 19 MULR 153.

place and may choose to withdraw their investment if that ownership structure changes for the worse. This information recognises shareholders in their investor role.

Analysis

What follows in this part is the justification for, and an examination of, the information shareholders receive about the capital of their company under the headings:

- transactions requiring shareholder approval;
- the registers of shareholders and option holders;
- the directors report;
- notifications to the ASX;
- identifying significant shareholders;
- prospectuses; and
- takeovers.

Although somewhat mundane (and giving the appearance of a shopping list) this analysis provides a detailed description of all of the laws in these areas. Some of these laws themselves prescribe in detail the information that must be provided.

Transactions Requiring Shareholder Approval

Individual shareholders, at any given point in time, own a defined portion of the currently issued share capital. This defined proportion in the share capital gives them concurrent rights to a defined proportion of the voting rights, any declared dividend and any capital gains to the value of the company (which are hopefully reflected in the share price). Any alteration to the issued capital position of the company will affect the shareholders proportional stake in the company (unless made on a pro rata basis). At first glance it therefore seems surprising that directors have the power to issue shares in the company.[1476] But it must be remembered that the exercise of the share issue power is subject to fiduciary duties. However as the reported cases attest there are many instances where the shareholders allege the directors did not comply with these duties.[1477] If this is the case then nothing can prevent it from occurring. But if the proposals I recommended in chapter 7.4 were adopted then ultimately disclosure of any non-compliance with these duties would occur.

Also the courts have recently and explicitly recognised that shareholders have a legally enforceable interest in their proportional stake in the company. In a case involving an issue of shares by directors for an allegedly improper purpose the South Australian Full Supreme Court held that a shareholder had standing to challenge the issue (ie this was an exception to the rule in *Foss v Harbottle*).[1478] The court reasoned that shareholders have a personal, equitable right to not have their voting rights improperly diminished. Shareholders also have property rights in their shares that can immunise them in certain

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1476 Table A cl 2, discussed in chapter 4.2. This power may also be exercised by shareholders; see *Donocon v Donocon* (1990) 2 ACSR 385 at 394 to 397.

1477 *Ngurli v McCann* (1953) 90 CLR 425; *Harlow's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co N.L.* (1968) 121 CLR 483; *Teck Corp Ltd v Millar* (1973) 33 DLR (3d) 288; *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285. In many case where plaintiffs allege the directors exercised the share issue power for improper purposes the plaintiffs were ultimately unsuccessful. Arguably the substantive law is wrong or courts are otherwise taking a too generous approach in favour of directors. I am unable to pursue these substantive criticisms in this thesis.

1478 *Residues Treatment & Trading Co Ltd v Southern Resources Ltd (No 4)* (1988) 14 ACLR 569.

circumstances from compulsory acquisition where an amendment to the constitution is required in order to achieve this.[1479]

Besides the power to issue shares which resides with the directors (and concurrently with the shareholders) almost any other alteration to the share capital must be approved by shareholders. The Corporations Law provides that the following matters must obtain such approval, namely:

- converting shares to a different class (unless certain rights are already specified in the constitution);[1480]
- converting shares into a smaller or larger number of shares;[1481]
- reducing share capital;[1482]
- varying or abrogating class rights;[1483]
- giving financial assistance for the acquisition of shares (subject to some exceptions).[1484] A statement setting out all the information known to the company that is material to the decision on how to vote on the resolution must be sent to shareholders;[1485] and
- employee, on market and equal access share buy backs which exceed the 10% in 12 month rule[1486] and selective share buy backs.[1487]

In addition the Listing Rules provide that the following matters must be approved by shareholders, namely:

- issuing, in certain circumstances, securities representing roughly 15% of existing share capital,[1488] subject to a range of broad exceptions;[1489]
- issuing, in certain circumstances, shares by a company the subject of a takeover;[1490]
- establishing[1491] or amending[1492] an employee incentive scheme;
- directors and their associates acquiring securities by participating in an employee incentive scheme;[1493]

1479 *Gambotto v W.P.C. Ltd* (1995) 127 ALR 417.

1480 CL s254G.

1481 CL s254H.

1482 CL s256B(1)(c) and 256C.

1483 CL s246B(2); by special resolution, unless the corporate constitution makes other provision.

1484 CL ss260A(1)(b) and 260B; by special resolution.

1485 CL s260B(4). The Corporations Law previously took a black letter law approach to the information that had to be sent to shareholders (previously CL s205(10)(c)).

1486 CL s257B & C.

1487 CL s257B & D. A special or unanimous resolution is required for this type of buy back.

1488 LR 7.1. LR 7.3 specifies the information which must be included with the notice of meeting. Included in what the notice must contain is the maximum number of securities to be issued, the allotment date, the issue price, the names of the allottees (if known) or the basis upon which allottees will be determined, the terms of the securities and the intended use of the funds raised from the issue; see *TNT Australia Pty Ltd v Poseidon Ltd (No 2)* (1989) 52 SASR 383.

1489 LR 7.2.

1490 LR 7.9; see *Residues Treatment and Trading Co Ltd v Southern Resources Ltd* (1988) 14 ACLR 375; and *FAI Insurances Ltd v Pioneer Concrete Services Ltd (No 2)* (1986) 10 ACLR 801.

1491 LR 7.37. A summary of the scheme must accompany the notice of meeting and a copy of the terms of the scheme must be sent to a shareholder on request and free of charge (LR 7.37.2(a)).

1492 LR 7.38.

1493 LR 10.14. Pursuant to listing rule 10.15 the notice convening the meeting must contain the following information:

> 10.15.1 If the person is not a director, a statement of the relationship between the person and the director that requires the approval to be obtained.
> 10.15.2 The maximum number of securities that may be acquired...

- altering the terms of options;[1494] and
- cancelling forfeited shares.[1495]

These are the greatest incursions into the broad powers of management enjoyed by the directors. The breadth of these incursions is a reflection of the strong view that shareholders have the greatest interest in these matters and they should be the ones who authorise them. Adequate information is provided to shareholders with the notice of meeting which convenes them to consider these matters.[1496]

Registers

For a variety of reasons the shareholders may want to know who their fellow shareholders are (and those who have an option to become their fellow shareholders). This is recognised by the obligation to maintain a register of shareholders and a register of option holders. These registers are open for inspection free of charge by shareholders and option holders[1497] who are also entitled to a copy of the register for a nominal fee.[1498]

Every company must maintain a register of members.[1499] The register of members contains the following information:

- the name and address of members[1500] and former members;[1501]
- the date on which a person commenced[1502] or ceased[1503] to be a member;
- the date[1504] and number[1505] of any allotment of shares to members;
- the shares held by each member;[1506]
- the class of shares;[1507]
- the share number (if any), or share certificate number (if any), of the shares;[1508]
- the amount unpaid on the shares (if any);[1509] and
- a notation of any shares held on a branch register.[1510]

10.15.3 The price (including a statement whether the price will be, or be based on, the market price), or formula for calculating the price, per security.
10.15.4 The names of all persons.... who received securities under the scheme since the last approval, the number of the securities received, and acquisition price for each security.
10.15.5 A voting exclusion statement.
10.15.6 The terms of any loan in relation to the acquisition.

1494 LR 6.23.
1495 LR 7.26.
1496 See chapter 10.4.
1497 CL s173.
1498 CL s173(3), CL Regulations schedule 4 item 1.
1499 CL s168(1)(a).
1500 CL s169(1)(a).
1501 CL s169(7)(a).
1502 CL s169(1)(b).
1503 CL s169(7)(b).
1504 CL s169(3)(a).
1505 CL s169(3)(b).
1506 CL s169(3)(c).
1507 CL s169(3)(d).
1508 CL s169(3)(e).
1509 CL s169(3)(f).
1510 CL s178(2).

If a company issues options over unissued shares then the company must keep a register of options.[1511] The register of options contains the following information:

- the name and address of the holder of the option;
- the date the option was granted;
- the date the option holder's name was entered on the register;
- the number and description of the shares over which the option was granted;
- the period during, or the time at, which the option may be exercised;
- any event that must happen before the option can be exercised;
- any consideration for the grant of the option; and
- any consideration for the exercise of the option or the method by which that consideration is to be determined.[1512]

A copy of every document that grants an option over unissued shares in the company must be kept with the register.[1513]

The information disclosed in the registers is adequate and importantly contains details as to price (but unfortunately only the original issue price, not the price of any subsequent sale and purchases). If a person contravenes the register provisions they are subject to a fine of up to 10 penalty units or imprisonment for three months.[1514]

The information in these registers is mundane but it is very important that shareholders have unhindered access to it. That shareholders enjoy free access to this information we almost take for granted in Australia. However there are more restrictive rules in the USA which can seriously impede shareholders who want to mount a proxy contest.[1515] Such restriction are inappropriate; why should shareholders not know who their fellow shareholders are and be able to communicate with them (even if the law wants to regulate the content of the communication, such as requiring it not be false or misleading)? Although proxy contests are rare in Australia shareholders registers are used by those seeking to takeover the company and this market has a role to play in the broader notion of corporate governance.[1516]

Directors' Report

The directors' report must contain a range of information concerning the shareholders. It principally gives an overview of the capital structure of the company and identifies significant investors. The report contains the following information for the relevant financial year:

- particulars of options over unissued shares as at the date of the report or shares issued by exercising an option during or since the end of the year;[1517]

1511 CL s168(1)(b).

1512 CL s170(1).

1513 CL s170(3). A copy does not have to be kept with the register if the option has been granted official quotation by a securities exchange.

1514 Schedule 3 to the Corporations Law. CL s9 defines penalty unit as $100.

1515 *Studebaker Corporation v Gittlin* 360 F.2d 692 (2d Cir. 1966); *Pillsbury v Honeywell Inc.* 191 NW 2d 406 (1971) ; Clark, *Corporate Law* (Little Brown & Co, New York, 1986) at 368 to 369; Cary and Eisenberg, *Corporations: Cases and Materials* (Foundation Press, USA, 6th ed, 1988) at 249 to 256.

1516 The role of the takeover market was discussed in chapter 4.6 and the information shareholders receive during a takeover is analysed later in this chapter.

1517 CL s300(1)(e) and (f). In addition CL s300(1)(d) requires details of options held by directors or the 5 most highly remunerated executives as part of their remuneration (discussed in chapter 7.4 under the sub-heading 'Personal Profits (Including Remuneration)).

- the names of the substantial shareholders and the number of equity securities in which they have an interest, as disclosed in substantial shareholder notices;[1518]
- the number of holders of each class of equity security[1519] and the voting rights attaching to each class;[1520]
- a distribution schedule of the number of holders in each class of equity security in the categories:
    - 1 - 1,000
    - 1,001 - 5,000
    - 5,001 - 10,000
    - 10,001 and over.[1521]
- the number of holders holding less than a marketable parcel;[1522]
- the names of the 20 largest holders of each class of equity securities, the number of equity securities each holds and the percentage of capital each holds;[1523]
- the address and telephone number of each office at which a register of securities is kept;[1524] and
- a list of other stock exchanges on which any of the entity's securities are quoted.[1525]

Notifications to the ASX

Listed companies also have to notify the ASX of a range of information that can be defined as 'corporate information', including:

- any call on partly paid shares;[1526]
- any reorganisation to be made to its capital;[1527]
- any change to the place of any of the company's securities registers;[1528]
- a proposed issue of securities;[1529]
- the lodgment of a prospectus;[1530]
- an issue of securities that has been made;[1531]
- the exercise by an underwriter of a right to avoid or change the underwriters obligations;[1532]
- an underwriting agreement for the exercise of options;[1533]
- any variation in the exercise price of an option or the number of underlying securities over which the option is exercisable;[1534]
- immediately after the expiry date, the number of options that were restricted securities that were exercised or have lapsed;[1535]

1518 LR 4.10.4. See below under the heading 'Identifying Significant Shareholders'.
1519 LR 4.10.5.
1520 LR 4.10.6.
1521 LR 4.10.7.
1522 LR 4.10.8.
1523 LR 4.10.9.
1524 LR 4.10.12.
1525 LR 4.10.13.
1526 LR 3.10.2.
1527 LR 3.10.1.
1528 LR 3.15.1.
1529 LR 3.10.3.
1530 LR 3.10.4.
1531 LR 3.10.5.
1532 LR 3.10.6.
1533 LR 3.11.3.
1534 LR 3.11.2.
1535 LR 3.11.1

- the progress of any buy back scheme;[1536]
- during a buy back, the disposal by directors or their related parties of shares in the company;[1537]
- where a company is taking over another company and extends the time for acceptance of a takeover, the offeror must disclose the percentage of shares the offeror was entitled to before the takeover and is entitled to at the time of the extension;[1538] and
- on the closing date of a takeover, the offeror must disclose the percentage of shares which it is entitled to and whether it will proceed to compulsory acquisition of the remainder.[1539]

Other disclosures about the share capital of the company may be required under the general continuous disclosure regime (discussed in chapter 10.2).[1540]

Identifying Significant Shareholders

The Corporations Law obliges any person who is a substantial shareholder to lodge a notice with the company when the person commences to be a substantial shareholder,[1541] any change to the persons entitlement to shares[1542] and when the person ceases to be a substantial shareholder.[1543] A person is a substantial shareholder if the person is entitled to at least 5% of the voting shares of the company.[1544] The notices must disclose a range of information including the number of shares the substantial shareholder is entitled to, the date the shares were acquired or disposed of, the consideration paid or received and an explanation of how the entitlement arises.[1545] A copy of the notice must be served on the ASX.[1546]

In addition to obliging substantial shareholders to provide these notices the Corporations Law provides a mechanism to trace the beneficial ownership of shares. Either the company or the ASIC (on its own initiative or at the request of the company or a member of a company) may, by written notice, request the registered holder of shares[1547] or others[1548] to disclose whether that person or any other person has a relevant interest or relevant instructions[1549] in the shares of the company.[1550] These notices enable the ASIC,

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1536 LR's 3.5 and 3.7 to 3.9 and appendices 7C to 7E.
1537 LR 3.6.
1538 LR 3.2.
1539 LR 3.3.
1540 For example there were two previous explicit disclosures required under the old listing rules which are now examples of disclosure required under LR 3.1. Those old rules were:
- LR 3A(16A)-any statement received under Part 6.8 of the Corporations Law ("Power to Obtain Information as to Beneficial Ownership of Shares"); and
- LR 3R(2)-if the company receives a notice that another company intends to takeover it.

1541 CL s709.
1542 CL s708.
1543 CL s709.
1544 CL s708.
1545 CL s709(3), 710(3), 711(3), Regulations 6.7 and Forms 603, 604 and 605.
1546 CL s713.
1547 Called a primary notice - see CL s717.
1548 Called a secondary notice - see CL s717.
1549 CL s717 defines "relevant instructions" as:
Instructions or directions -
(a) in relation to the acquisition or disposal of shares;
(b) in relation to the exercise of any voting or other rights attached to the shares; or

the company or a member to trace who are the ultimate owners of the company's shares. Presumably this procedure exists because some people do not comply with the substantial shareholder notice provisions mentioned above or holdings of less than 5% may sometimes be considered relevant.

Shareholders are informed of these notices when the company discloses them to the market.[1551] Previously the company had to keep a register of all information it received as a result of these types of notices being dispatched[1552] which register was open for inspection by shareholders.[1553]

Prospectuses

Shareholders and potential shareholders also receive information when a prospectus is issued. A prospectus is issued whenever (subject to certain exceptions)[1554] a company's securities are offered for subscription or purchase or invitations to subscribe or buy securities are issued.[1555]

The Corporations Law prescribes some specific information requirements[1556] but otherwise takes a fuzzy law approach to the contents of prospectuses. CL s1022(1) provides that a prospectus must:

> contain all such information investors and their professional advisers would reasonably require, and reasonably expect to find in the prospectus, for the purpose of making an informed assessment of:
>
> (a) the assets and liabilities, financial position, profits and losses and prospects of the corporation; and
>
> (b) the rights attaching to the securities.

Given a fuzzy law approach it is not possible to analyse in detail the content of prospectuses because such content is up to each issuing corporation. Of course every corporation must address the topic areas identified in paragraphs (a) and (b) above, but how they do so is entirely up to them. Under this approach for example the corporation may provide forecasts about its future performance.[1557] However the content of prospectuses and the processes that go into their preparation is significant shaped by the applicable liability rules.

There are special liability rules that apply to prospectuses.[1558] First, Corporations Law section 995 prohibits conduct that is misleading or deceptive or likely to be so in or in connection with any dealing in securities, in particular the issue of a prospectus. A

(c) in connection with any other matter relating to the shares.

1550 CL s718 and 719.

1551 Pursuant to listing rule 3.1 which gives this as an example of a required disclosure (previously LR 3A(16A)). Discussed above at chapter 8.3.

1552 CL s724(2).

1553 CL s724(3)(a)-inspection was available to members without charge. The requirement to keep this register was repealed with effect from 9 December 1995 (Act 115 of 1995).

1554 CL ss 1017 & 66.

1555 CL s1018.

1556 CL s1021.

1557 Kyrwood, 'Disclosure of Forecasts in Prospectuses' (1998) 16 C&SLJ 350 at 357 to 358. In the takeover context concerning forecasts see *Pancontinental Mining Ltd v Goldfields Ltd* (1995) 16 ACSR 463; *Ampolex v MEPA* (1996) 19 ACSR 354.

1558 See generally Baxt, Ford and Black, *Securities Industry Law* (Butterworths, Sydney, 1996) at chapter 4.

person who contravenes section 995 does not commit an offence,[1559] but this can ground civil liability (discussed below). Second, there is a separate prohibition against authorising or causing to issue a prospectus with a material statement which is false or misleading or has a material omission.[1560] It is reasonably clear that directors in the normal course will be taken to have authorised or caused to have issued the prospectus but it is less clear who else is liable. Others are potentially liable because of the ancillary liability provisions in section 5 of the *Crimes Act* 1914 (Cth) which apply to people who aid or abet or are knowingly concerned in the breach.[1561] This remains an uncertain area of the law.[1562] Materiality is the touchstone of liability which will always be a question of fact involving qualitative and quantitative issues.[1563] It is a defence to this liability if the person, after making reasonable enquiries, had reasonable grounds to believe and did believe that the statement was true and not misleading or the omission was not material or inadvertent.[1564] The principal consequence for a breach of this prohibition is that the defaulter is subject to a fine of up to 200 penalty units or 5 years imprisonment or both.[1565] However people whose conduct breaches this prohibition, and any other person involved in the contravention, are also civilly liable to compensate any person who suffers loss or damage as a result.[1566] In addition to compensation such people would also be entitled to an injunction to restrain the distribution of the prospectus and the issues of the securities.[1567] Those who are "involved in the contravention" are broadly defined and include the issuing corporation, its directors and others named in the prospectus as its professional advisers.[1568] Directors are not liable if they establish that the prospectus was issued without their knowledge or consent and they give reasonable public notice of this.[1569] Directors are also not civilly liable if, after making reasonable enquiries, they had reasonable grounds to believe and did believe that the statement was true and not misleading or there were no material omissions,[1570] or was based on an experts report or an official document or statement.[1571] There are similar defences for others who are potentially civilly liable.[1572] This is the so called due diligence

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1559 CL s995(3).

1560 CL s996(1). Baxt, Ford and Black, *Securities Industry Law* (Butterworths, Sydney, 1996) at [405] and [423].

1561 Baxt, Ford and Black, *Securities Industry Law* (Butterworths, Sydney, 1996) at [304].

1562 Earp and McGrath, *Listed Companies: Law and Market Practice* (Law Book Company, Sydney, 1996) at [251].

1563 Above at [243] and at [251] where the authors note that the term is not completely unambiguous.

1564 CL s996(2). It is not perfectly clear whether the existing due diligence defences in CL ss1008A(2) and 1011 apply to the general liability rule in CL s995 in addition to the liability rule in CL s996; see Croker, *Prospectus Liability Under the Corporations Law* (Centre for Corporate Law and Securities Regulation, Melbourne, 1998) at chapter 7. The *Corporate Law Economic Reform Program Bill* 1998 (Cth) s731 proposes to remove this ambiguity by making it clear that the due diligence defence applies to all the relevant liability rules (which are also being simplified).

1565 Schedule 3 to the Corporations Law. CL s9 defines penalty unit as $100.

1566 CL s1005. See Baxt, Ford and Black, *Securities Industry Law* (Butterworths, Sydney, 1996) at [406].

1567 CL s1324 discussed in Baxt, Ford and Black, *Securities Industry Law* (Butterworths, Sydney, 1996) at [407]. An injunction was the remedy sought and obtained in *Fraser v NRMA* (1995) 15 ACSR 590 but that was an unusual case in that dissident directors were seeking the injunction.

1568 See CL s1006(2) for the precise definition of this concept and those caught under it. See also s79, discussed in Baxt, Ford and Black, *Securities Industry Law* (Butterworths, Sydney, 1996) at [421].

1569 CL s1008.

1570 CL s1008A(4).

1571 CL s1008A(2) and (3).

1572 CL s1009 and s1011.

defence.[1573] Directors almost invariably arrange for due diligence investigations to be conducted concerning their company's affairs prior to the publication of a prospectus. Due diligence investigations involve accountants and lawyers (at least) investigating in their respective fields of expertise whether there is any information (usually adverse, which discloses a liability) that should be disclosed to shareholders. This process usually ensures the quality of the information set out in the prospectus. So the imposition of this pattern of liability has helped to ensure the quality of this information (particularly accuracy) by causing due diligence to be conducted.[1574]

There are also special liability rules that apply to forecasts. Issuing corporations must have reasonable grounds for any forecast they make.[1575] Under an ASIC practice note the ASIC's view is that the assumptions under which the forecast is made and how it was calculated must be published in the prospectus.[1576] In addition issuers are presumed not to have reasonable grounds unless they produce evidence to the contrary (ie there is a reverse onus of proof).[1577] However the current government regards the reverse onus as a disincentive to provide forward-looking information and therefore seek its repeal.[1578] This is certainly pro-business[1579] but can be criticised on the basis that given the information disparity between issuing corporations and investors it will be virtually impossible for investors to successfully prove that the forecast was not made on reasonable grounds.[1580] Others dispute this on the basis that because the assumptions on which the forecast is based must be published then this is sufficient evidence for anyone to test their reasonableness.[1581]

In addition to liability under the Corporations Law liability may also arise under section 52 of the *Trade Practices Act* 1974 (Cth).[1582] Section 52 prohibits false or misleading conduct or conduct that is likely to be false or misleading. The plaintiffs in *Fraser v NRMA*[1583] innovatively used section 52 to successfully challenge a prospectus. The plaintiffs used section 52 rather than the specialist corporate law liability rules because of clearer rights of standing to obtain an injunction (the remedy sought in NRMA)[1584] and because there are no equivalent due diligence defences available under the *Trade*

1573 Baxt, Ford and Black, *Securities Industry Law* (Butterworths, Sydney, 1996) at [432].

1574 Earp and McGrath, *Listed Companies: Law and Market Practice* (Law Book Company, Sydney, 1996) at [250].

1575 CL s765(1). This requirement is to be retained under the *Corporate Law Economic Reform Bill* 1998 (Cth) s728(2).

1576 ASIC, *Practice Note 67: Financial Forecasts in Prospectuses*. This is also the view of the current government; see Corporate Law Economic Reform Program, *Fundraising: Capital Raising Initiatives to Build Enterprise and Employment: Paper No. 2* (AGPS, Canberra, 1997) at 28.

1577 CL s765(2).

1578 Corporate Law Economic Reform Program, *Fundraising: Capital Raising Initiatives to Build Enterprise and Employment: Paper No. 2* (AGPS, Canberra, 1997) at 28.

1579 The policy underlying these reform proposals are explicitly pro-business, see above at 9 (the government endorses an economic framework for fundraising 'which is pro-business and underpins investor confidence in market integrity').

1580 See various submissions made to CLERP, summarised in Croker, *Prospectus Liability Under the Corporations Law* (Centre for Corporate Law and Securities Regulation, Melbourne, 1998) at 76 to 77.

1581 Above at 28 and 76 to 77.

1582 Earp and McGrath, *Listed Companies: Law and Market Practice* (Law Book Company, Sydney, 1996) at [256].

1583 (1995) 15 ACSR 590.

1584 The right to sue for declaratory and injunctive relief under sections 80 and 163A of the *Trade Practices Act* are clearer than under the *Corporations Law* section 1324.

Practices Act.[1585] The current government has indicated that it regards this overlapping liability as undesirable and that people whose concern is with claims of faulty information in prospectuses should only have recourse to the Corporations Law remedies.[1586] The policy underlying these changes is principally to reassert that fault based liability (rather than strict liability) is appropriate for an investment decision which inherently involves risk taking (and is therefore different to a consumption decision).[1587] The changes are also motivated by a desire to reduce transaction costs.[1588] However to date this recommendation has not been implemented although a Bill has been released to effect these changes.[1589]

The issue of who should be able to understand a prospectus is not clear cut.[1590] The Corporations Law gives some conflicting indications. Section 1022(3) provides:

> In determining what information is required to be included in a prospectus by virtue of this section, regard shall be had to:
>
> ...
>
> (b) the kinds of persons likely to consider subscribing to securities;
> (c) the fact that certain matters may reasonably be expected to be known to professional advisers of any kind whom those persons may reasonably be expected to consult.

Given that both individual (of differing sophistication) and institutional shareholders are prevalent in Australia[1591] then paragraph (b) suggests that prospectuses should be pitched so that all users can understand them including unsophisticated investors. However paragraph (c) seems to imply that it is reasonable for such people to consult professional advisers. However much may depend on the nature of the issue. If it is a public float where individual investors are targeted or it is an issue to existing shareholders who include the unsophisticated the implication in paragraph (c) may not necessarily arise. As a result arguably the prospectus should be understandable to the unsophisticated individual investor. There is some judicial support for this approach.[1592] Such an approach would be consistent with other areas of the law (for example the understandability of takeover documents, discussed next). To some extent the current government is addressing this issue by proposing to introduce short-form prospectuses

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1585 Section 52 involves an objective standard of liability regardless of the knowledge or care taken by those accused of a breach.

1586 Corporate Law Simplification Program, *Fundraising: Trade Practices Act, s52 and Securities Dealings* (AGPS, Canberra, 1995) at 18 to 21; Corporate Law Economic Reform Program, *Fundraising: Capital Raising Initiatives to Build Enterprise and Employment: Paper No. 2* (AGPS, Canberra, 1997) at 37 to 50; Croker, *Prospectus Liability Under the Corporations Law* (Centre for Corporate Law and Securities Regulation, Melbourne, 1998) at chapter 8.

1587 CLERP, *Fundraising* at 41; Croker, *Prospectus Liability Under the Corporations Law* (Centre for Corporate Law and Securities Regulation, Melbourne, 1998) at 10 to 11.

1588 CLERP, *Fundraising* at 39 to 40.

1589 *Corporate Law Economic Reform Program Bill* 1998 (Cth) s731.

1590 See generally Baxt, Ford and Black, *Securities Industry Law* (Butterworths, Sydney, 1996) at [410] and [423].

1591 See chapter 4.5.

1592 *Fraser v NRMA* (1995) 15 ACSR 590 at 602 to 603 where the Full Court of the Federal Court of Australia state:

> the addressees of the prospectus may be expected to include significant numbers of people who, while quite astute in dealing with their day to day financial affairs, have no experience in dealing with shares, with corporate reorganisation, or with a prospectus...It is also relevant to note that the addressees may be expected to include not only those who have no experience in dealing with shares or corporate reorganisation, but also people in the category who are, as well, less astute, less intelligent or less well-informed than the average member of the community.

and even shorter profile statements.[1593] The idea behind these changes is to make these shorter documents more understandable to unsophisticated, retail investors by incorporating other documents by reference and informing these investors that these other documents and a full prospectus are available for them if they so desire.[1594]

Also if the prospectus refers to a material contract then the company must make available for inspection without charge a copy of that contract.[1595] The courts have recognised that this is an unqualified right which is not restricted by either the class of person seeking inspection or their purposes or motives.[1596]

Takeovers

I have already discussed the role of takeovers in chapter 4.6. As mentioned there, chapter 6 of the Corporations Law regulates takeovers and in particular the information that must be sent to the existing shareholders. There are two ways to takeover a company; pursuant to a takeover scheme or for listed companies where the consideration is entirely cash, by a takeover announcement. Depending on which method is chosen dictates the type of statement which must be sent. Bidders have to provide information to existing shareholders of the target company in either a Part A (CL s637-takeover scheme) or Part C (CL s679-takeover announcement) statement. The takeover target must provide to its shareholders either a Part B (CL s647-takeover scheme) or Part D (CL s683-takeover announcement) statement.[1597] The content requirements of these statements are substantially similar for schemes and announcements and are set out in CL s750. As the existing shareholders are being offered to quit their investment it is not surprising that the information is directed to them in their investor role. This is evident not only from the prescribed categories of information that must be disclosed but also in the catch all provisions that apply to all of these statements. The catch all provisions provide that those preparing the statements must provide "any other information material to the making of a decision by the offeree whether or not to accept an offer".[1598] Materiality is also the touchstone for liability. Materiality is judged according to whether the fact is one which if omitted might reasonably deter or tend to deter the ordinary investor from accepting the offer.[1599]

1593 Corporate Law Economic Reform Program, *Fundraising: Capital Raising Initiatives to Build Enterprise and Employment: Paper No. 2* (AGPS, Canberra, 1997) at 15 to 22; *Corporate Law Economic Reform Program Bill* 1998 (Cth) ss705, 709, 712 & 721. An offer information statement is also an option (s705(4) & 709(4) & (5)) but this option is principally for the benefit of small business rather than to assist unsophisticated investors.

1594 Corporate Law Economic Reform Program, *Fundraising: Capital Raising Initiatives to Build Enterprise and Employment: Paper No. 2* (AGPS, Canberra, 1997) at 16 to 17.

1595 CL s1029.

1596 *Rossington Holdings Pty Ltd v Lion Nathan Ltd* (1992) 10 ACLC 722.

1597 There are proposed changes to these statements which move to a more fuzzy law approach based on the catch all provision, see *Corporate Law Economic Reform Program Bill* 1998 (Cth) ss 636 & 638. This Bill also proposes that there will be one disclosure document issued by each of the bidder and target regardless of whether the takeover is done on or off market.

1598 CL s750 Part A at clause 17, Part B at clause 13, Part C at clause 14 and Part D at clause 12. Such a view has been endorsed by the courts see *Samic Ltd v Metals Exploration Ltd* (1993) 11 ACLC 717 at 720 per King CJ who stated that the purpose of the s750 disclosures are "to put shareholders in possession of the information required to enable them to make an informed and critical assessment of the offer and an informed decision whether to accept it".

1599 *Re Rossfield Group Operations Pty Ltd* [1981] ACLC 40-710. See generally Little, *Law of Company Takeovers* (Law Book Company, New South Wales, 1997) at [703].

The information that offerors must provide includes information concerning the offeror's identity and activities,[1600] the period of the offer,[1601] the offeror's current shareholding in the target,[1602] trading in the past 4 months by the offeror or its associates in the target[1603] and the offeror,[1604] the terms of the purchase of other securities in the target (in certain circumstances),[1605] any pre-emption clause in the target's constitution,[1606] how cash components of the purchase price is to be provided,[1607] benefits or other agreements with officers of the target,[1608] changes in the target's financial affairs,[1609] any agreement to transfer shares acquired by the offeror,[1610] escalation clauses,[1611] the offeror's intentions about the business, assets and employees of the target,[1612] additional information required by the regulations[1613] and for a takeover scheme where part of the purchase price involves shares in the offeror or another body corporate information about those other shares.[1614]

The target company must provide information concerning each of the target directors' recommendation about acceptance of the offer,[1615] each target directors' shareholding in the target[1616] and whether they intend themselves to accept the offer,[1617] any target directors who did not approve the terms of the Part B or D statement and their reasons,[1618] the shareholding by target directors in the offeror,[1619] share transactions in the offeror by the target or its associates in the past 4 months,[1620] share transactions in the target by its associates in the last 4 months,[1621] proposed benefits to officers of the target,[1622] any other agreement with directors of the target in connection with the takeover,[1623] any interest a director of the target has in a contract with the offeror,[1624] sales of shares in the target (including price) in the previous 6 months[1625] and any

1600 CL s750 Part A clauses 2 (corporate offerors) and 7 (natural person offerors) and Part C clauses 2 and 4 respectively.
1601 CL s750 Part A clause 1 and Part C clause 1.
1602 CL s750 Part A clause 3 and Part C clause 3.
1603 CL s750 Part A clause 4 and Part C clause 5.
1604 CL s750 Part A clause 5 and Part C clause 6.
1605 CL s750 Part A clauses 8 and 9 and Part C clause 7.
1606 CL s750 Part A clause 10.
1607 CL s750 Part A clause 11 and Part C clause 8.
1608 CL s750 Part A clauses 12 and 13 and Part C clauses 9 and 10.
1609 CL s750 Part A clause 14 and Part C clause 11.
1610 CL s750 Part A clause 15 and Part C clause 12.
1611 CL s750 Part A clause 16 and Part C clause 13.
1612 CL s750 Part A clause 20 and Part C clause 15.
1613 CL s750 Part A clause 18.
1614 CL s750 Part A clauses 6 (alterations in share capital of offeror in past 5 years), 19 (information about shares in other body corporate) and 21 (price of such shares).
1615 CL s750 Part B clause 1 and Part D clause 1.
1616 CL s750 Part B clause 2 and Part D clause 2.
1617 CL s750 Part B clause 3 and Part D clause 3.
1618 CL s750 Part B clause 4 and Part D clause 4.
1619 CL s750 Part B clause 5 and Part D clause 5.
1620 CL s750 Part B clause 6 and Part D clause 6.
1621 CL s750 Part B clause 7 and Part D clause 7.
1622 CL s750 Part B clause 8 and Part D clause 8.
1623 CL s750 Part B clause 9 and Part D clause 9.
1624 CL s750 Part B clause 10 and Part D clause 10.
1625 CL s750 Part B clause 11.

material changes in the target's financial position since the date of the last balance sheet.[1626]

In certain circumstances an independent expert's report must also be sent to shareholders. Those circumstances, broadly speaking, are where there is a conflict of interest involving the offeror and offeree.[1627] The report addresses whether the offer is fair and reasonable[1628] and must be sufficiently comprehensive to enable shareholders to assess the merits of the offer.[1629]

The content of takeover documents is disputed territory with well resourced incumbent directors and rival bidders willing to challenge them in the hope of defeating or at least delaying the takeover.[1630] Therefore courts of law have had many opportunities to consider takeover documents and some general principles have arisen. Takeover documents must generally be understandable to the ordinary, reasonable investor[1631] without the assistance of legal[1632] or sophisticated investment[1633] advice. Such investors can be expected to read, even if quickly, at least the salient features of such documents[1634] but certainly not necessarily every line of lengthy and complicated documents.[1635] This is because takeover documents are essentially commercial documents and should be interpreted in a commonsense rather than a pedantic way.[1636] However the courts rightly concede that some of the material in takeover documents is inherently complex and there is a limit on how simply this type of information can be cast for unsophisticated shareholders; such shareholders will struggle to some extent in their understanding.[1637] Such treatment by the courts is sensible and consistent with my conclusions concerning understandability of information in chapter 4.6.[1638]

There are also special liability rules which apply to the information in section 750 statements. Under these provisions liability arises if the section 750 statements are false in a material particular, materially misleading or omit material matter.[1639] If there is such a breach then the offeror or offeree is liable (depending on whose statement was in breach) as are any of their directors unless the director was not present when the statement was authorised or the director voted against the statement.[1640] It is a defence to

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1626 CL s750 Part B clause 12 and Part D clause 11.

1627 CL s623, 648 and 703(5) and LR 10.1. Discussed in Little, *Law of Company Takeovers* (Law Book Company, New South Wales, 1997) at chapter 10.

1628 CL s648(1) and LR 10.10.2.

1629 *Strategic Minerals Corp Ltd v Hendry Rae and Court* (1996) 14 ACLC 485 at 489; *The Duke Group Ltd (in liq) v Pilmer* (1998) 16 ACLC 567 at 689. See Little, *Law of Company Takeovers* (Law Book Company, New South Wales, 1997) at [1009].

1630 Little, *Law of Company Takeovers* (Law Book Company, New South Wales, 1997) at [700].

1631 *Australian Consolidated Investments Ltd v Rossington Holdings Pty Ltd (No 2)* (1992) 10 ACLC 600 at 601 per Davies J.

1632 *Gantry Acquisition Corp v Parker & Parsley Petroleum Pty Ltd* (1994) 12 ACLC 628 at 633 per Sheppard J and 639 per Burchett J.

1633 *Pancontinental Mining Ltd v Goldfields Ltd* (1995) 13 ACLC 577 at 585 per Tamberlin J.

1634 *Re Myer Retail Investments Pty Ltd* (1983) 1 ACLC 990 at 997 per Sheppard J.

1635 *Tonville Pty Ltd v Stokes (Australasia) Ltd* (1986) 4 ACLC 338 at 348 per Brooking J.

1636 *Gantry Acquisition Corp v Parker & Parsley Petroleum Pty Ltd* (1994) 12 ACLC 628 at 633 per Sheppard J.

1637 *TNT Aust Pty Ltd v Normandy Resources NL* (1989) 7 ACLC 309 at 329 to 330 per Jacobs J; on appeal (1989) 7 ACLC 1090 at 1118 per O'Loughlin J.

1638 See also the similar treatment concerning the understandability of information sent to shareholders in general meeting for their consideration discussed in chapter 10.4.

1639 CL s704(1) and (3).

1640 CL s704(2) and (4).

liability if the person believed on reasonable grounds that the statement was true, not misleading or for an omission that there was no material omission or the omission was not material.[1641] If this belief ceases then it is also a defence if the person gave as soon as practicable reasonable notice of appropriate corrective information.[1642] If liable the offenders are subject to a fine of 50 penalty units or imprisonment for one year or both.[1643] They are also liable to pay compensation to any person who acts, or refrains from acting, on the statement and who suffers loss or damage as a result of relying on the false, misleading or omitted matter.[1644] The same defences as described above apply to civil liability.[1645] In addition liability also arises under Corporations Law section 995 (discussed above under prospectuses).[1646] As a result those involved in the contravention, including professional advisers, may also be liable.[1647] Liability under section 52 of the *Trade Practices Act* 1974 (Cth) also would seem to apply in these circumstances. Broadly speaking the liability rules for takeover documents are the same as for prospectuses. This pattern of liability also applies to expert's reports [1648] who can also be liable in tort.[1649]

Conclusion

In my opinion shareholders are justified in receiving and do receive adequate information on the capital structure of the company and the identity of the company's security holders. Australian law has recognised the shareholders vital interest in this topic. This occurs at a substantive level where there is the greatest incursion into the broad and exclusive powers of management enjoyed by the directors; alterations to capital and similar transactions require shareholder approval. There is also a broad range of specific disclosure obligations concerning the capital position of the company.

This information is accurate and complete. The capital position is a matter of concrete facts and therefore there is no problem with the information being accurate. The range of laws on this topic ensures that the information provided is complete. Directors' interest in distorting this information is small and therefore there is little concern with credibility. Also as the capital position is factual only the deliberately deceitful would attempt to misrepresent the position. The other qualities are not of particular relevance and I therefore do not discuss them.

Also shareholders receive adequate information at the time of a takeover or when a prospectus is issued. These are two critical times for shareholders in their investor roles; when they are being asked to subscribe to a new issue by the company and when they are being asked to sell all of their shares to someone who wants control of the company. The pattern of liability rules ensures that due diligence occurs which in turn enhances the

1641 CL s704(6).

1642 CL s704(6)(b)(ii).

1643 Schedule 3 to the Corporations Law. CL s9 defines penalty unit as $100.

1644 CL s704(7).

1645 CL s704(8).

1646 See CL s995(2)(b)(iii). Earp and McGrath, *Listed Companies: Law and Market Practice* (Law Book Company, Sydney, 1996) at [610].

1647 Such people can clearly be liable on the basis of CL s79 but Baxt, Ford and Black, *Securities Industry Law* (Butterworths, Sydney, 1996) at [405] doubt whether they can be liable pursuant to the special accessorial liability rule in CL s1006. In my opinion this interpretation goes against the clear wording in the relevant sections.

1648 Besides the sections mentioned above see CL s704(5); see generally Little, *Law of Company Takeovers* (Law Book Company, New South Wales, 1997) at [1019].

1649 *The Duke Group Ltd (in liq) v Pilmer* (1998) 16 ACLC 567 at 704 to 719.

quality of this information. Although not being an audit of such information, the involvement of professional advisers such as lawyers, accountants and merchant bankers who are potentially civilly liable for a breach of the liability rules helps to ensure the accuracy and credibility of this information. Particularly in the dynamic commercial setting of takeovers where there is unlikely to be adequate time to properly audit and certify such information then such liability provisions may be a suitable compromise. The understandability of information is more adequately addressed for takeovers (where suitable rules have been formulated by courts) than for prospectuses (which could use some clarification). Noticeably under both prospectus and takeover liability rules investors are able to recover any loss they suffer as a result of relying on these documents. This is consistent with their role as investors.[1650] Also in the takeover context, given the prospect of a legal challenge to the content of these documents this prospect is an incentive to ensure their accuracy. In addition, in a takeover information is provided by both the bidder and the target (usually antagonistic parties). Therefore it is more likely shareholders will receive information from different perspectives, which the shareholders can then decide which to give more weight.

8.4 CORPORATE

Introduction

This part of the chapter deals with the information shareholders receive about the separate entity that is their company. The disclosures made under this category are necessary but rather mundane, uncontroversial and do not need to be justified. This part examines the information shareholders receive about their company under the following headings:

- transactions requiring shareholder approval;
- registers of charges and debentures;
- directors report;
- notifications to the ASX; and
- miscellaneous.

Transactions Requiring Shareholder Approval

The Corporations Law requires shareholders to approve the following:

- transferring the company's place of incorporation;[1651]
- altering the status of a company;[1652]
- altering the constitution (if the company has one);[1653]
- a target company approving an acquisition of its shares that would otherwise be prohibited by Corporations Law Chapter 6 (takeovers);[1654]
- a decision to voluntarily wind up the company;[1655] and
- a compromise or arrangement between a company and its members.[1656]

1650 This contrasts with their inability to recover such losses if suffered as a result of relying on the periodic financial statements; see chapter 6.4.

1651 CL s1362B and Regulation 10.1.08.

1652 CL s162(1)(a); special resolution.

1653 CL s136(2).

1654 CL s623 (certain voting restrictions apply).

1655 CL s491; special resolution.

1656 CL s411(4)(a)(ii); special resolution. CL s412 prescribes the information which must be sent to the shareholders in an explanatory statement with the notice of meeting. Section 412(1)(a) provides:

I discussed the third, fourth and fifth dot points in chapter 4. Once again, adequate information is provided to shareholders with the notice that convenes them meet to consider these matters.[1657]

Registers

If a company issues debentures then the company must keep a register of debenture holders.[1658] The register must contain the name and address of the holders of debentures and the amount of debentures held by each of them.[1659]

Also the company must keep a register of charges.[1660] The register of charges contains particulars of "charge[s] (whether registrable or not) on property of the company or upon the acquisition of property subject to a charge".[1661] The Register must contain the following information:

- the date the charge was created or the date charged property was acquired;
- a short description of the liability (whether present or prospective) secured by the charge;
- a short description of the property charged;
- the name of the chargee or trustee for debenture holders; and
- the name of the person the company believes to be the holder of the charge.

So shareholders have access to information on the debt position of the company (and charges over property of the company securing these debts) by these two registers. This type of disclosure is similar to the information they receive on the equity position of the company by the register of shareholders and option holders (discussed above). In addition it must be remembered that information on the liabilities of the company, including the debts of the company, is set out in the balance sheet.

Directors' Report

The Directors' Report must contain the address and telephone number of the principal registered office in Australia.[1662] It is important that shareholders know where the

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with every notice convening the meeting that is sent to a creditor or member, send a statement....:

> (i) explaining the effect of the compromise or arrangement and, in particular, stating any material interests of the directors, whether as directors, as members or creditors of the body or otherwise, and the effect on those interests of the compromise or arrangement in so far as that effect is different from the effect on the like interests of other persons; and
> (ii) setting out such information as is prescribed and any other information that is material to the making of a decision by a creditor or member whether or not to agree to the compromise or arrangement, being information that is within the knowledge of the directors and has not previously been disclosed to the creditors or members....

The prescribed information is set out in regulation 5.1.01 and schedule 8 part 3. The prescribed information includes "whether the director recommends the acceptance of the Scheme or recommends against acceptance and, in either case, his or her reasons for so recommending" (see schedule 8, clauses 8301(a)(i) and (b)(i)).

1657 See chapter 10.4.
1658 CL s168(c). See also CL s1047.
1659 CL s171(1).
1660 CL s271(2).
1661 As above.
1662 LR 4.10.11.

company's registered office is. This is important if shareholders want to engage in any formal correspondence with the company or to invoke legal powers against the company (which requires service on the registered office).

Notification to the ASX

Listed companies also have to notify the ASX of:
- a change to the company's registered office;[1663] and
- any change to the constitution.[1664]

Miscellaneous

Shareholders also have access to:
- a copy of the constitution;[1665] and
- a copy of minutes of shareholders meeting.[1666]

Conclusion

As I stated previously, this is necessary information but it is mundane and uncontroversial. However it is part of the package of information provided to shareholders and completeness requires at least a description of this information.

8.5 CHAPTER CONCLUSION

Shareholders have a clear interest in receiving information on the three topics considered in this chapter. First, shareholders, or at least some of them, base their investment decisions based on the businesses that are owned and operated by their companies. Shareholders receive a range on information from a variety of sources on these businesses. Nonetheless improvements could be made, most noticeably by introducing a MD&A requirement into Australian law.

Second, shareholders also receive a range of information from numerous sources about the corporation's capital. It is not surprising to see the most information sent to them when they are offered more shares to buy (share issues generally require the publication of a prospectus) or they are all offered the opportunity to sell their shares (at the time of a takeover). However the disclosures are not restricted to these two situations and other disclosure requirements recognise the need for this type of information for a variety of reasons but principally in recognition of the need to identify the owners of shares in a fluid market. The information in both of these first two categories is a recognition by the law of the role of shareholders as investors who have information needs which are distinct form their role as monitors.

Third, information about the corporate entity is nuts and bolts type information that is necessary but is neither very interesting nor controversial.

1663 LR 3.14.
1664 LR 15.4.2.
1665 CL s139.
1666 CL s251B.

CHAPTER 9

SOCIAL INFORMATION NEEDS OF SHAREHOLDERS

9.1 INTRODUCTION

Shareholders have a financial relationship with the company, therefore it is not surprising that they are primarily interested in financial information. But are they interested in receiving information about the social impacts of the company (commonly called corporate social reporting (CSR))?

This is an important question because whilst companies are the engine room of our industrialised economy and make a lot of positive contributions to modern society they also have enormous negative social impacts.[1667] Companies collectively employ millions of people. If a company collapses it arguably affects employees a lot more directly and acutely than investors, since employees have their undiversified human capital invested in their company. It is companies with unsafe work practices which kill and injure thousands of employees each year.[1668] Companies are the culprits which manufacture and sell products. If they sell dangerous products this will directly and acutely affect consumers. Vivid examples of this are the horrendous consequences of companies which sold products such as thalidomide and more recently the Dalkon Shield.[1669] Also it is industrial companies which are pulling down our forests, mining our land, and pumping out their toxic wastes into our rivers, oceans and sky.[1670] Notable examples of horrendous pollution are the Exxon Valdez oil spill in Alaska and in South Australia the continuing problem of lead contamination of the air by BHP at Port Augusta.

These issues are critical and must be, and to some extent are being, tackled head on. The principal controlling device is substantive laws which directly regulate these matters. In Australia there are a vast array of laws designed to protect employees,[1671] consumers[1672] and the environment.[1673] Without in any way derogating from this approach, mandatory

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1667 Tolmie, 'Corporate Social Responsibility' (1992) UNSW Law Journal 268 at 275.

1668 Berns and Baron, *Company Law and Governance: An Australian Perspective* (Oxford University Press, Melbourne, 1998) at 114 to 115 who document the role of corporations with the industrial diseases associated with contact with asbestos; for a reported case on this see *Midalco v Rabenalt* [1989] VR 461. See also Fisse and Braithwaite, *The Impact of Publicity on Corporate Offenders* (State University of New York Press, USA, 1983) in chapter 9.

1669 More recently and closer to home there has been the Garabaldis' metwurst disaster which made a lot of children seriously ill and killed at least one of them.

1670 For a description of how companies have negative environmental impacts see Freedman, 'Accounting and the Reporting of Pollution Information' (1993) 5 Advances in Public Interest Accounting 31 at 31 to 32.

1671 *Safety Rehabilitation and Compensation Act* 1988 (Cth); *National Occupation Health and Safety Commission Act* 1985 (Cth); *Occupation Health and Safety Act* 1986 (S.A.); *Workers Rehabilitation and Compensation Act* 1986 (S.A.).

1672 *Trade Practices Act* 1974 (Cth); *Fair Trading Act* 1987 (S.A.); *Consumer Transactions Act* 1972 (S.A.); *Sale of Goods Act* 1895 (S.A.); *Consumer Credit (South Australia) Act* 1995 (S.A.) (which incorporates by reference the new *Consumer Credit Code*).

1673 *World Heritage Properties Conservation Act* 1983 (Cth); *Environment Protection (Impact of Proposals) Act* 1974 (Cth); *Environment Protection (Nuclear Codes) Act 1978* (Cth);

disclosure rules have their part to play in the arsenal of weapons to tackle these problems.[1674] Indeed such disclosure rules could complement these substantive rules.

In this chapter I take a broad look at CSR to shareholders. The pattern of this chapter is as follows:

- a definition of what is commonly referred to as CSR;
- whether mandatory CSR to shareholders is warranted (or whether it can be justified in favour of other stakeholders or on some other basis);
- a description of the current mandatory disclosure rules;
- a review of voluntary CSR by corporations drawing from the large number of empirical studies in this area including my own undertaken in 1995;
- a description of the types of mandatory CSR that are available; and
- the issue of the audit of CSR.

9.2 SOCIAL INFORMATION DEFINED

It is only possible to understand CSR by first understanding the social behaviour of companies. There is a maturing corporate social responsibility movement which has defined corporate social responsibility as "the impact of a company's activities on the welfare of a society".[1675] Corporations have a range of social impacts which are traditionally broadly categorised according to the constituents they affect, namely:
(1) employees, embracing such issues as health and safety, the physical and psychological working environment and equal opportunity.[1676] Included in this category are issues such as sexual and racial discrimination and "sweat shops" which occur both locally and in developing nations;
(2) consumers, where the origin, quality, composition, suitability and safety of goods and services are important;[1677]
(3) the community. Corporations are part of the community and corporate activities impact it. For example companies often have business premises in a local community where most of their employees and their families live. Perhaps the most startling impacts a company can have is in a smaller community where the company is the predominant employer and decides to shift its operations.[1678] Also a company's efforts at philanthropy and political donations (and even bribery!) are usually listed under this category; and
(4) the environment, where manufacturing activities in particular can have a devastating effect.[1679]

Environment Protection Act 1993 (S.A.); *Native Vegetation Act* 1991 (S.A.); and *Soil Conservation and Land Act* 1989 (S.A.).

1674 See generally Fisse and Braithwaite, *The Impact of Publicity on Corporate Offenders* (State University of New York Press, USA, 1983).

1675 Henderson & Peirson, *Issues In Financial Accounting* (Longman Cheshire, Melbourne, 6th ed., 1994) at 872. A different definition is provided by Tolmie, 'Corporate Social Responsibility' (1992) UNSW Law Journal 268 at 271: "....corporate social responsibility....involves, to some degree, the harnessing of corporate resources to identify social problems and evolve or enforce solutions to them". For a broad view of social and economic responsibility which goes beyond corporate actors see Galbraith, *The Good Society: The Humane Agenda* (Sinclair-Stevenson, Great Britain, 1996).

1676 Gray, Owen and Maunders, *Corporate Social Reporting* (Prentice Hall, U.K., 1987) at Chapter 6.

1677 Above Chapter 8.

1678 Berns and Baron, *Company Law and Governance: An Australian Perspective* (Oxford University Press, Melbourne, 1998) at 116.

1679 Above Chapter 4. See also Estes, *Corporate Social Accounting* (John Wiley & Sons, New York, 1976) at 19 to 22.

The constituents of the first three categories are reasonably well defined but with varying degrees of cohesiveness.[1680] Those who actively care for the environment are less clearly identifiable as a group but there is a significant number of them. These constituents clearly have an interest in receiving information on a corporation's activities which impact them. But note that shareholders are not part of this list. These issues do not directly impact on shareholders as shareholders the way it impacts these other people and therefore the company's social impacts are of less immediate interest to them. This is why I explore whether shareholders nonetheless have a sufficient interest to receive social information, or whether there are other reasons to justify such disclosures under the next heading.

It naturally follows that CSR is information on these topics. It is not surprising that the purpose of CSR is "to establish and communicate the social impacts of business actions on those who are affected by them".[1681]

9.3 JUSTIFICATION FOR DISCLOSURE OF SOCIAL INFORMATION

Whether disclosure of social information is warranted is a difficult question. The question is multi-faceted and involves weighing competing arguments often of a different nature. In this part of the chapter I consider whether shareholders have sufficient interest in such information to warrant disclosure.[1682]

Under a strict dualist view of the company,[1683] where profit maximisation is the residual goal of the company, then reporting social information is unnecessary. In fact voluntarily incurring the costs of such disclosures would be contrary to the purposes of a strict profit maximisation regime.[1684] However Australian law does not embrace a strict dualist approach. First, since monism is embraced then voluntary, seemingly altruistic expenditures are acceptable so long as they can be justified according to the long-term profitability of the company.[1685] Arguably if directors choose to depart from a strict

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1680 One author considers that consumers have no cohesion: "consumers are individuals, aggregated really only for statistical purposes"; see Medawar, *The Social Audit Consumer Handbook* (Macmillan, Great Britain, 1978) at 6.

1681 American Institute Of Certified Public Accountants, *The Measurement Of Corporate Social Performance* (AICPA, New York, 1976) at 6.

1682 It is also possible to argue that social disclosures are warranted because of the interest of other stakeholders or public policy generally, see for example Tolmie, 'Corporate Social Responsibility' (1992) UNSW Law Journal 268 at 270; and Wheeler, 'Inclusive Communities and Dialogical Stakeholders: A Methodology for an Authentic Corporate Citizenship' (1998) 9 Australian Journal of Corporate Law 1. However consistent with the framework of this thesis I will only consider this issue from the perspective of shareholders.

1683 Discussed in chapter 4.4.

1684 Henderson & Peirson, *Issues In Financial Accounting* (Longman Cheshire, Melbourne, 6th ed., 1994) at 873.

1685 Tolmie, 'Corporate Social Responsibility' (1992) UNSW Law Journal 268 at 270 and 286. However note the influential American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (St. Paul Minn, USA, 1994) has divorced social responsibility behaviour from the profit maximisation norm. ALI at 2.01 of its report provides:

> (a)...a corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.
>
> (b)Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business:
>
> > (1)Is obliged, to the same extent as a natural person, to act within the boundaries set by law;
> >
> > (2)May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and

profit maximising position they should report this information to shareholders and justify the expenditure, otherwise such expenditure is funds taken from the bottom line profit shareholders are entitled to.[1686] This will catch some forms of social information, notably positive acts that benefit constituencies other than shareholders. However disclosure under this justification will not catch negative social impacts a company has in the normal course of conducting its business.

Second, Australian law embraces a modestly idealistic view of corporations. Under this paradigm corporations are compelled to comply with the law even if their profits are thereby reduced.[1687] Therefore as I concluded in chapter 4.4, this justifies disclosure to shareholders as monitors of a corporation's compliance with social oriented laws.[1688] Disclosure by companies of their compliance with the vast array of social laws would go a long way to providing adequate disclosure to shareholders.

From a less theoretical perspective there are arguments that shareholders are interested in social information from an investment perspective. Various authors argue this, including:

- Bowman and Haire who argue that a balanced degree of corporate social responsibility is a sign of a flexible, sensitive and responsive management style that results in higher profitability.[1689] They rely on empirical research to support their argument.[1690] They also find that companies which actively engaged in socially responsible behaviour reflected this in their annual report compared with companies which were less active;[1691]
- similarly Trotman and Bradley see a link between social responsibility and long term planning.[1692] They argue:

  > Therefore, it can be expected that companies which place strong emphasis on the long term in making decisions would be more likely to disclose social responsibility information than companies which concentrate on the immediate future in making decisions. By disclosing social responsibility information the company may be improving its public image and increasing its chances of long run survival and growth.[1693]

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(3)May devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.

1686 *Hutton v West Cork Railway Co* (1883) 23 Ch D 654 per Bowen LJ at 671 "the law does not say that there are to be no cakes and ale, but there are to be no cakes and ale except as are required for the benefit of the company".

1687 Discussed in chapter 4.4.

1688 Henderson & Peirson, *Issues In Financial Accounting* (Longman Cheshire, Melbourne, 6th ed., 1994) at 880; Tolmie, 'Corporate Social Responsibility' (1992) UNSW Law Journal 268 at 269 to 270. Such disclosure would also be justified for the same reasons as I argue that directors should provide information about their compliance with their fiduciary duties (discussed in chapter 7.4).

1689 Bowman and Haire, 'A Strategic Posture Toward Corporate Social Responsibility' (1975-Winter) 18 California Management Review 49 at 54 and 57; see also Abbott and Monsen, 'On the Measurement of Corporate Social Responsibility: Self Reported Disclosures as a Method of Measuring Corporate Social Involvement' (1979) 22 Academy of Management Journal 501 at 513 to 514.

1690 Bowman and Haire, 'A Strategic Posture Toward Corporate Social Responsibility' (1975-Winter) 18 California Management Review 49 at 51 to 54. See also Wheeler, 'Inclusive Communities and Dialogical Stakeholders: A Methodology for an Authentic Corporate Citizenship' (1998) 9 Australian Journal of Corporate Law 1 at 14.

1691 Above at 51.

1692 Trotman and Bradley, 'Associations Between Social Responsibility Disclosure and Characteristics of Companies' (1981) 6 Accounting, Organisations and Society 355.

1693 Above at 358 (see also at 361).

A view to the long term is generally viewed as a sign of good management.[1694] This is supported by the material concerning management performance which listed "environmental competitiveness" as one of the intangibles managers must consider to enhance long term profitability;[1695] and

- Spicer argues:

> The sanctions that have been applied increasingly to corporate activities that have been judged to be socially undesirable include legislative enactments, government regulation, judicial remedies and consumer retaliation. Clearly, when severe and costly sanctions are invoked, the expected economic impact on the affected corporation may be sufficient to induce a direct relationship between its social performance on key issues (eg pollution control) and the worth of its securities. Under these conditions, it would not be surprising to find knowledgable investors considering a corporation's social performance in making their investment decisions;[1696]

Spicer's empirical study supported his argument.[1697] Support for Spicer's thesis is available from other studies based on empirical evidence drawn from institutional investors.[1698] This dovetails into another argument. As mentioned in the introduction to this chapter, there are a considerable number of socially oriented laws currently in existence. The costs to corporations of complying with these laws can be significant, as are the monetary and other sanctions if they breach them. Therefore any disclosure that corporations are not complying with the law will indicate to investors that the company will have to incur significant compliance costs and may be subject to significant penalties.[1699] These costs obviously detract from the future cash flows that are available to shareholders.

1694 Australian Institute of Company Directors, *Measuring Board Performance* (AICD, Sydney, 1993) at 3. Managers often criticise institutional investors of not being long term investors which hinders managers abilities to implement policies which is for the long term benefit to the company. See for example Black, 'Agents Watching Agents: The Promise Of Institutional Investor Voice' (1992) 39 UCLA Law Review 811 at 862 to 864; Coffee, 'Liquidity Versus Control: The Institutional Investor As Corporate Monitor' (1991) 91 Columbia Law Review 1277 at 1324 to 1326.

1695 Chapter 7.3.

1696 Spicer, 'Investors, Corporate Social Performance and Information Disclosure: An Empirical Study' (1978) 53 The Accounting Review 94 at 96. See also Spicer, 'Market Risk, Accounting Data and Companies Pollution Control Records' [1978] Journal of Business Finance and Accounting 67 quoted in Trotman and Bradley, 'Associations Between Social Responsibility Disclosure and Characteristics of Companies' (1981) 6 Accounting, Organisations and Society 355 at 358; Abbott and Monsen, 'On the Measurement of Corporate Social Responsibility: Self Reported Disclosures as a Method of Measuring Corporate Social Involvement' (1979) 22 Academy of Management Journal 501 at 506.

1697 Spicer, 'Investors, Corporate Social Performance and Information Disclosure: An Empirical Study' (1978) 53 The Accounting Review 94. So did a subsequent empirical study, see Shane and Spicer, 'Market Responses to Environmental Information Produced Outside the Firm' (1983) 58 The Accounting Review 521.

1698 Longstreeth and Rosenbloom, *Corporate Social Responsibility and the Institutional Investor* (Praeger Publishers, USA, 1973) (which is quoted in Spicer, 'Investors, Corporate Social performance and Information Disclosure: An Empirical Study' (1978) 53 The Accounting Review 94 at 96); Freedman, 'Accounting and the Reporting of Pollution Information' (1993) 5 Advances in Public Interest Accounting 331 at 33 to 34 where the author discusses 3 previous studies, two of which support Spicer's thesis and one which contradicts it but has itself been subjected to subsequent criticism.

1699 Shane and Spicer, 'Market Responses to Environmental Information Produced Outside the Firm' (1983) 58 The Accounting Review 521 at 524. See also Tilt, 'Environmental Policies of Major Companies: Australian Studies' (1997) 29 British Accounting Review 367 where she concludes from the result of her study that "environmental laws (or the threat of environmental laws) appears to be a major influence on companies' policy development and environmental

So the need for CSR can be linked to shareholders as investors.[1700] There is also empirical evidence which supports the desire by shareholders for CSR.[1701]

Without derogating from shareholders being investors, they are also human beings. Many human beings are interested (some acutely and others with varying degrees of enthusiasm) in issues such as the environment, product safety and equal opportunity to name a few types of social information. This receives limited statutory recognition in the takeover context where bidders must supply information concerning their intentions about the employees of the target.[1702] This has been judicially interpreted "to perhaps impliedly acknowledge that offeree shareholders may be motivated by considerations other than economic self interest".[1703] Also some shareholders have a more holistic approach to their investments in companies and have an interest in receiving social information is evidenced by some shareholders directing their funds to "ethical investments".[1704] Ethical investments are investments made not simply on the basis of a company's financial performance but also on its social performance. A positive or negative screen, or both usually determine social performance.[1705] Under a positive screen the company is assessed to see if it has policies in place to ensure the company has positive social impacts.[1706] A negative screen identifies whether companies at the least do not have negative social impacts. Social criteria are established for both screens.[1707] Investments are then made in companies which pass the screening process. However given that the trend to ethical investments is not pervasive or even commonplace then the demand for social information from shareholders based on this evidence must be regarded as weak.[1708]

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activities". However she also concludes that most companies do not disclose their corporate environment policies to the public.

1700 Other reasons have been posited for CSR. For example Abbott and Monsen, 'On the Measurement of Corporate Social Responsibility: Self-Reported Disclosures as a Method of Measuring Corporate Social Involvement' (1979) 22 Academy of Management Journal 501 at 508 to 509 note the decline in public confidence in business and view CSR as an attempt to bolster this sagging confidence and legitimise business actions. Alternatively Epstein, Flamholtz and McDonough, 'Corporate Social Accounting in the United States of America: State of the Art and Future Prospects' [1976] Accounting, Organisations and Society 23 argue that CSR is voluntarily undertaken by companies out of fear of, and in the hope of averting, mandatory government regulation.

1701 Anderson and Epstein, 'The Usefulness of Annual Reports' (1995-April) Australian Accountant 25; Simpson, 'Annual Reports: Glossy, Expensive and Useless?' (1997-September) Australian Accountant 16; Rankin, *Corporate Reporting-The Green Gap* (Institute of Chartered Accountants in Australia, Queensland, 1996) at 11 to 13; Epstein and Freedman, 'Social Disclosure and the Individual Investor' (1994) 7 Accounting, Auditing and Accountability Journal 94 at 105.

1702 See chapter 8.3 under the sub-heading 'Takeovers'.

1703 *Associated Dairies Ltd v Central Western Dairy Ltd* (1993) 11 ACLC 827 at 835 per Ryan J; approved by Burchett J in *Gantry Acquisition Corp v Parker and Parsley Petroleum Australia Pty Ltd* (1994) 123 ALR 29 at 40.

1704 An example of a company which manages such investments is Australian Ethical Investment Ltd (contactable at www.austethical.com.au).

1705 Mangos, 'Ethical Investments', unpublished draft conference paper (author on file).

1706 Above Part 3.

1707 Above Part 3. One live issue in the debate is whose ethics are used. This is an interesting philosophical question which I am unable to pursue in this thesis. However the criticism of whose ethics does not scuttle the whole debate. Above Part 2.

1708 There is a small amount of research which supports this conclusion. The research is summarised in Gray, Owen and Maunders, *Corporate Social Reporting* (Prentice Hall, U.K., 1987) at 69.

There is another argument that is different from, but in a similar vein to, the last one. Shareholders are not necessarily different and discreet from the groups of people primarily affected by a company's social impacts.[1709] A person may have more than one connection with the company. For a shareholder may also be an environmentalist employed by the company who consumes the company's goods or services and lives in the local community. Such a person may suffer conflicting loyalties and interests, for example if her employer is seriously polluting the local environment.[1710] These people with pluralistic connections with the company have a clear interest in receiving pertinent social information.

One objection to these last two arguments is that shares are often owned not by individual people by other companies, bank intermediaries and governments.[1711] But all of these institutions ultimately have human actors behind them. Certainly the ultimate individual investors may represent a particular gender, race and class of society, most likely the upper to middle classes. For example some of the direct individual owners and indirect ultimate beneficiaries of unit trusts may fall within this category. But just because a person is from a particular class does not necessarily mean they have different interests in other types of information than the rest of society. In any event in the case of institutional investors the ultimate beneficial owners are often employees participating in superannuation schemes. Given the rise of institutional investors[1712] then this argument must be given credence. In the case of governments holding shares, then governments ultimately represent their entire constituency. Shareholdings by institutional investors and government agencies suggests that the ultimate beneficial owners of these shares have pluralistic connections with the company. This adds weight to the argument that a more holistic view of who shareholders are should be taken.[1713]

The need for CSR can also be linked to shareholders as citizens. As concluded in chapter 5, shareholders as corporate citizens should as a general principle be entitled to information on any topic concerning the corporation. This is only subject to an exception for commercial-in-confidence information and trade secrets. Social information is certainly a topic of information concerning the corporation and therefore a legitimate topic for disclosure to shareholders.

There are arguments against mandatory CSR to shareholders. Public policy on social issues has found expression in a range of laws (other than corporate law). It would be unduly narrow to consider corporate law, and the disclosures warranted by it, in isolation from these other laws. Where these laws require disclosure to a government regulatory body then shareholders and others generally have access to this information from the regulatory body under FOI legislation.[1714] It is difficult to assess the adequacy of these

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1709 Wheeler, 'Inclusive Communities and Dialogical Stakeholders: A Methodology for an Authentic Corporate Citizenship' (1998) 9 Australian Journal of Corporate Law 1 at 16 states "the reality is that often an individual is a member of many different communities at the same time which do not necessarily have shared interests".

1710 A vivid and now well known situation which shows this is the story of Karen Silkwood, popularised in the movie starring Meryl Streep simply titled "Silkwood". Silkwood was an employee at a nuclear plant who had concerns about the safety of the plant and who was exposed to radiation during the course of her employment.

1711 Australian Stock Exchange Limited, *1995 Annual Report* at M10.

1712 Discussed in chapter 4.5.

1713 Unfortunately I suspect that courts would not take such a broad, holistic view of who shareholders are. They are likely to look at the issue with more particularity and view shareholders in their capacity as shareholders. On the other hand the Legislature may take a broader view.

1714 Discussed in chapter 5.4.

laws in the context of the issue being considered. On one hand it can be argued that separate disclosure to shareholders is not required because companies operate against the backdrop of these laws and shareholders and other stakeholders should rely on the proper and effective operation of them. Social disclosure by individual companies can then be viewed as an additional, superfluous requirement that is not justified, particularly given the additional costs of such disclosures. There is some weight to these arguments but they are weak and there are counter arguments. First, there is concern about the level of compliance with a lot of these laws so arguably the existing system needs reinforcement. Second, if directors know they must make regular disclosures about their companies compliance with social oriented laws then they will take these laws more seriously (ie. disclosure has a deterrent effect). This may even mean directors adopting legal compliance programs to ensure conformance by their companies with the law.[1715] If this is the end result of disclosure this can only be a good outcome. If an effective compliance program is in place then reporting on the outcomes of that program should not require much additional effort or cost. Third, and the strongest argument, is that if disclosure to shareholders is warranted, then disclosure should be made directly to them. Also the two step process of access to information[1716] means this information is not particularly accessible. For these reasons CSR to shareholders remains justified.

Although I have mentioned the cost of social disclosures during the preceding discussion it also bears mentioning separately. There is a financial cost to the provision of any information. This cost must be weighed against the benefits to be received by requiring disclosure. In the context of social disclosure this is particularly difficult comparison because money is being compared with social outcomes. That is, it involves people expressing their evaluation of such topics as the environment and comparing this with very different topics such as the accountability of companies and the cost of information. To a large extent these are incommensurable.[1717] In the end each person has to make an individual judgement on whether disclosure is warranted. In my opinion companies should be accountable[1718] for their social impacts and the key to accountability is the publication of pertinent information (except for those obvious cases where the deleterious impact is patently observable and speaks for itself). This is justifiable from shareholders in their monitoring, citizenship and investment roles. Therefore in my opinion companies should be compelled[1719] to disclose the following information:

- any voluntary expenditures on corporate social responsibility issues, since this ensures accountability on a monist view of the company; and

1715 This is similar to the arguments made in chapter 7.4.

1716 The two step process in the US is described in Baram, 'Risk Communication Law and Implementation Issues in the United States and the European Community' in Baram and Partan (eds), *Corporate Disclosure of Environmental Risks: U.S. and European Law* (Butterworths, U.S., 1990).

1717 See the discussion in chapter 9.6 under the fifth heading concerning incommensurability.

1718 Gray, Owen and Maunders, *Corporate Social Reporting* (Prentice Hall, U.K., 1987) usefully define accountability as "...the onus, requirement, or responsibility to provide an account (by no means necessarily a *financial* account) or reckoning of the actions for which one is held responsible" at 2.

1719 There is empirical support that such disclosures should be mandated by users of the financial statements (but not by preparers of them), see Rankin, *Corporate Reporting-The Green Gap* (Institute of Chartered Accountants in Australia, Queensland, 1996) at 16 to 17; Tilt, 'The Influence of External Pressure Groups on Corporate Social Disclosure: Some Empirical Evidence' (1994) 7 Accounting, Auditing and Accountability Journal 47 at 60; Frost and Wilmshurst, 'Going Green ...But Not Yet' (1996-September) Australian Accountant 36.

- the corporations compliance with its obligations under laws designed to protect employees, consumers, the environment and the community.[1720] Such disclosure is warranted under a modestly idealistic view of the company and is supported by the link between this information and rational investment decision making. In addition as will be seen below, this is the most feasible type of CSR available at this time.

In addition companies should be encouraged to provide additional information if their social record exceeds the minimum legal requirements. This may still send useful messages to investors, other stakeholders and the public that may give the company an advantage over other companies that can only report compliance with the minimum standards set by the law.

9.4 MANDATORY DISCLOSURE LAWS

Subject to one exception, the Corporations Law and the regulations made thereunder do not explicitly require disclosure of any social information.[1721] In contrast the disclosure regimes in both the UK[1722] and the USA[1723] require some CSR to shareholders.

1720 This is the same conclusion as reached by Gray, Owen and Maunders, *Corporate Social Reporting* (Prentice Hall, U.K., 1987), discussed above and accompanying text.

1721 Deegan, 'Environmental Reporting for Australian Corporations: An Analysis of Contemporary Australian and Overseas Environmental Reporting Practices' (1996) Environmental and Planning Law Journal 120 at 121. The Whitlam government of the early 1970's introduced a Bill to require some social disclosure by companies. When the Whitlam government was removed from office the Bill, which had been passed in the House of Representatives, never passed through the Senate. Schedule 3, clauses 3(z) to (zc) of the *Corporations and Securities Industry Bill* 1975 (Cth) required the following items to be included in the annual report of a company:

> (z)the prescribed particulars in respect of the conduct during the financial year of relations between the corporations in the group and persons employed by any of them and in respect of the personnel and employment policies of the corporations in the group;
> (za)particulars of any arrangements made by the corporation in the group during the financial year for protecting the safety and health of their employees;
> (zb)particulars of any arrangements made by the corporations in the group during the financial year for protecting the safety and health of the public in relation to the activities of those corporations and for protecting the environment;
> (zc)particulars of any arrangements made by the corporations in the group during the financial year for the protection of consumers of goods or services supplied by those corporations.

The contents of this Bill is reproduced and commented on in Trotman, 'Social Responsibility Disclosures by Australian Companies' (1979-March) The Chartered Accountant in Australia 24 at 28.

1722 Guthrie and Parker, 'Corporate Social Disclosure Practice: A Comparative International Analysis' (1990) 3 Advances in Public Interest Accounting 159 at 166 to 167 where the authors state:

> For example, the following disclosures must be made by corporations in the Directors Report section of their annual report to shareholders:
> - Charitable donations (*Companies Act* 1967, Section 19)
> - Political donations greater than £200 (*Statutory Instrument* 1055 of 1980)
> - Disabled employee policy (*Health and Safety at Work Act* 1974; *Employment Act* 1982, Section 1)
> - Conditions of South African workers (Required by Board of Trade as per code of conduct for companies with an interest in South Africa [1978])
> - Employee consultation and communication policy (*Employment Act* 1982, Section 1).

1723 Brown, *The Regulation of Corporate Disclosure* (Aspen, USA, 2nd ed, 1995) at chapter 2; Boehm and Smith, 'SEC Environmental Disclosure Requirements: The Hazards for Issuers (1992) 3 (No. 1) Journal of Corporate Disclosure & Confidentiality 5 at 29 to 31.

The one explicit disclosure requirement was introduced by *The Company Law Review Act* 1998 (Cth). This Act was amended in the Senate at the instance of the Labour party and the Democrats. The amendment alters the *Corporations Law* by obliging directors to provide in their annual directors' report:

> if the entity's operations are subject to any particular and significant environmental regulation under a law of the Commonwealth or of a State or Territory-details of the entity's performance in relation to environmental regulation.[1724]

This amendment does not apply to financial years ending on or before 1 July 1998.[1725] Therefore the first disclosures will occur for the 1998/99 financial year with annual reports usually appearing in October and November. This delay is frustrating but is appropriate, as many companies will have to implement environmental compliance programs in order to be able to comply with this legislation. It will be interesting to see which environmental regulations will be regarded as "significant" and which as insignificant! (Is there such a thing as an insignificant environmental regulation?) Compared with the range of topics CSR can cover, then this amendment must be regarded as a very piecemeal approach to CSR. However this topic remains a political football. Despite agreeing to the amendments to ensure the Act was passed and passed on time, the government has since announced that it opposed this amendment (and some others).[1726] The government has referred these matters to the Parliamentary Joint Committee on Corporations and Securities. The very real prospect is that this new provision may be repealed prior to it becoming operative!

Besides this one explicit requirement, some socially oriented behaviour of corporations has a financial impact and therefore disclosure of this will appear in the financial statements. It is in the more detailed regulation of the financial statements, particularly the Accounting Standards, that disclosure of three types of social information arises. However simply calling it social information is slightly misleading. It is financial information and it is disclosed because of its financial impact on the company, albeit on a topic of social significance.

Employee Entitlements

AASB 1028[1727] requires detailed disclosure in the financial statements of all employee entitlements. Employee entitlements are defined to mean "benefit entitlements which employees accumulate as a result of the rendering of their services to an employer up to the reporting date, and include, but are not limited to, wages and salaries (including fringe benefits and non-monetary benefits), annual leave, sick leave, long service leave, superannuation and other post-employment benefits".[1728]

1724 See CL s299(1)(f); see also ASIC, *Practice Note 68: New Financial Reporting and Procedural Requirements*, 1 November 1998 at paragraphs 72 to 75. A similar rule exists in the USA, see Regulation S-K item 101 made under s13 of the *Securities Exchange Act* 1934 (USA).

1725 CL sections 1431 and 1412.

1726 Letter from the Treasurer to the chairperson of the Parliamentary Joint Committee on Corporations and Securities dated 10 July 1998.

1727 Australian Accounting Standards Board 1028 'Accounting for Employee Entitlements'.

1728 AASB 1028 at paragraph 9. However the standard is currently not finalised on the issue of superannuation contributions (see the preface to the standard).

Liabilities (Including Contingent Liabilities)

Corporations must disclose in their balance sheet their liabilities.[1729] Statement of Accounting Concept 4 defines liabilities as "the future sacrifices of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events".[1730] However disclosure of a liability in the balance sheet is only appropriate if "it is probable that the future sacrifice of economic benefits will be required" and "the amount of the liability can be measured reliably".[1731] If a liability of a social nature exists and meets the requirements of probability and measurability then the amount of the liability will be included in the balance sheet. If this occurs then the amount of the liability will be lumped in with other liabilities as one total dollar amount and users of the financial statements will be unaware of the nature of any particular liability.

If a liability does not meet the probability and measurability criteria then it is regarded as a contingent liability and must be disclosed in the notes to the financial statements.[1732] Liabilities of a social nature, such as environmental litigation[1733] or warranty claims for faulty products,[1734] will often be contingent liabilities and therefore would have to be disclosed in this way.

Extractive Industries - Restoration Costs

AASB 1022 and UIG Abstract 4 apply to companies operating in the extractive industries (eg mining companies). These standards explain how companies that have restoration costs for a mining site are to report those costs in the financial statements.[1735] The standards do not require separate disclosure of the restoration costs so this amount may simply be lumped in with other costs and appear as one total.[1736] Mining companies are frequently obliged to incur restoration cost as a condition of their permit or as a matter of policy such companies may voluntarily decide to incur such costs.[1737] Such costs are not contingent liabilities because it is not an amount the company is obliged to make to "another entity".

As all of these three potential disclosures occur in the financial statements they are subject to the usual requirement that the amounts involved be material.[1738] Therefore in public companies with very large market capitalisation it is likely that only very significant social events will have to be disclosed in the financial statements. It is

1729 AASB 1034 'Information to be Disclosed in Financial Reports'.

1730 SAC 4 'Definition and Recognition of the Elements of Financial Statements' at clause 48.

1731 SAC 4 'Definition and Recognition of the Elements of Financial Statements' at clause 65.

1732 AASB 1034 'Information to be Disclosed in Financial Reports' at clause 7.1(c) to 7.2.1.

1733 SAC 4 'Definition and Recognition of the Elements of Financial Statements' at clause 70 (which mentions litigation in a general way).

1734 SAC 4 'Definition and Recognition of the Elements of Financial Statements' at clause 71.

1735 AASB 1022 'Accounting for the Extractive Industries' at paragraph .40, discussed in Deegan, 'Environmental Reporting for Australian Corporations: An Analysis of Contemporary Australian and Overseas Environmental Reporting Practices' (1996) Environmental and Planning Law Journal 120 at 121.

1736 Frost and Wilmshurst, 'Going Green ...But Not Yet' (1996-September) Australian Accountant 36.

1737 AASB 1022 'Accounting for the Extractive Industries' at paragraph (xv). See also Henderson and Peirson, *Issues in Financial Accounting* (Longman, Melbourne, 7th ed., 1995) at 778. The authors point out a weakness in the relevant standards concerning the provision for restoration costs.

1738 Materiality was discussed in chapter 6.3 under the subheading "Content of the Accounts".

strongly arguable that these matters are so important that they should not be bounded by the materiality requirement. This certainly is the approach adopted in the US concerning disclosure of environmental litigation involving a government authority.[1739] This is where the tension over whether this is principally financial information or principally social information becomes critical. Whilst these requirements remain part of the financial statements then materiality will be and is logically relevant. I disagree with this, as I make clear later in this chapter under suggested reforms.

Besides disclosure in the financial statements there are two other ways disclosure of social information may arise. First, the directors' report must describe the corporation's business and any significant changes to the company's operations during the financial year, after balance date (up until the time of the report) and in the future (although this is optional). These are very general requirements that do not specifically require the disclosure of any social information. However if a particularly significant social development arises then it may have to be disclosed under these requirements. Only particularly noteworthy developments would need to be reported since the threshold is "significant change" or "significant affect".

Second, particularly pertinent social information may need to be disclosed under the continuous disclosure regime.[1740] However disclosure is only required of material events so the same argument of materiality of financial information (as above) is relevant.

As is self evident from this description, the current mandatory disclosure requirements are very piecemeal and limited. This is particularly so given the type of disclosures which I have established are warranted and the type of disclosures which are feasible (discussed below).

9.5 VOLUNTARY DISCLOSURES - EMPIRICAL STUDIES

Despite only very limited mandatory CSR obligations in Australia, there is empirical evidence that some companies are sensitive to and voluntarily disclose some social information. CSR has been the subject of a myriad of empirical studies. It is not feasible to summarise all of these studies in this thesis.[1741] To give a flavour of these previous studies, I summarise some of the Australian studies, one with an international comparison of Australian, UK and US disclosures and my own study undertaken in 1995.

Trotman 1977

Trotman undertook a survey of the 1977 annual reports of the top 100 listed Australian companies to establish what voluntary social disclosures were made.[1742] Trotman compared this with the disclosures made 5 and 10 years previously. Trotman screened the annual reports to see what disclosures were made under 5 categories. Those categories were energy, human resources, products, community involvement and other. The study also explored the nature of the disclosure made: whether it involved monetary quantification, non-monetary quantification, both, or no quantification. The last category

1739 *Securities Exchange Act* 1934 (US), Regulation S-K item 103, instruction 5.

1740 Discussed in chapter 10.2.

1741 See generally Gray, Kouhy and Lavers, 'Corporate Social and Environmental Reporting: A Review of the Literature and a Longitudinal Study of UK Disclosure' (1995) 8 Accounting, Auditing and Accountability Journal 47.

1742 Trotman, 'Social Responsibility Disclosures By Australian Companies' (1979-March) The Chartered Accountant In Australia 24.

seems to only involve narrative disclosure which Trotman describes as often involving merely "vague statements".[1743] Trotman discovered that 69% of companies made some social disclosure in 1977 (up from 48% in 1972 and 26% in 1967).[1744] Trotman also noted that companies had an average disclosure of social information of .57 pages per company (up from .3 in 1972 and .08 in 1967).[1745] The other results of Trotman's study are set out in the two tables below.

Categories of Disclosure	Number of Disclosing Companies		
	1977	1972	1967
Environment	35	18	6
Energy	10	0	1
Human Resources	43	30	17
Products	4	3	3
Community	23	19	5
Other	34	13	5

Type of Disclosure	Number of Disclosing Companies		
	1977	1972	1967
Monetary quantification	2	5	0
Non-monetary quantification	20	11	12
Both	11	3	1
No quantification	36	29	13

Pang - 1982

Pang undertook a similar survey to Trotmans, of the 1980 annual reports of the top 70 listed public companies and 30 selected at random.[1746] Pang screened the annual reports to see what disclosures were made under 5 categories. Those categories and the percentage of companies which made disclosure were energy (15%), human resources (77%), products and consumer issues (23%), community involvement (29%) and the environment (24%). By 1980 79% of companies made some disclosure.[1747] The percentage of companies that disclosed information increased the higher their market capitalisation.[1748] Pang also classified the type of disclosures companies made. The types of disclosures and the percentage of companies making each type were monetary

1743 Above at 24, which description is reinforced by some of the examples given in the paper.

1744 Above at 25.

1745 Above at 24, although Trotman does not disclose if this average is drawn from only those companies that made some social disclosure or from all companies surveyed.

1746 Pang, 'Disclosures of Corporate Social Responsibility' (1982-July) The Chartered Accountant in Australia 32.

1747 Above at 32.

1748 Above at 32 where the following statistics appear:

Market capitalisation ($000,000)	Number disclosing	%
$500 and above	14	93
$200-$500	27	82
$100 -$200	23	74
below $100	16	73

quantification (5%), non-monetary quantification (20%), both monetary and non-monetary quantification (20%) and no quantification/narrative (55%).

Trotman and Bradley - 1978

Trotman and Bradley surveyed the annual reports of 207 Australian listed public companies drawn from the top 600 companies.[1749] This study was designed to see if there were certain associations between the CSR of companies and those companies characteristics (rather than presenting raw data to the reader). The conclusion they came to was that:

> companies which provide social responsibility information are on average, larger in size, have a higher systematic risk and place stronger emphasis on the long term than companies which do not disclose this information. In addition, for those companies which disclose social responsibility information, a positive association was found between the amount of the social responsibility disclosure and the size of the company, the degree of the social constraints faced by the company and the emphasis the company places on the long term in making decisions.[1750]

Guthrie and Parker - 1983

Guthrie and Parker examined the annual reports of the top 50 listed companies in Australia, the U.K. and the U.S.A published in 1983.[1751] They scrutinised the annual reports under 6 categories, namely the environment, energy, human resources, products, community involvement and other. Guthrie and Parker also looked to see the type of evidence companies used in support of their CSR. Their categories of evidence were monetary, non-monetary, declarative or none. They also measured the extent of the disclosure made by counting the amount of pages devoted to CSR.

Guthrie and Parker found that 56% of Australian, 98% of U.K. and 85% of U.S.A. companies made some social disclosure. Of the companies that made disclosure, the table set out below summarises their results.[1752]

	Australia	UK	USA
Type of Social Data Disclosed	Companies Making Disclosure (%)		
Environment	21	14	53
Energy	4	2	43
Human Resources	93	98	75

1749 Trotman and Bradley, 'Associations Between Social Responsibility Disclosure and Characteristics of Companies' (1981) 6 Accounting, Organisations and Society 355.

1750 Above at 361. Trotman and Bradley noted (at 357) two previous studies that also discovered an association between company size and social responsibility activity. Those two studies were: Eilbert and Parket, 'The Current Status of Corporate Social Responsibility' (1973-August) Business Horizons 5; Spicer, 'Investors, Corporate Social Performance and Information Disclosure: An Empirical Study' (1978-January) The Accounting Review 178. This conclusion was also reached by Cowen, Ferreri and Parker, 'The Impact of Corporate Characteristics on Social Responsibility Disclosure: A Typology and Frequency-Based Analysis' (1987) 12 Accounting, Organisations and Society 111 at 121.

1751 Guthrie and Parker, 'Corporate Social Disclosure Practice: A Comparative International Analysis' (1990) 3 Advances in Public Interest Accounting 159.

1752 Above at 164.

Products	0	10	35
Community Involvement	29	96	63
Other	18	0	0
Method of Information Disclosed	Number of Disclosures (%)		
Both Monetary and Non-monetary	32	49	58
Monetary	4	45	8
Non-monetary	46	2	22
Declarative	18	4	12
Extent of Disclosure (pages)	Disclosing Companies (%)		
.01-.25	21	29	30
.26-.50	36	27	15
.51-.75	21	6	15
.76-1	4	9	10
Greater than 1	18	29	30
Bad News	Disclosures (%)		
Environment	0	2	22
Energy	0	0	8
Human Resources	39	12	8
Products	0	0	5
Community Involvement	0	6	5
Other	0	2	0

Guthrie and Parker acknowledged that there were both similarities and differences between the disclosures made by companies in different countries. They noted that the disclosure patterns in all three countries revealed that companies appeared to rank disclosure of human resources first, community second and environment third.[1753] The authors explained the high rate of disclosure by UK companies (98%) as being required by particular UK laws.[1754] The authors noted the "predominance of 'good news' disclosures" and went on to comment about the bad news disclosures in the following terms:

> The "bad news" disclosures that were observed , were largely (in the U.S.) cases required by professional accounting and audit standards. The content and character of those that were voluntarily made supports the argument that such disclosures constitute a corporate portrayal of its efforts to minimise its dysfunctional impacts on affected social groups.[1755]

However the authors closely scrutinised these bad news disclosures and concluded that many disclosures "provide absolutely minimal if not token social disclosures".[1756]

Blanchard - 1995

I reviewed the reports mentioned below for fiscal year 1995[1757] of the top ten listed companies in Australia and the U.S.[1758] Those reports were:

1753 Above at 167.

1754 Those laws were mentioned above.

1755 Guthrie and Parker, 'Corporate Social Disclosure Practice: A Comparative International Analysis' (1990) 3 Advances in Public Interest Accounting 159 at 171.

1756 Above at 171.

- for Australian corporations, the annual report to shareholders and notice of the AGM; and
- for U.S. corporations, the annual report to shareholders, the Form 10-K and the proxy statement for the AGM.

Restricting the study to the top ten corporations results in a limited sample.[1759] However the hope is that these corporations would and could afford to implement the best social disclosure practice available. This hope is supported by the findings of previous studies.[1760]

I summarise the results of my study in the tables below and then discuss those results afterwards.

	Australia	USA
Type of Social Data Disclosed	Companies Making Disclosure[1761]	
Employees	10	10
Consumers	3	6
Energy	1	4
Environment	6	9
Community	8	8
Other	5	5
Method of Information Disclosed	No. of Disclosing Companies	
Narrative	10	10
Statistical (Monetary)	9	10
Statistical (Non-monetary)	3	6
Comparison with Social Indicators	0	0
Legal Compliance	0	6
Social Balance Sheet	0	0
Extent of Disclosure (pages)	No. of Disclosing Companies	
1-2.5	4	0
2.5-5	4	1
5-7.5	2	2
7.5-10	0	2
Greater than 10	0	5

1757 In Australia the corporate fiscal year is commonly from 1 July to 30 June whereas in the U.S. it commonly is the calendar year. My study was for Australian companies of the 1994/95 fiscal year, although one company had a calendar financial year and another had from 1 October to 30 September.

1758 The results of this survey is also published as Blanchard, 'Corporate Social Reporting' (1998) 23/4 Alternative Law Journal 172.

1759 It is worth bearing in mind the different businesses conducted by the corporations in the two top ten lists, as this can affect the nature and amount of disclosures to be expected. Many corporations operate diversified businesses, but most have a core area (which the following list reflects). The Australian top ten companies comprised 3 mining companies, 3 manufacturers, 3 banks, 1 retailer and 1 media corporation. The U.S. top ten comprised 2 petroleum corporations, 3 manufacturers, 2 retailers, 2 motor vehicle manufacturers and 1 utility.

1760 Both Pang's and Trotman and Bradley's studies found a positive correlation between the size of the corporation and the amount of social disclosure.

1761 All statistics relate to the number of companies making such disclosure.

Bad News	No. of Disclosing Companies	
Employees	2	5
Consumers	1	4
Energy	0	1
Environment	2	7
Community	0	1
Other	2	0

All companies in the sample made some disclosure concerning their employees. Thereafter disclosures of the environment and community involvement were roughly the same. This corresponds with Pang's results, although more importance is now placed on the environment. This is explicable due to the increased importance the environment has as a social issue and in the U.S. to explicit disclosure rules concerning the environment.

The most common methods of disclosure were by narrative disclosure and monetary statistics. Most corporations adopted a combination of both methods. Noticeably also are the high number of disclosures by U.S. corporations of their compliance with legal requirements (and the complete absence of this method in Australia). In the U.S. the most common such disclosures were compliance with environmental laws followed by a small number of disclosures concerning compliance with product standards, labelling laws and equal opportunity legislation. These types of disclosures occurred in the form 10-K under the heading Description of Business, MD&A and Legal Proceedings or in the proxy statement pursuant to shareholder requisitioned resolutions. Corporations usually only make such disclosure when compelled to do so by mandatory disclosure rules. Not surprisingly, no corporation attempted disclosure by social indicators or by utilising a social balance sheet.

The amount of disclosure made by corporations in my study is significantly higher than in previous studies. This is consistent with the recognised trend to increased disclosures over time.[1762] However this is where my sample from the top 10 companies may not be particularly representative. Also the U.S. statistics, which are particularly high, are inflated to the extent that not all companies fully utilised the integrated disclosure regime. So some companies made the same or very similar disclosures in both the 10-K and the annual report to shareholders (which are essentially the same document) and both were counted in my study. In addition all of the U.S. corporations referred in their annual reports to special documents dedicated to aspects of their social policies and performance. These documents were often quite lengthy but were selective and painted a picture very favourable to the corporation. However only one Australian corporation referred to such a report (which was incomplete at the time the annual report was published).

Disclosure of bad news was almost exclusively only reported because the disclosure laws mandated such disclosure. In Australia this was principally under disclosure of contingent liabilities. However one case seems to have been voluntary, but may have

1762 Deegan and Gordon, 'A Study of the Environmental Disclosure of Australian Corporations' (1996) 26 Accounting and Business Research 187 at 191; Gray, Kouhy and Lavers, 'Corporate Social and Environmental Reporting: A Review of the Literature and a Longitudinal Study of UK Disclosure' (1995) 8 Accounting, Auditing and Accountability Journal 47 at 61 to 62; Deegan, 'Environmental Reporting in Australia: We're Moving Along the Road, But There's Still a Long Way to Go' paper presented at a staff seminar at the School of Commerce, University of South Australia, 29 May 1998 (author on file) who notes increased level and quality of environmental disclosures by mining companies in the last few years.

been reasonably notorious in any event (reporting the deaths of several miners). There is some empirical evidence which supports this contention, at least when the media give widespread coverage to the issue.[1763] In the U.S. disclosure of bad news appeared under several categories because laws required such disclosure. In my opinion this practice strongly points to the need for mandatory disclosure rules if social disclosures are considered to be an important and serious topic.

The protean concern arising from all of the empirical studies is the tendency of corporations to only report good news.[1764] This raises concerns about the scope and effectiveness of the mandatory disclosure rules. For example existing practices indicate a difference between a company's actual environmental performance and its disclosure on this topic.[1765] This is most telling even when it has been established that there is bad news to report (successful prosecution of breach of environmental laws) but there is no disclosure of this in the annual report (although positive disclosures increase).[1766] There is even evidence of significant disparity of the type of disclosures made by companies in the same industry who were under the same compulsory disclosure rules and would be likely to be subject to the same types of liabilities under environmental laws.[1767] In addition many companies do not make any disclosures in clear contravention of the law.[1768] Also those companies which did make a disclosure often provided inadequate information to enable readers of the information to make rational decisions.[1769] At least part of the solution to this problem is regulators enforcing the mandatory disclosure rules.[1770] The general consensus is that CSR degenerates into a public relations exercise that reveals very little of the companies true social performance.[1771] Another risk is that

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1763 Deegan, Rankin and Voght, 'Firms' Disclosure Reactions to Major Social Incidents: Australian Evidence' paper presented at a staff seminar at the School of Commerce, University of South Australia, 29 May 1998 (author on file).

1764 Guthrie and Parker, 'Corporate Social Disclosure Practice: A Comparative International Analysis' (1990) 3 Advances in Public Interest Accounting 159 at 171; see also Hackston and Milne, 'Some Determinants of Social and Environmental Disclosures in New Zealand Companies' (1996) 9 Accounting, Auditing and Accountability Journal 77 at 100; Deegan, 'Environmental Reporting for Australian Corporations: An Analysis of Contemporary Australian and Overseas Environmental Reporting Practices' (1996) Environmental and Planning Law Journal 120 at 122 gives a vivid example of an apparent non-disclosure by BHP of a contingent environmental liability but disclosure of two environmental performance awards. See also Henderson & Peirson, *Issues In Financial Accounting* (Longman Cheshire, Melbourne, 6th ed., 1994) at 880; Blair and Ramsay, 'Mandatory Corporate Disclosure Rules and Securities Regulation' in Walker and Fisse (eds), *Securities Regulation in Australia and New Zealand* (Oxford University Press, Auckland, 1994) at 271; Seligman, *Corporations: Cases and Commentary* (Little, Brown and Company, U.S.A., 1995) at 258.

1765 Freedman and Wasley, 'The Association Between Environmental Performance and Environmental Disclosure in Annual Reports and 10Ks' (1990) 3 Advances in Public Interest Accounting 183.

1766 This is the conclusion of Deegan and Rankin, 'Do Australian Companies Report Environmental News Objectively? An Analysis of Environmental Disclosures by Firms Prosecuted Successfully by the Environmental Protection Authority' (1996) 9 Accounting, Auditing and Accountability Journal 50 at 59.

1767 Freedman and Stagliano, 'Disclosure of Environmental Cleanup Costs: The Impact of the Superfund Act' (1995) 6 Advances in Public Interest Accounting 163 at 170.

1768 Above at 170. Deegan, 'Environmental Reporting for Australian Corporations: An Analysis of Contemporary Australian and Overseas Environmental Reporting Practices' (1996) Environmental and Planning Law Journal 120 at 121.

1769 Freedman and Stagliano, 'Disclosure of Environmental Cleanup Costs: The Impact of the Superfund Act' (1995) 6 Advances in Public Interest Accounting 163 at 170 to 171.

1770 Above at 171.

1771 Cowen, Ferreri and Parker, 'The Impact of Corporate Characteristics on Social Responsibility Disclosure: A Typology and Frequency Based Analysis' (1987) 12 Accounting, Organisations reporting will be spasmodic (in particular there is evidence that the "luxury" of corporate social reporting decreases during an economic recession).[1772] Also industry type and the role of environmental lobby groups can "pressure" particular companies into voluntary disclosures in an attempt to legitimise themselves.[1773] The conclusion is that current disclosure practices are woefully inadequate. The disclosures made certainly can not be regarded as high quality when measured against criteria of accuracy, credibility, completeness etc.

9.6 TYPES OF CORPORATE SOCIAL REPORTING

Many different types of corporate social reporting have been promulgated which vary not just in what is reported but also how it is reported.[1774] Turning first to how CSR is done, the authors of one recent book suggest there are five possibilities.[1775] However the five methods are not necessarily mutually exclusive and a company could blend some of the five types into one disclosure, as appears to have been occurred in the past and continues as present practice.[1776] I describe each in turn and comment on each of their strengths and weaknesses.

1. Narrative disclosure

With a narrative disclosure the company describes its social record over the financial year. Narrative disclosure is the most widespread CSR practice currently used, probably because it is the cheapest and easiest to implement.[1777] A narrative disclosure can vary

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and Society 111 at 113 and 121; Shane and Spicer, 'Market Responses to Environmental Information Produced Outside the Firm' (1983) 58 The Accounting Review 521 at 523 who note the "imprecise, ambiguous, and often self-serving nature of the voluntary disclosures investigated". Deegan, 'Environmental Reporting for Australian Corporations: An Analysis of Contemporary Australian and Overseas Environmental Reporting Practices' (1996) Environmental and Planning Law Journal 120 at 123. Note that under accounting theory it is accepted that one of the purposes of CSR is to "enhance the corporate image"; see Tilt, *Corporate Environmental Policies of Australian Companies* (draft Ph.D thesis, author on file) in chapter 2 'Theoretical Frameworks'.

1772 Gray, Owen and Maunders, *Corporate Social Reporting* (Prentice Hall, U.K., 1987) at 92 to 93.

1773 Deegan and Gordon, 'A Study of the Environmental Disclosure of Australian Corporations' (1996) 26 Accounting and Business Research 187 at 194 to 197. See also Tilt, 'The Influence of External Pressure Groups on Corporate Social Disclosure: Some Empirical Evidence' (1994) 7 Accounting, Auditing and Accountability Journal 47 at 59.

1774 For example see the "initially practical system" described nearly 20 years ago in American Institute Of Certified Public Accountants, *The Measurement Of Corporate Social Performance* (AICPA, New York, 1976) through a range of systems described in the following works; Sherer & Kent, *Auditing And Accountability* (Pitman, London, 1983) in chapter 12; Gray, Owen and Maunders, *Corporate Social Reporting* (Prentice Hall, U.K., 1987); Paul and Lyndenberg, 'Applications Of Corporate Social Monitoring Systems; Types, Dimensions, and Goals' (1992) 11 Journal Of Business Ethics 1 which endorses a system called the Sullivan Principles.

1775 Gray, Owen and Maunders, *Corporate Social Reporting* (Prentice Hall, U.K., 1987) in Chapters 5 and 6. Other commentators adopt different categorisations. For example see Henderson & Peirson, *Issues In Financial Accounting* (Longman Cheshire, Melbourne, 6th ed., 1994) at chapter 25 "Accounting for Corporate Social Responsibility" where the authors suggest the four categories of inventory, cost, program management and cost benefit approach. I prefer the categorisation of Gray, Owen and Maunders but point to this alternative classification in the footnotes to the discussion which follows.

1776 The results of Pang's study confirms this. See also Gray, Owen and Maunders, *Corporate Social Reporting* (Prentice Hall, U.K., 1987) at 92.

1777 Above at 93 to 94. See also Henderson & Peirson, *Issues In Financial Accounting* (Longman Cheshire, Melbourne, 6th ed., 1994) at 880 (their inventory category roughly corresponds with from "general statements of good intention in the annual report and accounts through to relatively thorough analyses of specific issues produced as separate documents".[1778] The major problem with narrative disclosure is that the managers who prepare the information can be and are very selective in what they include. The empirical evidence supports this conclusion since narrative disclosure is one of the most popular methods of disclosing such information. Such disclosures enable the type of biased reporting which is the current practice. That is it is more of a public relations exercise rather than a serious attempt to discharge accountability on serious social topics.[1779] Also this approach makes comparisons with the social disclosures of other companies virtually impossible.[1780]

2. Statistical summaries

Companies sometimes present statistical summaries of their social performance (although some narrative usually supports these summaries as well).[1781] The rationale behind statistical summaries is "to provide the reader with some systematic indication of the *input* to and/or *activities* (process) of an organisation. (As opposed to the *output* or *impact* of its activities)".[1782] Although statistical summaries may be more precise than narrative disclosures they also suffer from the selectivity problem. If different companies adopted the same basis for their statistical summaries then there could be comparability but there is no compelling reason for this to occur. It seems that no company has consistently reported using statistical summaries over a sustained period with the result that this type of reporting remains underdeveloped.[1783]

3. Comparison with predetermined social indicators

This version of CSR draws from social indicators developed at an international level to measure the well being of society.[1784] These social indicators are best explained by giving some examples of them. Generally known social indicators include:

Proportion of households with one car
Proportion of households with more than one car
Proportion of households below the poverty line
Number per thousand of the population who are homeless
Still births per thousand live births
Number per thousand of the population educated beyond the age of 16
Measures of level of crime
Proportion of waterways unable to support fish life through pollution.[1785]

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this category, although one feature which distinguishes it is that it is meant to be a comprehensive inventory).

1778 Gray, Owen and Maunders, *Corporate Social Reporting* (Prentice Hall, U.K., 1987) at 93.

1779 This is consistent with my general findings concerning voluntary information discussed in chapter 6.6.

1780 Henderson & Peirson, *Issues In Financial Accounting* (Longman Cheshire, Melbourne, 6th ed., 1994) at 879. This difficulty in making inter-company comparisons where companies use narrative disclosure was recognised by two researchers trying to undertake such comparative research: see Freedman and Wasley, 'The Association Between Environmental Performance and Environmental Disclosure in Annual Reports and 10Ks' (1990) 3 Advances in Public Interest Accounting 183 at 185.

1781 Gray, Owen and Maunders, *Corporate Social Reporting* (Prentice Hall, U.K., 1987) at 98.

1782 Above at 99 to 100.

1783 Above at 100 to 104.

1784 Dating from the a study by the United Nations in 1954 called *Report on International Definition and Measurement of Standards and Levels of Living* referred to in Gray, Owen and Maunders, *Corporate Social Reporting* (Prentice Hall, U.K., 1987) at 104.

Clearly before a social indicator is created thought has gone into considering why it is important to measure a particular social phenomenon and the conclusions that can be reached as a result of taking such a measurement. This is one of the differences between social indicators and statistics.[1786] Although it must be conceded that the decision to select particular statistics rather than others suggests that similar thought has been involved. That is, there is a blurring between these two categories.[1787] Another difference is that the indicator itself acts as a yardstick; the results of an entities performance is measured against that indicator (and can be compared with other entities performance).[1788]

The difficulty with using social indicators is successfully translating them to the corporate context or devising indicators appropriate for companies. A social indicator approach has been used by government authorities, nationalised industries and at least one bank in the U.S.A.[1789] However no attempt has been made by mainstream industrial companies to adapt and apply social indicators to their own social behaviour. Therefore at this stage it is not possible to take social indicators as a serious and legitimate approach to CSR, although the undeveloped potential is there.[1790]

4. Compliance with legal standards

The fourth possible approach is for companies to report on their compliance with legal standards.[1791] As mentioned in the introduction, in Australia there is a vast array of laws designed to protect employees, consumers and the environment. Laws may not perfectly capture a society's views on such social issues due to power factions being able to dominate the law making process and the law lagging behind societal developments.[1792] Nonetheless law represents the views of our representatively elected governments on

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1785 Gray, Owen and Maunders, *Corporate Social Reporting* (Prentice Hall, U.K., 1987) at 105.

1786 Above at 105.

1787 Above at 108.

1788 Above at 108.

1789 Above at 106 to 109.

1790 As is pointed out in Gray, Owen and Maunders, *Corporate Social Reporting* (Prentice Hall, U.K., 1987) at 106 "[Social indicators] stands, however, as a potentially fascinating approach to CSR". They also conclude at 109 that "[w]ith a more systematic approach it may be possible to derive a more manageable CSR approach based on [social indicators/performance indicators] that *does* discharge accountability but no such attempt has yet been made". Some environmental performance guidelines are beginning to be developed by particular industries, see Deegan and Gordon, 'A Study of the Environmental Disclosure of Australian Corporations' (1996) 26 Accounting and Business Research 187 at 193. In time these could be used by companies in those industries.

1791 Gray, Owen and Maunders, *Corporate Social Reporting* (Prentice Hall, U.K., 1987) at 109 talk of compliance with standards "partly from law and partly from other sources". However in their subsequent discussion they do not refer to any standards other than legal ones. A comprehensive set of non-legal standards do not seem to exist, and really is the same issue as there being no social indicators. There are some environmental performance indices developed by the Council of Economic Priorities (a US organisation); see Freedman and Wasley, 'The Association Between Environmental Performance and Environmental Disclosure in Annual Reports and 10Ks' (1990) 3 Advances in Public Interest Accounting 183 at 185 who describe these indices. These indices are of limited scope though and do not offer a comprehensive alternative set of standards from which to judge a companies overall social performance. Therefore in this thesis I will only consider compliance with legal standards.

1792 "Law, marching with medicine but in the rear and limping a little"; Windeyer J in *Mount Isa Mines v Pusey* (1971) 125 CLR 383 at 395 (a comment made in the context of tortious liability for nervous shock). See also Gray, Owen and Maunders, *Corporate Social Reporting* (Prentice Hall, U.K., 1987) at 109 to 113.

these issues.[1793] These laws generally adopt well-defined standards which makes it possible and feasible to measure a company's compliance (or non compliance). Reporting should not just be of when a regulatory agency has detected and successfully prosecuted a breach of the law by a company.[1794] Rather companies should develop their own internal control and reporting system to hopefully ensure compliance with all such laws but also reporting any breaches of the law (as no system is perfect).

Such an approach is consistent with a modest idealist view of the company (as discussed above). It is also a feasible approach that could be implemented relatively easily with little time delay. A further advantage is that companies operating in similar industries would have to comply with the same laws and therefore it would be possible to compare different companies compliance with these laws. This is the model adopted by the one explicit disclosure that must appear in the directors' report concerning corporations compliance with environmental regulation.

5. Translating social information into financial information and presenting a type of social balance sheet

This approach involves a comprehensive and systematic CSR where the social impacts of a company are translated into a monetary amount and reported in the form of itemised financial statements.[1795] Various theoretical frameworks for such CSR have been developed.[1796] One U.S. public relations company, Abt Associates Inc., published integrated social and financial statements during the 1970's, although it must be acknowledged that during this time the company was marketing itself as being able to provide this service for other companies.[1797] However this approach to CSR has been effectively criticised over a sustained period.[1798] The most compelling and fatal criticism is that it is difficult, if not impossible, to place a value on social goods or to price negative impacts companies have on them. How do we value such matters as equal opportunity, a safe working environment, safe consumer goods and clean air? How do we price the activities of a company which operates an unsafe factory, manufactures defective and dangerous goods or pollutes the environment? The insurmountable hurdle is that these are incommensurable[1799] and any attempt to put a price to these items is

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1793 This is true of laws made by Parliaments but arguably not of laws made by courts. However most socially oriented laws derive from Parliaments, such as environmental, employment and consumer legislation.

1794 Reporting such breaches should be mandatory. There is evidence that Australian companies do not report convictions of environmental laws: see Deegan, 'Environmental Reporting for Australian Corporations: An Analysis of Contemporary Australian and Overseas Environmental Reporting Practices' (1996) Environmental and Planning Law Journal 120 at 124.

1795 Gray, Owen and Maunders, *Corporate Social Reporting* (Prentice Hall, U.K., 1987) in chapter 6. This is described as the "cost-benefit approach" in Henderson & Peirson, *Issues In Financial Accounting* (Longman Cheshire, Melbourne, 6th ed., 1994) at 881; Estes, 'Accounting for Social Costs' in Estes (ed), *Accounting and Society* (Melville, USA, 1973).

1796 Estes, *Corporate Social Accounting* (John Wiley & Sons, New York, 1976). See also Linowes, 'Lets Get On With the Social Audit-A Specific Proposal' (1972) Business and Society Review 39; Dilley and Weygant, 'Measuring Social Responsibility- an Empirical Test' (1973-September) Journal of Accountancy 62; Maitre, 'The Measurement of the Creation and Distribution of Wealth in a Firm by the Method of Surplus Accounting' (1978) 3 Accounting, Organisations and Society 227.

1797 Gray, Owen and Maunders, *Corporate Social Reporting* (Prentice Hall, U.K., 1987) at 124.

1798 See the criticisms summarised in Gray, Owen and Maunders, *Corporate Social Reporting* (Prentice Hall, U.K., 1987) at 128 to 133.

1799 For an interesting discussion on commensurability in the context of the award of damages in tort law see Radin, 'Compensation and Commensurability' (1993) 43 Duke Law Journal 56.

necessarily going to be arbitrary and involve a subjective assessment.[1800] The CSR reports prepared by Abt Associates have been criticised on this basis.[1801] For this reason a comprehensive social balance sheet is not a feasible approach to CSR.[1802]

From this analysis the most appropriate method is requiring disclosure of a companies compliance with pre-existing legal criteria.[1803] However there is no need to regard the various categories as mutually exclusive. A legal compliance CSR would necessarily involve a narrative description, could include statistical information and financial information about corporate expenditures undertaken in order to comply with the law or to remedy a known breach of the law.

The content of CSR will vary enormously from company to company. Given the diverse nature and activities of companies and the laws they are compelled to comply with it is not possible to provide an objective shopping list style account of what should go into CSR. In recognition of this Gray, Owen and Maunders adopt a more flexible approach which can be tailored to different companies. They suggest that a CSR should have the following characteristics:

> (1)A full statement of the intended general objectives of the report must accompany the report. The statement should also allow the reader to assess:
>
> > (a) what selectivity of data has been made and why; and
> > (b) why the particular presentation has been chosen;
>
> (2)The objective of the report should be to inform society about the extent to which actions for which an organisation is held responsible have been fulfilled;
>
> (3)The report, in its choice of data, emphasis, method of presentation, and availability, should provide information directly relevant to its objectives and in particular to the objectives it holds for the interest groups to whom it is directed; and
>
> (4)The report should present direct raw (unmanipulated) data that can be understood by a non-expert undertaking a careful and intelligent reading of the report.[1804]

If this approach is adopted then users of the CSR would be able to assess the appropriateness of both the report and its contents.

9.7 AUDIT

Finally the credibility of any CSR would be significantly enhanced if it was independently audited.[1805] This is necessary for the same reasons that both the financial statements are audited[1806] and the proposed management information discussed earlier in this thesis should be audited.[1807] The persuasive reason is that unless an independent person examines the financial information then the preparers of this information will

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1800 In the environmental context see Deegan, 'The Environment: An Accountants Dilemma' (1994-August) Charter 64.
1801 Henderson & Peirson, *Issues In Financial Accounting* (Longman Cheshire, Melbourne, 6th ed., 1994) at 882 to 884.
1802 Gray, Owen and Maunders, *Corporate Social Reporting* (Prentice Hall, U.K., 1987) at 133.
1803 This is also the preferred option of Gray, Owen and Maunders, *Corporate Social Reporting* (Prentice Hall, U.K., 1987) at 109.
1804 Above at 82 to 85.
1805 Above at 85.
1806 See chapter 6.5.
1807 Discussed in chapter 7.3.

have a tendency to manipulate information that presents a picture of the company most favourable to them. There is empirical support for the need for environmental audits.[1808]

Perhaps the only live issue in this context is who should audit the CSR. Accountants made an early claim to have the relevant expertise.[1809] In terms of the auditing process of collecting, testing and reporting information this claim is undoubtedly correct. But accountants' experience is limited because they are trained and experienced only in auditing financial information. Since I recommended that a legal compliance model of CSR is the most appropriate, lawyers should also be involved. In addition, as the audit of CSR may well involve inputs from the fields of "sociology, politics, biology, chemistry, psychology, economics, communication theory, personnel management, statistics, etc.",[1810] then a multi-disciplinary team may be the most appropriate.[1811]

9.8 CONCLUSION

CSR is no longer a new phenomenon. It now has been adequately defined as communicating the "social impacts of business actions on those who are affected by them". Comprehensive CSR is justified. From a modestly idealistic view of corporations, disclosure of a corporations compliance with social laws is justified. In addition, drawing from a monist view of corporations, they should also disclose their voluntary social expenditures. Such disclosures can also be justified drawing from the perspective of shareholders as monitors, citizens and investors let alone drawing from the perspective of other stakeholders in the corporation or as a matter of public policy.

However the amount of CSR currently required of corporations in their regular reports remains sparse and piecemeal. There is one explicit disclosure requirement of performance under environmental regulations, although this has not yet applied to the majority of Australian corporations (and may be repealed). The principal disclosures required come from accounting requirements (principally concerning contingent liabilities) which are designed to ensure a true and fair financial report to shareholders. These requirements draw from a narrow dualist view of the corporation under which shareholders are viewed solely as investors interested in profit maximisation. In my opinion this is unduly narrow.

Turning to the empirical evidence, my study confirms a trend over the years of increased CSR. However given the piecemeal state of the current disclosure rules it is not surprising to see those responsible for providing this sort of information to be selective and in particular very reluctant to report bad news unless compelled to do so. The charge that can still be levelled at most CSR is that it is self-congratulatory public relations aimed at corporate imaging.

1808 Rankin, *Corporate Reporting-The Green Gap* (Institute of Chartered Accountants in Australia, Queensland, 1996) at 21 to 23; Epstein and Freedman, 'Social Disclosure and the Individual Investor' (1994) 7 Accounting, Auditing and Accountability Journal 94 at 105.

1809 American Institute Of Certified Public Accountants, *The Measurement Of Corporate Social Performance* (AICPA, New York, 1976) at 251; Freedman, 'Accounting and the Reporting of Pollution Information' (1993) 5 Advances in Public Interest Accounting 331.

1810 Gray, Owen and Maunders, *Corporate Social Reporting* (Prentice Hall, U.K., 1987) at 16.

1811 Although whether accountants should have superordination in this process is contestable, see Power, 'Expertise and the Construction of Relevance: Accountants and Environmental Audit' (1997) 22 Accounting, Organisations and Society 123.

There is a mature methodology on how to undertake CSR, the preferred option being corporations reporting their compliance with all social laws (as a minimum). The disclosures should be required to meet the hallmarks of quality information.[1812] As the laws set defined standards and reporting of a corporation's compliance with these standards involve verifiable facts then disclosure of this should be able to be accurate and complete. Credibility will occur only if this information is audited, which should be required. There may remain problems of comparability but this will be less so for companies in the same industry who are subject to the same laws. The other qualities I developed in chapter 2 can also all be easily satisfied. There is no reason that social disclosures can not be made understandable to the average investor if principles of plain English are adopted. This is particularly so given a legal compliance model is adopted. If the CSR occurred in the annual report there would be no problem with either accessibility or timeliness (reporting of CSR being less time critical than financial information). There is empirical support for this to appear in a separate part of the annual report.[1813] Confidentiality is not a relevant issue under a legal compliance model which does not involve commercially sensitive information. This is particularly so if all companies are subject to the same regime of disclosure. Finally I have already argued that the cost of CSR is justified.

If mandatory, comprehensive CSR is implemented then over time it will mature and become increasingly sophisticated and thus less prone to manipulation. Over time it is possible to observe the same happening with financial accounting which is continuing to mature, particularly with the evolving body of rules set out in the accounting standards. My hope, based on this observation, is that CSR will similarly mature and evolve. However in my opinion the necessary next step is to make CSR mandatory. Otherwise as a voluntary exercise it will languish as a public relations tool, rather than a serious topic for which corporations and managers should be accountable.

1812 Voluntary disclosures do not meet these hallmarks, see Tilt, 'The Influence of External Pressure Groups on Corporate Social Disclosure: Some Empirical Evidence' (1994) 7 Accounting, Auditing and Accountability Journal 47 at 63 to 64.

1813 Rankin, *Corporate Reporting-The Green Gap* (Institute of Chartered Accountants in Australia, Queensland, 1996) at 13.

CHAPTER 10

METHODS OF DISCLOSURE

10.1 INTRODUCTION

This chapter considers a range of methods by which shareholders have access to information. These methods of disclosure do not require the disclosure of any particular type of information (eg financial or management). However by these methods of disclosure any type of information may be disclosed depending on the underlying circumstances that trigger their operation. This chapter considers three areas:

- the continuous disclosure regime provided for in the Listing Rules as supported by the Corporations Law;
- the right of shareholders to inspect corporate documents pursuant to section 247A of the Corporations Law. I consider whether this right of inspection could be improved by utilising Freedom of Information principles (which I argued were appropriate for corporations in chapter 5.4); and
- the information shareholders are entitled to when they are asked to consider a matter in general meeting.

I also analyse whether each method of disclosure is justified towards the end of each section. I finish each section with a conclusion. Given the disparity of the topics I do not provide an overall conclusion at the end of the chapter.

10.2 CONTINUOUS DISCLOSURE

In Australia[1814] the ASX Listing Rules requires listed companies to notify the stock exchange of a wide range of events concerning the company.[1815] Notification is usually required immediately[1816] and before the information is released to any other person (including the media).[1817] The ASX then releases this information to the market generally. All shareholders and others then have access to this information.

1814 Similar continuous disclosure regimes exist in Ontario and the UK; see Blair, 'Australia's Continuous Disclosure Regime: Proposals for Change' (1992) Australian Journal of Corporate Law 54 at 57 and 70 to 72. Note that in the US there is not an equivalent continuous disclosure regime under Federal Law. Listed companies have to file current reports on Form 8-K within 15 calendar days of certain triggering events. However the list of triggering events is limited, and includes only matters such as changes in control, acquisition or disposal of a significant amount of assets, bankruptcy, changes to the company auditors and resignation of directors because of a dispute with management. See generally Brown, *The Regulation of Corporate Disclosure* (Aspen, USA, 2nd ed., 1995) at 2.02 [1][b]. However the listing rules of the New York Stock Exchange (and others) requires a form of continuous disclosure: see Blair, 'Australia's Continuous Disclosure Regime: Proposals for Change' (1992) Australian Journal of Corporate Law 54 at 68 to 69.

1815 The matters which require disclosure are principally set out in LR 3.

1816 See explanatory note that precedes LR 3.1 and the words of LR 3.1 itself.

1817 LR 15.7. See ASX, *Guidance Note: Continuous Disclosure: Rule 3.1* (ASX, Australia, 1996) at paragraph 7.

The primary disclosure requirement is the continuous disclosure regime set out in Listing Rule 3.1. The continuous disclosure regime is designed to ensure a prompt flow of information to investors[1818] in the sharemarket in between the time of the periodic reports (discussed in chapter 6). Listing Rule 3.1 provides:

> Once a [company] is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the [company's] securities, the [company] must immediately tell ASX that information. This rule does not apply to particular information while each of the following applies.
>
> 3.1.1 a reasonable person would not expect the information to be disclosed.
>
> 3.1.2 the information is confidential.
>
> 3.1.3 one or more of the following applies.
>
> (a) It would be a breach of a law to disclose the information.
>
> (b) The information concerns an incomplete proposal or negotiation.
>
> (c) The information comprises matters of supposition or is insufficiently definite to warrant disclosure.
>
> (d) The information is generated for the internal management purposes of the company.
>
> (e) The information is a trade secret.

Traditionally one perceived weakness of Listing Rule 3.1 was the general problems associated with enforcing the Listing Rules.[1819] However since 5 September 1994 Listing Rule 3.1 is supported by s1001A of the Corporations Law which imposes liability for a breach of the Listing Rule. Section 1001A(2) provides that listed companies must not fail to comply with Listing Rule 3.1 by:

> intentionally, recklessly or negligently failing to notify the securities exchange of information:
>
> (a) that is not generally available; and
>
> (b) that a reasonable person would expect, if it were generally available, to have a material effect on the price or value of [the company's shares].

Such liability is criminal if performed intentionally or recklessly[1820] and attaches to the company and those who aid, abet, counsel, procure or are knowingly concerned in or party to the contravention.[1821] Civil liability applies if those responsible for the non-disclosure acted intentionally, recklessly or negligently and operates in favour of anyone who has suffered loss or damage as a result of a contravention of the listing rule.[1822] People who suffer loss can sue the company or anyone who was involved in the contravention.[1823] Together with the liability provisions for prospectuses, this is one of the few areas where shareholders as investors have a clear legal right of action against the authors of poor quality information or against those who should have disclosed information but did not. In this situation shareholders are focused in their role as

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1818 The focus of the continuous disclosure regime is shareholders as investors, not as monitors; see Nicoll, 'Lost Opportunities for Improved Disclosure within the Corporate Law Reform Bill (No 2) 1992' (1993) 3 Australian Journal of Corporate Law 27 at 45.

1819 Blair, 'Australia's Continuous Disclosure Regime: Proposals for Change' (1992) Australian Journal of Corporate Law 54 at 57 to 58; Magarey, 'Enforcement of the Listing Rules for the ASX' (1995) 13 C&SLJ 6.

1820 CL s1001A(3).

1821 *Crimes Act* 1914 (Cth) s 5(1).

1822 CL s1005. See also Hambleton, 'Continuous Disclosure for Listed Entities CASAC Report-It Works' (1997) 15 C&SLJ 55 at 56; cf Koeck and Ramsay, 'Continuous Disclosure - A Critical Review' (1993/April) Australian Corporate Lawyer 6 (who reviewed the proposed statutory continuous disclosure regime before it was operative and were very critical of it).

1823 CL s1005(1) and s79.

investors and therefore liability is appropriate. However the arguments that shareholders as investors should not have the benefit of liability rules, as applies to the financial statements, are also potentially applicable here.[1824] Two responses are appropriate here. First, liability only arises if non-disclosure or a misleading disclosure arose intentionally or recklessly, which is unproblematic, or negligently. Some regard liability for negligent non-compliance as too onerous.[1825] Arguably, although it is not entirely clear cut, as a result of such liability directors should have internal compliance systems in order to ensure compliance with Listing Rule 3.1.[1826] However I view such a result as desirable and is consistent with my recommendations under the duty of care. Second, the principal concern for such liability rules is the potential for indeterminate liability. However during the years since the operation of the continuous disclosure regime supported by the statutory liability rules there have not been a flood of legal claims so this concern seems to be grossly overstated. In my opinion the liability rules are appropriate.

A few elements of the principal obligation require discussion.[1827] They are "immediacy", "concerning the company", "material effect" and "price or value". The exceptions also require discussion. I tackle each of these in turn.

Immediacy

If the requirement that the company report information immediately to the ASX is taken literally then disclosure would have to occur simultaneously with its cognition. This can not be the case.[1828] Those responsible for the disclosures must have time to:

- digest information and appreciate its significance, including whether it meets the requirements of the listing rule (ie is material, etc);
- be satisfied that the information is accurate and credible. This is particularly so given the sanctions under the Corporations Law for issuing false and misleading statements;[1829]
- draft the terms of the disclosure to the ASX and ensure the accuracy and completeness of this document.

However subject to these necessary steps there should be no other delays to disclosure. Once these steps have been taken then, and only then, is the company able to immediately disclose it to the ASX.[1830]

Concerning the Company

The phrase "concerning the company" is ambiguous. The word "concern" has been defined as "to relate to; be connected with; be of interest or importance to; affect".[1831]

1824 See chapter 6.5 under the sub-heading 'Report to (Whom)?'.

1825 Koeck and Ramsay, 'Continuous Disclosure - A Critical Review' (1993/April) Australian Corporate Lawyer 6 at 9 to 10.

1826 Ford, Austin and Ramsay, *Ford's Principles of Corporations Law* (Butterworths, Sydney, 9th ed., 1999) at [10.330].

1827 Nearly every word in the Listing Rule could be scrutinised: see White, 'Just in Time: ASX Listing Rule 3A (1)' (1994) 18 Butterworths Corporation Law Bulletin 351. But the issues I have selected to discuss are the most important.

1828 White, 'Just in Time: ASX Listing Rule 3A (1)' (1994) 18 Butterworths Corporation Law Bulletin 351 at 353.

1829 CL s1308(2). See Koeck, 'Continuous Disclosure' (1995) C&SLJ 485 at 505.

1830 See Koeck, 'Continuous Disclosure' (1995) C&SLJ 485 at 502 to 504 who argues that 'immediately' should be interpreted to mean "as soon as practicable". I disagree with his analysis primarily because it strains the language of the Listing Rule and because of my analysis in the text above.

Therefore the phrase could either mean the information must be about the company or the information could be on a subject extraneous to the company but which affects it.[1832] For example, to a producer of Australian oil news of the Iraqi war and the subsequent ban of oil products from Iraq meant a steep increase in the price of oil products. This information is extraneous to the company but has a significant impact on it. Nonetheless it can be said that this information concerns the company. Often this extraneous information is public knowledge and disclosure under the Listing Rule would not be so much of the information itself but of its significance to the company. On one hand it is easy to see how this type of information concerns the company, how directors are uniquely positioned to appreciate its significance and therefore how shareholders should be informed. On the other hand to require such disclosure is patronising to investors and requires directors to think for investors. But often the extraneous information will not be in the public domain or its significance to the company will not be so apparent. In my opinion it is not possible to fashion a rule that distinguishes between information that is well known and the significance of its impact on the company's fortunes is obvious and those cases where it is less well known or its significance on the company is less obvious. Therefore in my opinion the concept of "concerning the company" should be interpreted broadly to include this type of extraneous information. Such an interpretation is particularly beneficial to unsophisticated investors. However presently the correct interpretation under the Listing Rules remains an unresolved issue in Australian law,[1833] although the ASX considers the broader interpretation to be correct.[1834]

However for liability under s1001A the issue is a little clearer, but a result opposite to the one I recommend is adopted. Liability under the Corporations Law only attaches to information that is "not generally available".[1835] This phrase is broadly defined in the Corporations Law[1836] and even extends to "deductions, conclusions or inferences" drawn from information in the public domain.[1837] The result of this broad definition is that investors are presumed to be able to understand the significance of public information as it effects the corporation. Therefore for publicly available information there is a potential difference between the position under the Listing Rule and under the Corporations Law. This difference may be explicable on the basis that criminal liability under the Corporations Law, for an intentional or reckless non-disclosure,[1838] is not appropriate where the non-disclosure was not of raw information but of an inference drawn from publicly available information (which inference arguably any person is

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1831 *The Macquarie Dictionary* (The Macquarie Library, Australia, 3rd ed, 1997) at 454.

1832 Koeck, 'Continuous Disclosure' (1995) C&SLJ 485 at 494 to 495.

1833 In the US disclosure of extraneous information and its significance to the company is required in some circumstances. In *re Caterpillar Inc.* (Exchange Act Release No. 30,532) Caterpillar was required by the SEC to disclose the effects of hyper inflation in Brazil on its Brazillian subsidiary. See Brown, *The Regulation of Corporate Disclosure* (Aspen, USA, 2nd ed., 1995) at 2.02 [2].

1834 ASX, *Guidance Note: Continuous Disclosure: Rule 3.1* (ASX, Australia, 1996) at paragraph 13, where the ASX states "The information to be disclosed is information concerning the [company]. A [company] is not required to disclose general information, such as the gold price. However, if the information has a particular effect on the [company] (eg a lower gold price means that the [company] can no longer economically operate a mine) that effect may be required to be disclosed".

1835 CL s1001A(2)(a). See Koeck, 'Continuous Disclosure' (1995) C&SLJ 485 at 494 to 495.

1836 See CL s1001C.

1837 CL s1001C(3). See also Tomasic, 'Reform and Enforcement of Australian Stock Exchange Rules and the New Continuous Disclosure Laws' (1995) 4 No.2 Asia Pacific Law Review 21 at 32 to 33.

1838 CL s1001A(3).

capable of drawing).[1839] For information that is not generally available the position is the same under both the Listing Rules and the Corporations Law.

Material Effect

The information must have a material effect on the price or value of a company's shares. Materiality is the heart of the continuous disclosure obligation, but is an imprecise notion.[1840] What quantitative effect must information have on the price or value of securities for it to be a material effect? Some guidance is provided in the Corporations Law. Corporations Law section 1001D provides that information has a material effect if "the information would, or would be likely to, influence persons who commonly invest in securities in deciding whether or not to subscribe for, or buy or sell, the [securities]". This section does not give a quantitative measure to the issue of materiality, but points to the type of persons whose judgement is relevant.[1841] Notice the test is directed to those who "commonly" invest in securities. Hence it is pitched at the more regular and therefore arguably the more sophisticated investor.

There does not seem to be any objective quantified measure of materiality. But nonetheless those engaged in the stock market will have an intuitive feel for the types of information that will affect share prices or value. Although there is no definitive measure of materiality there are guides to its meaning. The ASX has issued a Guidance Note to listing rule 3.1 which assists in its meaning.[1842] Materiality is used in other areas of the Corporations Law such as the financial statements,[1843] related party disclosures,[1844] prospectuses[1845] and takeovers.[1846] Although none of these uses of materiality applies to a routine investment decision taken under normal market conditions, these other uses of materiality are a useful guide in this context.[1847] Also US securities law has a rich

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1839 Hambleton, 'Continuous Disclosure for Listed Entities CASAC Report-It Works' (1997) 15 C&SLJ 55 at 57.

1840 Hewitt, 'Developing Concepts of Materiality and Disclosure' (1977) 32 The Business Lawyer 887 at 892 to 893 ("materiality in the abstract is a meaningless concept"); Seligman, *Corporations: Cases and Materials* (Little, Brown and Company, USA, 1995) at 800 ("The most protean concept in federal securities fraud litigation is materiality").

1841 Hewitt, 'Developing Concepts of Materiality and Disclosure' (1977) 32 The Business Lawyer 887 at 893 to 895 ("formulations of materiality vary depending on who the test is directed at - under US law the reasonable investor in securities, rather than creditors or others, is the person the information must be material to").

1842 ASX, *Guidance Note: Continuous Disclosure: Rule 3.1* (ASX, Australia, 1996) particularly at paragraphs 9 and 10.

1843 AASB 1031 'Materiality'; Koeck, 'Continuous Disclosure' (1995) C&SLJ 485 at 500.

1844 AASB 1017 'Related Party Transactions'. See Koeck, 'Continuous Disclosure' (1995) C&SLJ 485 at 501.

1845 CL s1022, discussed in chapter 8.3. The purpose is to have essentially equivalent disclosure obligations for both the primary and secondary markets; see Digby, 'Proposed Continuous Disclosure Legislation' (1992) 10 C&SLJ 342 at 343.

1846 CL s750 mandates the disclosures that must be made by both bidders and the target company to offeree shareholders. The catch all provision is any other material information. See Part A Statement clause 17, Part B Statement clause 13, Part C Statement clause 14 and Part D Statement clause 12. Koeck, 'Continuous Disclosure' (1995) C&SLJ 485 at 501 to 502. King CJ in Samic Ltd v Metals Exploration Ltd (1993) 60 SASR 300 at 303 stated that information was material if it "would assist shareholders to assess critically the attractiveness or otherwise" of the takeover offer. This statement of principle was approved in *Gantry Acquisition Corp v Parker and Parsley Petroleum Australia Pty Ltd* (1994) 123 ALR 29 at 35 per Sheppard J and 40 per Burchett J.

1847 Black and Minns, 'Commentary on the ASX Listing Rules' in *Australian Corporations Law* (Butterworths, Australia, 1996) at 101,180; Koeck, 'Continuous Disclosure' (1995) C&SLJ 485 history on the concept of materiality which is of assistance in Australia.[1848] Under US law two factors are balanced: the kind of impact on the investor and the likelihood of the information having such an impact.[1849] Under the first factor (kind of impact) the information does not have to change the investors mind on a particular investment decision; it is sufficient if the information is considered important in the context of the aggregate of available information (ie the "total mix"[1850] of information).[1851] Under the second factor (likelihood of occurrence) there must be a "substantial likelihood that [the information] would have assumed actual significance in the deliberations of the reasonable investor".[1852] The balancing of these two factors obviously offers useful guidance to decision-makers in determining whether information is material. Finally over time Australian courts will develop a body of law on the meaning of "materiality" under Listing Rule 3.1 itself which will then be able to guide directors in their deliberations.

In my opinion the concept of materiality is sufficiently definite to be a workable concept. Of course there will be borderline cases. If directors are uncertain of the materiality of particular information then they could seek expert and confidential advice on the matter from market participants, perhaps their own broker, merchant banker, accountant or lawyer. Ultimately if a matter goes to court then it would be sensible to call these people as experts on the issue. Certainly there will be differences in opinion but the end result for directors is that if they wish to avoid liability they should adopt a simple rule of "if in doubt, disclose".

Price or Value

The Listing Rule applies to information that can effect either the price or value of the securities. This requirement in the listing rule clearly points to the obligation to disclosure being directed to shareholders as investors.

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at 500 to 502. For example in *Ical v Country Natwest* (1988) 13 ACLR 129 at 137, Bryson J stated:

> The shareholder whom I should hypothesise for the purpose of materiality is not considering a Part C statement in an ordinary market situation. The offeror is trying to induce him to come into the market, but he may not wish to do so. He does not have the ordinary motivations to inform himself and be vigilant that a willing vendor has when he set out to find a willing purchaser. The Part C statement may be the first thing that he hears or sees. The legislation requires that it have a lot of information in it and be without omission of material matter. Tests of an offeror's disclosures which are applied in unregulated market situations must be set to one side and the [Corporations Law] must be applied.

1848 Hewitt, 'Developing Concepts of Materiality and Disclosure' (1977) 32 The Business Lawyer 887; Koeck, 'Continuous Disclosure' (1995) C&SLJ 485 at 497 to 499; Black and Minns, 'Commentary on the ASX Listing Rules' in *Australian Corporations Law* (Butterworths, Australia, 1996) at 101,180.

1849 Hewitt, 'Developing Concepts of Materiality and Disclosure' (1977) 32 The Business Lawyer 887 at 893; Clark, *Corporate Law* (Little Brown & Co, New York, 1986) at 328 to 329. This is similar to the negligence calculus under tort law where the likelihood and seriousness of injury are balanced against the interest the tortfeasor must sacrifice in order to avoid the risk of injury to determine if a breach of duty has arisen; see *Conway v O'Brien* 111 F 2d 611, 612 (1940).

1850 *TSC Industries Inc v Northway Inc* (1976) 426 U.S. 438; followed in *United Paperworks International Union v International Paper Co* (1993) 985 F.2d.1190 at 1199.

1851 Hewitt, 'Developing Concepts of Materiality and Disclosure' (1977) 32 The Business Lawyer 887 at 895 to 896.

1852 *TSC Industries Inc v Northway Inc* (1976) 426 U.S. 438; Hewitt, 'Developing Concepts of Materiality and Disclosure' (1977) 32 The Business Lawyer 887 at 896 to 899; Koeck, 'Continuous Disclosure' (1995) C&SLJ 485 at 497.

This concept of price or value raises the issue of whether there is such a thing as an accurate pricing model for corporations which I discussed in the Chapter 4.6 under the heading "Shareholders as Investors". I do not wish to revisit that discussion. However one area where the twin concepts may have different applications is where a corporation's shares are extremely rarely traded and new information may not be likely to have any effect because there is no trading.[1853]

Exceptions

Listing Rule 3.1 itself excludes certain information from disclosure under the continuous disclosure regime. There are two threshold characteristics that the information must have before considering whether a number of enumerated exceptions apply. So there is a three tier, cumulative pattern of exceptions.

First, a reasonable person must not expect the information to be disclosed. This is a curious provision. It seems designed to ensure that the directors do not mechanically apply the other requirements of the exceptions which are more straight forward. Even if these other requirements are met the directors still need to consider whether disclosure should or should not be made, the touchstone being the opinion of the reasonable person. The ASX in its Guidance Note states that the reasonable person would balance any potential prejudice to the company arising from a disclosure against the need to keep the market informed.[1854]

Second, the information must be confidential. As discussed in chapter 2, many companies by their nature possess a lot of sensitive information which would prejudice it commercially if its competitors or others knew the information. Information remains confidential despite its dissemination to the company's own advisers, parties with whom it is negotiating or regulatory bodies provided these other peoples right to use the information is restricted to the purposes for which it is given.[1855] Information would no longer be confidential if it became known to a segment of the public or if people traded on the stock market based on this information.[1856]

The third requirement is that the information satisfies one of an enumerated list of exceptions. Those exceptions, and comments on them, are:

- it would be a breach of a law to disclose the information. Only if a law, rather than private agreement, compelled non-disclosure would this exception be satisfied.[1857] This will be extremely rare;
- the information is, or is part of, an incomplete proposal or negotiation. This will commonly occur in the corporate world. Companies that operate in competitive markets will lose competitive advantage if incomplete proposals or delicate negotiations become public knowledge. However clearly once proposals mature into

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1853 Koeck, 'Continuous Disclosure' (1995) C&SLJ 485 at 499. However even this proposition is doubtful since a vendor may decide to change the sale price based on the information even if a trade does not eventuate.

1854 ASX, *Guidance Note: Continuous Disclosure: Rule 3.1* (ASX, Australia, 1996) at paragraphs 17 to 19. The ASX also considers this exception is satisfied if disclosure results in "an inordinate amount of detail being disclosed". In my opinion such an interpretation is inappropriate.

1855 Above at paragraph 21.

1856 Above at paragraph 22.

1857 Koeck, 'Continuous Disclosure' (1995) C&SLJ 485 at 488; ASX, *Guidance Note: Continuous Disclosure: Rule 3.1* (ASX, Australia, 1996) at paragraph 20.

decisions and negotiations transform into agreements, then the benefit of the exception disappears;[1858]

- the information comprises matters of supposition or is insufficiently definite to warrant disclosure. Disclosure of such information does not assist shareholders to come to rational investment decisions. In fact disclosure may be counter productive and cause speculative trading. This exception recognises that disclosure of such information is not necessary;
- the information is generated for the internal management purposes of the company. This is an interesting exception, but has passed without critical comment in the literature.[1859] It is difficult to establish a convincing policy justification for this exception.[1860] Perhaps it is thought that management needs the cloak of secrecy to ensure its effective operation. For example, similar to the cabinet exemption under FOI legislation (discussed in chapter 5.4), managers need secrecy in order for there to be full and effective debate. But I have already established that this reasoning is not appropriate in the corporate context. In addition much of the more sensitive management information would be properly protected under the previous two exceptions and is warranted on that basis. It is possible to demonstrate the lack of a cogent policy basis for the exception by use of an example. The most obvious information protected under this category is monthly financial statements and other information regularly prepared for senior management and directors' meetings. If this information contains price sensitive information, why should it not be disclosed? Certainly monthly financial statements have not been audited (or even reviewed by the auditors) and is therefore less reliable, but surely reasonably informed investors appreciate this and can be appropriately sceptical. If such information were disclosed then less would be left to surprise for the end of year and half yearly reports. The sharemarket would consistently operate more efficiently. Also such disclosures would result in more open management practices that could only assist shareholders in their monitoring role and thus make managers more accountable. This is particularly the case given that shareholders have an interest in how their companies are managed[1861] and in the businesses being run by the company.[1862] Consistently with this view and for the other reasons stated in my opinion this exception is not warranted. However I would propose a new exception to protect information about the company's competitive position in the market (consistent with the confidentiality exception proposed in chapter 2). So within this exception information about the company's costs of its goods or services, pricing policy, market plans etc would be exempt from disclosure. Such information if released could cause significant commercial detriment to the company without any offsetting information advantages for shareholders. In the long term the value of this information will be reflected in the level of the company's commercial success which is the more pertinent information for shareholders; or

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1858 See the examples to the operation of the listing rule at ASX, *Guidance Note: Continuous Disclosure: Rule 3.1* (ASX, Australia, 1996) at paragraphs 45 to 48.

1859 Koeck, 'Continuous Disclosure' (1995) C&SLJ 485 at 488; Black and Minns, 'Commentary on the ASX Listing Rules' in *Australian Corporations Law* (Butterworths, Australia, 1996) at 101,186 ("this is self-explanatory").

1860 That the exception exists suggests that some people think the exception is justified, presumably on some good policy basis. Note the parallel with the exception for "Internal Working Documents" exception to disclosure of government information under FOI legislation (described in chapter 5.5).

1861 See chapter 7.

1862 See chapter 8.2.

- the information is a trade secret This exception is clearly warranted and is self explanatory.[1863]

Subject to my comments on the "internal management" exception, overall these exceptions seem appropriate. The essential touchstone to all of the exceptions is their confidentiality which is a necessary protection of certain business information in a competitive market.

Justification for Continuous Disclosure

There are several reasons for having a continuous disclosure regime, including:[1864]

- given the trigger for the continuous disclosure regime is an event which is expected to have a material effect on the price or value of the company's securities, then the continuous disclosure regime is clearly justified. Shareholders as investors require such information in order to come to intelligent investment decisions;[1865]
- as a sub-set of the last justification, if credence is given to the ECMH, as it should be, then continuous disclosure is necessary to support and give effect to this hypothesis;[1866]
- to ensure a transparent and credible market;[1867]
- in order for the capital market to be an effective discipline on directors;[1868]
- to improve internal information systems. This arises because a corporation is taken to be aware of information "where a director or executive officer has, or ought reasonably to have, come into possession of the information". This requirement, in going beyond actual knowledge, encourages directors to have reasonable internal information systems in order to avoid breaching the Listing Rule;[1869] and
- to reduce the amount of inside information (which otherwise gives insider's the opportunity for unfair trading advantages).[1870]

1863 See the discussion of trade secrets in chapter 3.

1864 Other reasons include to improve allocative efficiency and to promote equity issues (by incorporating by reference in the prospectus material previously released); see Blair, 'Australia's Continuous Disclosure Regime: Proposals for Change' (1992) Australian Journal of Corporate Law 54 at 63; but cf McEwin, 'Australia's Continuous Disclosure Regime: Some Comments' (1992) 2 Australian Journal of Corporate Law 77 who critiques these justifications and the others listed below in the main text of this thesis.

1865 The Australian Stock Exchange, Discussion Paper, 'The Role of the Australian Stock Exchange and its Listing Rules' (ASX, Australia, 1990) at paragraph 22 justifies the continuous disclosure regime in the following terms:

> The market must be advised by timely disclosure of any information which may affect security values or influence investment decisions, or in which security holders, investors and the Exchange have a legitimate interest or which is publicly disclosed elsewhere.

1866 See chapter 4.6. See also Blair, 'Australia's Continuous Disclosure Regime: Proposals for Change' (1992) Australian Journal of Corporate Law 54 at 62;

1867 Tomasic, 'Reform and Enforcement of Australian Stock Exchange Rules and the New Continuous Disclosure Laws' (1995) 4 No.2 Asia Pacific Law Review 21 at 42.

1868 See chapter 4.6. See also Blair, 'Australia's Continuous Disclosure Regime: Proposals for Change' (1992) Australian Journal of Corporate Law 54 at 62.

1869 Blair, 'Australia's Continuous Disclosure Regime: Proposals for Change' (1992) Australian Journal of Corporate Law 54 at 64; Koeck, 'Continuous Disclosure' (1995) C&SLJ 485 at 491; Nicoll, 'Lost Opportunities for Improved Disclosure within the Corporate Law Reform Bill (No 2) 1992' (1993) 3 Australian Journal of Corporate Law 27 at 28; ASX, *Guidance Note: Continuous Disclosure: Rule 3.1* (ASX, Australia, 1996) at paragraph 6.

1870 Blair, 'Australia's Continuous Disclosure Regime: Proposals for Change' (1992) Australian Journal of Corporate Law 54 at 63.

Conclusion

The continuous disclosure requirements specifically address the matters that concern investors, that is information which may affect the market price or value of shares. The requirements positively oblige the company to promptly release to the market any price sensitive information. The exceptions to disclosure seem appropriate, except for the "internal management exception". A recent review of the operation of the continuous disclosure regime concluded that it operates effectively, subject to the need for some minor fine-tuning.[1871]

The main concern with information released under the continuous disclosure regime is its quality, in particular its accuracy, credibility and completeness. Given the purpose of this regime, namely to provide prompt information in between the time of the periodic reports, then review of the information by an independent auditor does not seem appropriate. The risk of directors manipulating information has been lessened by the Listing Rules being given statutory teeth, which hopefully deters such behaviour. One positive step that could also be taken is to insist that where there is documentary evidence in support of the disclosure then those documents should also be sent to the ASX and available for inspection by those with an interest. For example if a company discloses that a new agreement has been concluded then a copy of the agreement should be sent to the ASX, subject to confidentiality concerns.

Since the information is necessarily about specific and unique events then comparability is not a relevant consideration. There is no problem with understandability or accessibility. Confidentiality is adequately protected under the exceptions to the disclosure regime. Disclosure is very timely and in the whole reason for the continuous disclosure regime. The cost of disclosure is obviously not regarded as prohibitive.

10.3 COURT ASSISTED ACCESS TO INFORMATION

Common Law

The common law initially vacillated on the issue of whether shareholders had a general right to inspect the company's books. One view was that "shareholders were seen as equitable owners of the corporate property and on this basis access to corporate documents was seen as a property right of members".[1872] This view has since been rejected principally because shareholders rights in the company are no longer regarded as being proprietary in nature.[1873] I considered this issue in chapter 4 and agree with this analysis (but not necessarily with any inference drawn form it concerning shareholders right to information).

Ultimately a narrow approach was adopted by the courts which resulted in more restricted access by shareholders to the company's books. The present position at common law is that shareholders seeking inspection must establish a specific dispute or

1871 Companies and Securities Advisory Committee, *Report on Continuous Disclosure* (AGPS, Australia, 1996) at paragraphs 1.1 to 1.3; Hambleton, 'Continuous Disclosure for Listed Entities CASAC Report-It Works' (1997) 15 C&SLJ 55.

1872 Sinnott & Duns, 'Shareholders' Rights of Access to Corporate Books' (1990) 8 C&SLJ 73.

1873 Norman, 'Access To Corporate Information' (1986) 4 C&SLJ 149 at 157. See chapter 4.2 under the sub-heading "Role of Directors" where the view of shareholders as property owners was rejected. See also chapter 4.3 under the sub-heading "Property" where this receives a full analysis.

question and an established interest in that dispute or question[1874] (and possibly an interest greater than other shareholders).[1875]

Certainly a simple desire to "roam at will through the company's affairs"[1876] whether motivated by general discontent with management performance or otherwise[1877] has been rejected. One justification for this approach is that unlimited rights of inspection would be too disruptive to the orderly management of a company's affairs.[1878] In my opinion this speculative argument is not of itself sufficiently persuasive to deny a right to inspection. Companies involved in significant commercial litigation have to discover documents. Discovery is intrusive and disruptive but nonetheless occurs. The same can be said of a due diligence exercise undertaken at the time a prospectus is prepared.[1879] Therefore inspection by shareholders is not necessarily of itself too disruptive. Certainly if many requests for inspection were made of the same company then this could be sufficiently detrimental to justify refusal. But this could be accommodated not by a blanket denial of a right of inspection but by the court flexibly exercising its discretion whether to allow inspection.

More fundamentally though this approach denies that shareholders have any legitimate interest in monitoring management performance.

Corporations Law

The Corporations Law has improved on the common law position. As a replaceable rule, Corporations Law s247D provides:

> The directors of a company, or the company by a resolution passed at a general meeting, may authorise a member to inspect books of the company.

So the directors may cooperatively provide inspection or the shareholder may pursue this in a shareholder meeting seeking authorisation by a resolution of themselves. If these avenues are not pursued, or if the rule is not available in a particular company (it is a replaceable rule only), then the only other option is to use CL s247A.

Section 247A of the Corporations Law provides:

> (1) On application by a member of a company...the Court may make an order:
> (a) authorising the applicant to inspect books of the company...; or
> (b) authorising another person (whether a member or not) to inspect books of the company...on the applicant's behalf.
>
> The Court may only make the order if it is satisfied that the applicant is acting in good faith and that the inspection is to be made for a proper purpose.

The section is reasonably straightforward and in most respects has been sensibly interpreted by the courts.[1880] The one problematic area is the shareholder establishing

1874 *Edman v Ross* (1922) SR (NSW) 351.

1875 *Bank of Bombay v Suleman Somji* (1908) 109 LT 62.

1876 *Edman v Ross* (1922) SR (NSW) 351.

1877 *Bank of Bombay v Suleman Somji* (1908) 109 LT 62; *R v The Wardens of The Merchant Tailors Company* (1831) 2 B & Ad 115 at 128.

1878 *R v The Wardens of The Merchant Tailors Company* (1831) 2 B & AD 115 at 129.

1879 Discussed in chapter 8.3 under the sub-heading "Prospectuses".

1880 Pursuant to the *Company Law Review Act* 1997 (Cth), s247A replaced s319. There are minor differences between s247A and s319. Under s247A the applicant can personally inspect the company's books, whereas under s319 only the applicant's lawyer or auditor could inspect.

good faith and proper purpose. At one level the debate is pedantic and sterile: does the phrase "good faith and proper purpose" constitute a separate or composite requirement.[1881] The good faith requirement seems not to be satisfied if the applicant only recently acquired a small number of shares and is clearly acting strategically.[1882]

The more important issue is what the courts have regarded as proper purposes. It is generally regarded that the applicant must be pursuing an interest as a shareholder.[1883] So the courts starting point is certainly correct as a matter of principle.[1884] Recent Australian cases recognise the following as either proper or improper purposes.

Proper Purposes

It is a proper purpose to:
- take measures to protect a substantial investment (ie. a substantial shareholding) which may be jeopardised in view of a proposed substantial transaction of the company;[1885]
- investigate whether directors have breached their statutory duty;[1886]
- investigate the current value of one of the company's principal assets in order to determine the value of the applicant's shares;[1887]
- investigate the company's potential right of legal action;[1888]
- establish whether there are grounds for an oppression remedy pursuant to s246AA of the Corporations Law;[1889] or
- investigate whether information in a prospectus is false or misleading.[1890]

Improper Purpose

It is an improper purpose to use the application for inspection:
- as a bargaining chip in a wider dispute with the company;[1891]
- as part of a political feud between the applicant and the CEO;[1892]
- to help facilitate a takeover;[1893]

However the principal structure of the sections, an application to a court and shareholders acting in good faith and for a proper purpose, are the same. Therefore the case law on s319 is relevant under s247A.

1881 Willcocks, *Shareholders Rights & Remedies* (The Federation Press, Sydney, 1991) at 102; Sinnott & Duns, 'Shareholders' Rights of Access to Corporate Books' (1990) 8 C&SLJ 73 at 85.

1882 *Quinlan v Vital Technology Australia Ltd* (1987) 5 ACLC 389 at 393.

1883 *Knightswood Nominees Pty Ltd v Sherrin Pastoral Company Ltd* (1989) 7 ACLC 536; *Garina Pty Ltd v Action Holdings Ltd* (1989) 7 ACLC 962.

1884 See chapter 4.

1885 *Grants Patch Mining Ltd v Barrack Mines Ltd* (1988) 6 ACLC 97 (First Insurance per Ryan J) and (1988) 6 ACLC 101 (Full Supreme Court of Queensland); *Intercapital Holdings Ltd v MEH Ltd* (1988) 6 ACLC 1,068.

1886 *Re Humes Ltd* (1987) 5 ACLC 64; *Knightswood Nominees Pty Ltd v Sherwin Pastoral Company Ltd* (1989) 7 ACLC 536; *Biala Pty Ltd v Mallina Holdings Ltd* (1989) 7 ACLC 894.

1887 *Knightswood Nominees Pty Ltd v Sherwin Pastoral Company Ltd* (1989) 7 ACLC 536.

1888 As above.

1889 *Quinlan v Vital Technology Australia Ltd* (1987) 5 ACLC 389.

1890 As above.

1891 *Giant Resources* unreported decision of McPherson J, Supreme Court of Queensland, No 21 of 1988; discussed in Sinnott & Dunn, 'Shareholders Rights of Access to Corporate Books' (1990) 8 C&SLJ 73 at 81.

1892 *McMahon v Dispatch Printing Co* 129 A 425 (1925). Although an American case US law in this area is similar to Australian law and therefore the American cases are relevant. Also as a matter of principle this decision seems correct.

- to defeat a transaction proposed by the directors;[1894] or
- to challenge a normal management decision.[1895]

The Courts have held that so long as a proper purpose is the primary purpose then a secondary improper purpose will not defeat the application.[1896]

As stated earlier the courts have started from the correct position; the applicant must be pursuing an interest as a shareholder. Unfortunately the courts which have considered the issue have not addressed the fundamental question of who shareholders are and what information they are legitimately interested in; there is no conceptual underpinning to the decisions.[1897] In the decided cases the courts recognise that shareholders have a legitimate interest as both monitors and investors but do not develop this in a systematic way.

In recognising that shareholders have a proper purpose investigating whether directors have breached their duty the monitoring role is recognised. But the same role is denied when applicants want to investigate a normal management decision. So the courts allow monitoring for conformance to legal standards (eg. directors duties) but not performance (measured commercially). This reticence is consistent with the courts view about the division of management power between directors and executives (ie directors have exclusive management powers and are not subject to the direction of shareholders).[1898] Certainly shareholders do not enjoy management powers, but after monitoring management they may decide to remove their elected directors which does not involve a disruption to this division of power. Also as the courts are not being asked to make substantive judgments about performance, which they feel ill equipped to make,[1899] but merely to allow shareholder inspection, then this reticence is difficult to fathom. This is particularly so where shareholders as a result of their investigations may not be returning to the court for a further remedy (eg. they may initiate a self help remedy such as selling their shares or removing directors from office).

Similarly the investor function of shareholders is validated where courts recognise as a proper purpose the desire to value shares. But investors do not want to know the value of the shares as an abstract exercise; they want to know the value to be able to intelligently decide whether to sell or hold their existing shares or to buy more shares. This reality is denied by denying the facilitation of a takeover as a proper purpose. Surely the decision to buy all of a company's shares is simply the most extreme form of a normal investment decision. Certainly issues of confidentiality are involved, particularly where the bidder is

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1893 *Re Augold NL* (1987) 5 ACLC 268; *Garina Pty Ltd v Action Holdings Ltd* (1989) 7 ACLC 962 (both cases where the application was refused on this basis); *Quinlan v Vital Technologies Australia Ltd* (1987) 5 ACLC 389.

1894 *Grants Patch Mining Ltd v Barrack Mines Ltd* (1988) 6 ACLC 97 at 101.

1895 *Re Augold NL* (1987) 5 ACLC 286 at 294.

1896 *Re Humes Ltd* (1987) 5 ACLC 64; *Grants Patch Mining Ltd v Barrack Mines Ltd* (1988) 6 ACLC 97 at 101.

1897 In the USA a more conceptual approach is adopted. One aspect of this approach is that only economic interests of shareholders are recognised. So a social interest, such as the desire to stop a company from manufacturing anti-personnel fragmentation bombs used in the Vietnam War, was not regarded as an economic interest. Therefore the applicant did not have a proper purpose. See *Pillsbury v Honeywell Inc.* 191 NW 2d 406 (1971); discussed in Norman, 'Access to Corporate Information', (1986) 4 C&SLJ 149 at 172 ff. Although limiting shareholders interests to economic interests is questionable (see chapter 9) at least a conceptual underpinning to their case law exists.

1898 See chapter 4.2 under the sub-heading "Role of Directors".

1899 See chapter 7.4 under the sub-heading "Reasonable Decisions".

a competitor of the target, but surely these concerns can be accommodated by confidentiality orders. Once again the courts recognise the investor function of shareholders but do not take this to its logical conclusion.

If a shareholder obtains an order from the court authorising inspection but the company refuses to comply then the shareholder could go back to court for an order of contempt of court.[1900]

Comparison with Freedom of Information Legislation

In chapter 5.4 I argued that a freedom of information style regime was appropriate in corporations. I deferred discussing how that could be adapted for corporations until now. I did this because of the obvious parallel with the right of inspection under section 247A.

There are two significant differences between section 247A and FOI legislation. Under section 247A the applicant must apply to the court for inspection and has the onus of satisfying the court that he or she is acting for a proper purpose (which has been narrowly interpreted by the courts). Under FOI legislation the applicant applies directly to the person who has the documents the applicant is after and the applicant does not have to establish a proper purpose.

In my opinion both of these hurdles to inspection under section 247A should be removed. In this thesis I have argued for a broad view of who shareholders are and what information they have a legitimate interest in. Shareholders have an interest in monitoring the directors they have appointed (and their delegates the executives) and the activities of the company. Shareholders are also citizens of the corporate democracy interested in all information about the company. Shareholders are also investors who are legitimately interested in evaluating the worth of their investment which depends on the worth of the company. Given the broad role of shareholders they will almost always have a proper purpose and therefore this requirement is superfluous. If as a prerequisite to using this disclosure regime shareholders were required to hold a certain shareholding over a reasonable period of time[1901] then this should minimise the risk of opportunistic or strategic applications. This conclusion makes redundant the intervening supervision of the courts given the main reason to insist on court approval is to test proper purposes. Thus the interposition of the court between the applicant and the source of the information is unnecessary. An additional reason to jettison an application to court is that it obviously involves considerable time and expense[1902] which operates as a real disincentive to seeking disclosure (under FOI only a nominal fee is paid).

However I would allow directors the right to refuse inspection, with the sanction of a court, in two situations. First, if the directors can establish that the shareholder is acting in bad faith or for a non-monitoring, non-citizenship or non-investment purpose then access would not be appropriate. These situations will be rare but would cover situations where shareholders are acting for personal reasons (for example the first two dot points mentioned above under "Improper Purposes"). Second, if the company is inundated with requests so that administratively it is causing a prejudicial amount of disruption to the company's operations then inspection should not be permitted. This exception should be tightly circumscribed and forcing shareholders who have inspected information to share the results of their inspection with other shareholders (if requested) could lessen its

1900 Miller, *Contempt of Court* (Elek Books, London, 1976) at chapter 14.

1901 As proposed in chapter 5.5 under the sub-heading "FOI in Corporations".

1902 Not only the applicant's legal fees but if the applicant is unsuccessful the risk of paying the company's legal fees too.

impact. Note that under this proposal managers would have the carriage and cost of any application to court and the evidentiary onus of establishing that the application for inspection is not warranted. In addition the right of inspection would not extend to commercially confidential information.[1903]

Justification for shareholder inspection rights

The preceding analysis in arguing how this right can be improved inferentially justifies a right of shareholders to inspect corporate records. Perhaps the strongest generic justification is that shareholders as citizens require such a right since modern principles of open government are appropriate for corporations. In the political context the principles of open government result in the FOI regime and, as I argued above, this clearly justifies a similar regime in the corporate context. However shareholders will use such a right in their role as monitors and investors (as shown by the cases discussed above) and therefore is also justifiable from these perspectives.

Conclusion

The existing rights of inspection are too restrictive and based on too narrow view of who shareholders are and what information they are legitimately interested in. This is particularly so when contrasted with the unrestricted right of access to information by directors[1904] and auditors,[1905] who both are after all representatives of shareholder. In my opinion shareholders should have an FOI style right of inspection subject only to limited exceptions. It is worth noting that if my other proposals for reform were adopted then shareholders would be receiving considerably more information in any event. The FOI style right of inspection would therefore be rarely used. However it would be an important measure of last resort if shareholders suspected that nonetheless they were not receiving significant information from the company.

As this section is concerned with shareholders themselves examining "raw" corporate information then the qualities of accuracy, credibility etc are not relevant.

10.4 TRANSACTIONS REQUIRING SHAREHOLDER APPROVAL

Introduction/Justification for disclosure

In various places in this thesis I have indicated that the Corporations Law, Listing Rules or the general law require certain transactions to be approved by shareholders.[1906] This derogates from the broad proposition that directors are delegated extremely extensive and exclusive powers of management.[1907] Where a matter requires shareholder approval then

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1903 See chapter 2.

1904 See chapter 4.3.

1905 See chapter 6.5.

1906 In addition to where the law requires it, the shareholders can voluntarily take action, although on some matters a special resolution may be required (eg to amend the constitution, discussed in chapter 4.2 under the heading "Role of Shareholders"). Also the general law allows shareholders to unanimously agree on anything concerning their company; See *Brick & Pipe Industries Ltd v Occidental Life Nominees Pty Ltd* (1990)3 ACSR 649 at 683 to 689; see also Ford, Austin and Ramsay, *Ford's Principles of Corporations Law* (Butterworths, Sydney, 9th ed., 1999) at [7.590]; and Redmond, *Companies and Securities Law* (Law Book Company, Sydney, 2nd ed., 1992) at 244 to 245. Clearly this doctrine has extremely limited application to public companies due to the number of shareholders involved.

1907 Discussed in chapter 4.2 under the Sub-heading "Role of Directors".

shareholders are exercising their rights as corporate citizens and are therefore entitled to appropriate information, which I discuss below.[1908] In addition to this blanket justification, many of the topics on which shareholders are asked for their approval concern their interests as monitors or investors and therefore in these circumstances disclosure of information is also justified on this basis.

Notice Requirements

Whenever a transaction must be approved by shareholders the constitution and general law[1909] stipulates the type and quality of the information shareholders must receive in order to consider properly the proposed resolution. Corporate constitutions usually provide that the notice of meeting must state "the general nature of the business to be transacted at the meeting".[1910] The general law has embellished this broad proposition and developed its own principles designed to protect shareholders.

First, shareholders must receive notice of all business to be transacted at a meeting. The meeting is only competent to deal with the business specified in the notice.[1911] The courts strict but justifiable approach is seen in the further rule that if a notice states that a matter is only to be discussed then the meeting cannot pass a resolution on that matter.[1912]

Second, the notice must contain certain information. The directors are under a fiduciary duty to provide shareholders with full and accurate information (ie. not misleading) concerning the proposed business.[1913] This information must be intelligible not only to an experienced business person or lawyer, but to the ordinary investor who may only read the document quickly.[1914] This approach certainly requires the full text of any resolution,[1915] or any amendments to the constitution,[1916] to be set out in the notice. The usual practice is for the notice to also separately explain the reasons for and the effect of the resolution.

Directors are not expected to be completely neutral in the explanatory material. Usually they are entitled to support it and urge shareholders to approve it. However there is a limit in how far directors can go in supporting resolutions. For example, directors are not able to barrack for the election of certain directors and oppose the election of others

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1908 In addition to the general information requirements the law sometimes requires:
(1)these transactions to be approved by a special resolution;
(2)stipulates special information requirements that must be provided to shareholders. Where this is the case I have indicated this in the footnotes where the relevant requirement has been discussed; or
(3)restricts identified persons who are interested in the transaction from voting.

1909 Listed companies also have to notify the ASX of:
(1)the proposed date of any shareholders meeting if directors are to be elected (LR 3.13.1);
(2)the outcome of each resolution put to shareholders (LR 3.13.2); and
(3)the contents of any prepared announcement (including any prepared address by the Chair) that will be delivered at a meeting of security holders (LR 3.13.3).

1910 Table A cl 41(1).

1911 *Deveraux Holdings Pty Ltd v Pelsart Resources N.L (No. 2)* (1985) 9 ACLR 956 at 956.

1912 *Stanham v National Trust of Australia (NSW)* (1989) 15 ACLR 87.

1913 *Bulfin v Bedarfald's Limited* (1938) 38 S.R. (N.S.W.) 423; *Deveraux Holdings Pty Ltd v Pelsart Resources NL* (No. 2) (1985) 9 ACLR 956 at 956; *Fraser v NRMA* (1995) 15 ACSR 590 at 601.

1914 *Re Moorgate Mercantile Holdings Ltd* [1980] 1 All ER 40; *Re Marra Developments Ltd* (1974-76) 1 ACLR 470 at 471.

1915 As above at 5.

1916 *Bancorp Investments Ltd v Primac Holdings Ltd* (1985) 3 ACLC 69.

in a partisan way.[1917] Also directors are obliged to at least point out the disadvantages to anything they are proposing (eg they could outline the "no" case of any proposal they were advocating in favour of).[1918] In a similar vein and consistent with fiduciary duty if directors have a personal interest in any matter to be approved by shareholders then the nature and extent of that interest must be fully disclosed.[1919]

It has not been authoritatively decided that shareholders have standing to sue for a breach of this fiduciary duty. The obstacle to such a right is the decision in *Foss v Harbottle*[1920] which regards the company as the proper plaintiff for a breach of directors' fiduciary duty. However there are reasons why shareholders should have the right to sue. First, even if *Foss* is relevant the exception of shareholders personal rights should apply. The right to vote is a personal right[1921] and providing this information is a prerequisite to the valid exercise of the right to vote and therefore is also to be properly regarded as a personal right. Second, arguably in this situation *Foss* should not apply at all because in this situation directors are dealing directly with shareholders and as a matter of principle it is nonsensical to say that directors owe their duty to the company and not shareholders. Third, courts have consistently entertained suits by shareholder plaintiffs. In these cases either the directors were altering the shareholders right to vote by amending the constitution in which case the personal rights exception applied[1922] or the issue of standing was not argued but the court nonetheless granted a remedy.[1923] On balance the better view is that shareholders have a right to sue for a breach of this fiduciary duty. Shareholders will have access to the full range of remedies available for a breach of fiduciary duty. However the usual remedy sought is a declaration of invalidity or an injunction to prevent the meeting from proceeding; these remedies have often be granted.[1924]

Conclusion

Courts have strenuously and justifiably protected shareholders' right to full and accurate information when they are sent a notice of meeting which requests them to consider a matter. In this situation the law sets appropriate standards so that shareholders receive appropriate information. Unfortunately the law has not addressed the wider and substantive issue of trying to curb the problem of agenda setting by corporate managers. If this were addressed in the manner I suggested in chapter 4.2 then shareholders would receive much more relevant information and their consent to certain corporate transactions would be more meaningful. As is presently the case there must be concerns about the credibility and completeness of the information shareholders receive. Comparability is not in issue when unique issues are put up to shareholders for their approval. The courts have squarely addressed the issue of understandability. The information must be understandable by the average investor. It is accessible to them as

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1917 *Advance Bank of Australia Ltd v FAI Insurance* (1987) 5 ACLC 725.

1918 *Fraser v NRMA* (1995) 15 ACSR 590.

1919 *Chequepoint Securities Ltd v Claremount Petroleum NL* (1986) 4 ACLC 711.

1920 (1843) 67 E.R. 189, discussed in chapter 4.2.

1921 *Pender v Lushington* (1877) 6 Ch D 70; *Residues Treatment & Trading Co Ltd v Southern Resources Ltd (No 4)* (1988) 14 ACLR 569.

1922 *Bancorp Investments Ltd v Primac Holdings Ltd* (1985) 3 ACLC 69 at 73.

1923 *Advance Bank of Australia Ltd v FAI Insurance* (1987) 5 ACLC 725; *Chequepoint Securities Ltd v Claremount Petroleum NL* (1986) 4 ACLC 711; *Bain & Co Nominees Pty Ltd v Grace Bros Holdings Ltd* (1983) 7 ACLR 770.

1924 As it was in *Bancorp Investments Ltd v Primac Holdings Ltd* (1985) 3 ACLC 69 at 73; *Chequepoint Securities Ltd v Claremount Petroleum NL* (1986) 4 ACLC 711; *Bain & Co Nominees Pty Ltd v Grace Bros Holdings Ltd* (1983) 7 ACLR 770.

each shareholder receives a copy of the notice of the meeting.[1925] If the directors are seeking shareholder approval then necessarily confidentiality is not an issue. Timeliness is by necessity satisfactory because information is received whilst the matter is only a proposal and will remain so unless the shareholders approve it. The cost of convening meetings is considerable, but no one seriously suggests that companies should not meet this cost if a topic is serious enough to require shareholder approval.

1925 Table A, cl 96(1).

CHAPTER 11

CONCLUSION

This thesis is about the information needs and rights of shareholders. In order to understand their needs and rights, I deconstructed the concepts of information and the identity and role of shareholders. The concept of information was analysed using the insights from a variety of disciplines, namely philosophy, psychology, sociology, science and information theory. These disciplines all had modern theories about communication and knowledge transmission which I used to develop my own definitions of information and communication. I also examined the legal discipline which allows private rights to certain types of information but generally does not regard information as private property. This multi-disciplinary approach informed many aspects of the thesis, none more important than the reality that knowledge is non-absolute (and therefore total accuracy is not feasible). Other concepts were useful in particular contexts, such as Popper's view of scientific method (which does not prove truth but attempts to discredit a law/theory), which helps to explain the audit expectation gap. During the fundamental analysis of information I also developed criteria in order to assess the quality of information. The quality of information was measured against the criteria of accuracy, credibility, relevance, comparability, understandability, accessibility and timeliness compared with its cost and confidentiality concerns. Later in the thesis the actual disclosures made by corporations were measured against these quality criteria.

This broad approach to the concept of information led to a definition of communication as "the endeavour of passing knowledge by information from one person to another". This definition is purposive and requires a focus on the nature of the relationship between speaker and audience and in particular the information needs of the audience. Therefore I had to deconstruct the identity and role of shareholders. My analysis of the relationship between directors and shareholders concluded that shareholders are comprehensive monitors and investors. Drawing from the political, democratic model of governance shareholders can also be regarded as a class of citizens. This model of shareholders as monitors, investors and citizens informs the nature and extent of the information that shareholders require. Traditionally this type of analysis has not occurred. Designating shareholders as comprehensive monitors, investors and citizens points to the need for maximum disclosure in order to enable shareholders to adequately acquit themselves in these roles. The need for maximum disclosure is also warranted since information is a public/primary good (and that in corporations the interests of shareholders as citizens is analogous to the public interest). However there are two broad constraints to maximum disclosure. First, in a commercial context there is a legitimate need for confidentiality in order to exploit market advantages in the pursuit of profit. An analysis of the law of confidentiality points to juridical confusion as to its nature. In my opinion the protection given is not proprietary but equitable in nature, which is a lesser form of protection. This is consistent with the desire of restraining as far as feasible the claim of confidential information so as to minimise its intrusion into the principle of maximum disclosure. A second restraint is the cost to produce and disseminate information. Certainly computer technology can help to reduce these costs but they nonetheless remain substantial. In my opinion the need for maximum disclosure is more compelling than a claim that such disclosures are too costly. Ultimately though the judge of this will be market forces and the political will of governments.

The model of shareholders as monitors, investors and citizens was used for three purposes in the thesis. First, to determine if the types of information shareholders currently receive is justifiable based on the model. That is, is the information directors currently disclose to shareholders legitimately directed to satisfying the needs of shareholders in their role as monitors, investors or citizens. For shareholders to properly function in those different roles requires and justifies the disclosure of different types of information. The conclusion is that all current disclosures can be justified from the traditional model of shareholders as monitors and investors. Some of the current disclosures can also be justified on the basis of shareholders as citizens, but the current disclosures do not rely on this justification.

Second, the model was used to analyse whether additional types of information and improvements to existing disclosures or disclosure methods are justified. The broad conclusion is that whilst maximum disclosure is warranted as a matter of principle this is not the practice. Shareholders as monitors, investors and citizens have a legitimate interest in a range of information that is not currently being adequately addressed. In addition to a host of minor improvements to current disclosures on various topics, shareholders do not receive any information that satisfies quality criteria concerning:

- direct measures of management performance;
- directors' compliance with their legal duties of honesty and care (and the disclosures on the duty of loyalty could be improved); and
- social information.

Certainly there are usually some voluntary disclosures on these topics but such disclosures are flawed when measured against the desired qualities of information. Viewed from the perspective of the total information needs of shareholders and using my quality criteria, the information shareholders currently receive is incomplete. Finally under this use of the model, shareholders as citizens justifies an FOI style disclosure regime and adaptation of the reasons for decisions doctrine in administrative law in corporations consistently with evolving notions of open government.

Third, the model was used to determine whether the information shareholders currently receive is suited and useful to their needs. Suitability raises the relevance of information; usefulness squarely brings into play the other quality criteria developed in chapter 2. Financial information is well suited to the information needs of shareholders as investors (and also as monitors) in "for profit" enterprises. Subject to specific reform proposals made in chapter 6 and the notion that concepts of knowledge are always evolving and maturing, shareholders receive adequate financial information. Financial information generally measures quite well against the quality criteria. In particular the use of auditors endeavours to address the credibility of information. Enhancing credibility by outside auditors is particularly important given there are no other outside influences to test information such as an active opposition to the incumbent directors or an effective media. Whilst recognising that liability rules have a role in enhancing the quality of corporate information, such rules do not equate to independent or antagonistic scrutiny of this information on a systematic basis. Another live issue in this area is the understandability of this information by unsophisticated investors. There is no easy or entirely satisfactory response to this. My conclusion is that information should be as understandable as possible but recognising that financial knowledge involves complex and sophisticated concepts and therefore financial information will necessarily reflect this complexity and sophistication. Other qualities are largely satisfied, such as comparability by the presence of the Accounting Standards.

There are real concerns under the third purpose of the model about the scope (analysed above) and quality of non-financial information. In particular there is no requirement that this other information be audited. Those liability rules that allow a due diligence defence encourage managers, as far as liability rules can, to prepare and publish quality information. However there is a limit on what liability rules can achieve as against people who plan to be deliberately deceptive. The reported cases are replete with instances of such behaviour and no doubt this will continue. But for other types of information, and in particular voluntary disclosures on topics such as management performance and social information, the quality of current disclosures (to the extent that they occur) leaves a great deal to be desired. As a result this information is not very useful to shareholders as monitors, investors and citizens to help them to rationally make decisions concerning the company.

Also, as mentioned previously in this conclusion, liability rules have a role to play in enhancing the quality of financial information. However throughout the analysis different liability rules were seen to apply to different types of corporate information. Even those liability rules in the Corporations Law are located in different places and have varying bases of liability and defences. These rules do not establish a coherent pattern of liability, both within the Corporations Law and because of unnecessary overlap with other rules, principally section 52 of the *Trade Practices Act* 1974 (Cth). The current government is addressing, or hopes to partially address, this incoherence.[1926] However there are larger concerns than the incoherence of these liability rules. Shareholders do not have legal standing to enforce most of these liability rules, liability for prospectuses and takeover documents being the most notable exceptions, and therefore shareholders can not obtain remedies for their breach.[1927] In particular shareholders as investors often suffer losses because they have relied on misinformation but cannot recover compensation for these losses. As a matter of principle this seems indefensible. However there are countervailing policy considerations, including concerns of indeterminate liability, that the current legal orthodoxy regards as outweighing the arguments in favour of allowing liability (which on balance seems correct). There is a clear conflict between the practice and the legal position. The practice is that this information is addressed to shareholders and this information is relevant in making their decisions. But they can not legally rely on the information; ie they cannot sue the authors of this information if it is inaccurate or otherwise flawed. That is, the information is legally irrelevant. There is a deep irony in this discordance.

Finally, another theme explored in the thesis was the separation of ownership and control and the increasing size and sophistication of modern business. The modern reality is that directors of large public companies can no longer manage the day to day affairs of their corporations. They must delegate this role to the executives. This is similar to what occurs in government between cabinet ministers and their departments connected by the notion of responsible government. Since directors can not manage the day to day affairs of their corporations they also do not as a matter of course necessarily know about the affairs of their corporation. That is they are not omniscient about their corporations.

1926 Discussed above in chapter 8.3 'Prospectuses'.

1927 Shareholders are not regarded as the proper plaintiff: *Foss v Harbottle* (1843) 67 E.R. 189. There are exceptions to this rule and some limited statutory rights of standing, such as CL s1324 which entitles shareholders to obtain an injunction. But these are all exceptions to the general rule that shareholders are not the proper plaintiff. The current government is proposing a statutory derivative action; see *Corporate Law Economic Law Reform Program Bill* 1998 (Cth) Part 2F.1A. But a statutory derivative action itself reinforces the primacy of the general rule.

This justifies the need for strong systems of internal control and information systems.[1928] This need for information systems is also supported by information theory which recognises the decaying effect of entropy along successive chains of communication. This need receives scant recognition in the law.[1929] In my opinion the need for internal control and information systems requires explicit recognition by the law.[1930] My proposal is that such recognition should occur as part of the duty of care. Applied to a particular context, directors should know of their corporation's compliance with social laws and should be able to report accordingly. Overall such a requirement would improve the endeavour of effective communication and in particular improve the quality of corporate information.

1928 Institute of Internal Auditors, *Australian Control Criteria: Effective Internal Control to Achieve Business Objectives Within an Acceptable Degree of Risk (Exposure Draft)* (Institute of Internal Auditors, Sydney, 1998).

1929 The auditing standards recognise the need for auditors to be alert to the risk of fraud (AUS 210 'Irregularities, Including Fraud, Other Illegal Acts and Errors') and to be cognisant of the internal control structure, which management is principally responsible for (AUS 402 'Risk Assessments and Internal Controls' particularly at paragraph .15). Also the circumstances where a corporation is taken to be "aware" of information under the continuous disclosure regime encourages internal information systems (see chapter 10.2). However none of these can be regarded as central to a mandatory disclosure obligation which should be imposed on corporations.

1930 There is such a requirement in the US; see *Securities Exchange Act* 1934 (US) s13(b)(2)(B) (this section was inserted by the *Foreign Corrupt Practices Act* (US)); Seligman, *Corporations: Cases and Commentary* (Little, Brown and Company, U.S.A., 1995) at 373 to 374.

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