LISTENING AT THE BOARDROOM DOOR

WHAT THE ASX MUST DO FOR SHAREHOLDERS

By MALCOLM McCOMAS

As stories continue to unfold of questionable management conduct, the attitude of shareholders and investors has become clear: that's enough!

The development of the limited liability company and the public trading of shares on stock exchanges since the 1890s has been a convenient and catching habit for the creation of wealth. However, in Australia in recent years there has been a significant transfer of wealth from shareholders to management in a small but highly visible group of public companies. This has occurred largely because of the absence of a workable system for the enforcement of disclosure standards for public companies. As a result, international investors have questioned the credibility of the Australian Stock Exchange, the adequacy of our regulatory environment and the efficiency of Australia's capital markets.

I need not dwell on examples of how in some cases the beneficiaries of transactions have included management, certain large shareholders associated with management, associates, other public companies and the vendors of assets of questionable value. Where wealth has not been transferred to management, it has been dissipated by those who enjoy the luxury of having to report only once a year, at an annual general meeting, on their ability to manage shareholders' funds. The concerns of shareholders, as proprietors of the companies in which they invest, are ignored for the convenience of management.

In such cases, shareholders have had little opportunity to question or even understand the actions of the directors. It is this lack of accountability, resulting from inadequate disclosure requirements and shareholder controls, that has caused the current shareholder revolt by both institutional and private investors.

> **Corporation** (n): an ingenious device for obtaining individual profit without individual responsibility.
>
> **Ambrose Bierce**
> ***The Devil's Dictionary***

Shareholders have become intolerant of the way in which regulators have failed to provide for and enforce adequate disclosure. They are now demanding to be heard; to be given an opportunity to understand and vote on the merits of material transactions, appoint non-executive directors and force management to make adequate disclosure. Greater disclosure and shareholder control of material transactions must come to Australia; it is a worldwide trend that we cannot ignore. The carefully scripted annual meeting, where managers could once ignore the shareholders, is fast becoming a thing of the past.

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The *Economist* magazine recently described this phenomenon of shareholders behaving like owners as the concept of the "proprietor-capitalist". It can be contrasted with the "punter-capitalist" who rode the 1980s bull market with little regard for the outcome for the future purchasers, the company and the economy. The Australian regulatory environment must catch up with international standards of disclosure and the preservation of shareholders' rights or lose the ability to attract international investment capital.

The lack of disclosure falls into three categories:

- inadequate financial reporting in a timely and detailed manner;
- a lack of detailed information to explain the financial implications of material transactions such as acquisitions, divestments and the issue of new shares; and
- an inconsistent and haphazard approach to the content and method of disclosure in each of the above circumstances.

The Stock Exchange must be encouraged to observe adequately its responsibilities to existing shareholders and potential investors, and to ensure that those interests are protected. However, the debate on disclosure has so far failed to identify what changes are necessary to the Stock Exchange listing rules to take the Australian stockmarket into the 21st century. This paper considers what immediate improvements can be made, without legislative intervention, to prevent the further erosion of shareholder wealth.

Financial reporting

The number and size of recent corporate collapses—including Bond, Qintex, Westmex, Hooker and Giant—some following record reported profits, have made institutional investors take a long, hard look at the adequacy of reporting standards in Australia, especially regarding cashflow and indebtedness.

In addition, public examinations by liquidators have revealed secret commissions, premature recognition of profits, inflated asset-values and hidden management contracts. Accounts have failed to disclose the financial impact of material acquisitions, divestments or other financial arrangements, preventing proper forecasts or comparisons with previous years. This has forced analysts to re-create accounts to determine the true financial effects on earnings and shareholders' funds.

Because few transactions now require prior shareholder approval, a fast-moving entrepreneur can leave the private shareholders unaware of what the company has done during a reporting period. The shareholders are hopelessly unable to make an informed decision on the investment merits of the company.

It is obviously time to follow the practice which governs, for example, all North American countries and require *quarterly reporting of profits and losses*. These reports should include revenue and profit details, a pro-forma balance sheet and a summary cashflow statement, and be accompanied by commentaries on trading conditions and analyses of significant transactions.

These details are provided as a matter of course to lenders, directors and management; it is inconsistent that owners are not given the same opportunity to analyse basic financial information. Instead, they have to guess at the nature and effects of transactions. All that is required is a succinct and relevant summary of the historical activities and immediate prospects of the company in question. Already, all resource companies are required to provide quarterly working-capital reports; the immediate extension of this requirement is imperative. The cost of preparing and publishing such information is irrelevant in the scale of things.

The content of *half-yearly reporting* must be improved. The current form of information does not adequately explain the source and quality of profits, material changes in expenses such as interest, capital expenditure or the disposal or acquisition of assets. A pro-forma balance sheet showing cash, indebtedness, current assets and liabilities should be provided in addition to a profit-and-loss statement with supporting notes on material matters.

The problem of inadequate financial reporting is not limited to public companies and their shareholders. The government, compared with those of other OECD countries, consistently fails to produce appropriate financial and economic statistics. As a result, we live in a half-light

TOO MUCH OF A GOOD THING?

Early in 1990 the Securities Institute made a submission to the inquiry into corporate practices and the rights of shareholders conducted by the Parliamentary Standing Committee on Legal and Constitutional Affairs.

The SIA submission was drafted by a Melbourne-based committee chaired by Mr Dick McCrossin, a councillor of the Institute. Mr McCrossin later in the year gave evidence at a Melbourne hearing of the inquiry.

While it acknowledged that there was some scope for tightening and better enforcement of existing legislation and listing rules, the submission cautioned against "over-regulation".

"There are already in place considerable laws, codes, statutes and legislation. . . it is in the area of enforcement, rather than the coverage of the laws themselves, that controls have been lacking," the submission noted.

Other points made in the SIA submission included:

- The practice of directors and executives of a listed public company being shareholders in a "management company" should be examined with a view to considering whether it should be prohibited. "Any form of separate management or services company cannot but cause an immediate conflict of interest and destroy the directors' objectivity and impartiality in relation to the shareholders they entrusted to serve."
- There will always be an element of *caveat emptor* in the securities industry. Whilst small shareholder apathy may be prevalent. . . knowledge of the industry will assist in militating against blatant management excesses which disadvantage shareholders.
- The industry must continue to develop self-regulation of its activities and participants through such means as the conduct of orderly markets, peer-group pressure, a proper code of conduct and professional practitioner education.

of misinformation perpetuated by journalists who are often forced to provide opinions in place of analyses of facts. And so it is with company reporting: the journalist and the shareholder, under current disclosure requirements, are frequently denied even the most basic financial statistics such as the enlarged issued share capital, the level of indebtedness and the full terms and conditions of material transactions. The journalist often resorts to tips from "reliable sources close to the company" to produce an opinion lacking in facts and therefore credibility. Without the timely and factual analysis of performance, the market will remain uninformed.

Cashflow reporting is an essential requirement. A statement of sources and applications of funds, as now required, does not provide an adequate basis for cashflow analysis, providing little information beyond a comparison of balance sheets.

Material transactions

Australian listing rules do not oblige companies to seek shareholder approval for major acquisitions. In a takeover where the offer comprises an issue of new shares, shareholders can see their stakes significantly diluted while being powerless to vote on whether the acquisition is in their best interests. In such cases, shareholders are not formally advised of a material acquisition until the publication of the annual report, where it may receive a passing comment in the chairman's address. It is ironic that the shareholders of the target company will receive more information about the offeror company in the offer document than the shareholders of the offeror.

Compare this with the UK, where all transactions involving publicly listed companies are classified according to the size of the deal and the relationship between the parties. Size is determined by comparing the listed company which is acquiring or disposing of assets with the size of the assets. The tests relate to assets, profits, the price of the purchase or sale and, where the consideration is funded by a share issue, the amount of new share capital.

If any of the comparisons value the asset to be acquired or sold at 15 per cent or more of the relative value of the listed company, then the transaction is Class 1. If the value is

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25 per cent or more, the transaction is Major Class 1. If it is more than 5 per cent but less than 15 per cent, the transaction is Class 2, and so on. Various classes of transactions require shareholder approval as well as the notification to shareholders of detailed information.

An increase by more than 10 per cent of the issued share capital of a listed company requires the publication of listing particulars, which provide a much more substantial disclosure of the financial situation of the issuing company than is the case in Australia.

The UK also requires specific information to be provided to shareholders in relation to the various classes of transactions. Details which must be sent in a circular to shareholders include:

- a statement from directors that, in their opinion, the company has sufficient working capital available to it, or, if not, details of how it is proposed to provide the additional working capital considered by the directors to be necessary;
- a litigation statement regarding any legal or arbitration proceeding pending or threatened against the group which may have a significant effect on the group's financial position;
- a summary of the principal contents of each material contract entered into by the company in the previous two years, including dates, parties, terms and conditions and the consideration;
- a statement of the aggregate value of the consideration for the transaction (including put and call obligations) and how it will be satisfied;
- a statement of any variation in the total payments to directors of the company;
- a statement of any significant change in the financial or trading position of the group since the latest date up to which results have been published; and
- an indebtedness statement given at a date no more than 28 days before the date of the circular.

Further, if the transaction is the acquisition of a company, combined statements should be made for the acquiring company and the target, including details of:

- directors' service contracts;
- consideration passing, the extent and nature of interests of directors, terms which are unusual in their nature or conditions significant to the business of the company; and
- the group's financial and trading prospects for at least the current financial year and, where a profit forecast appears, the principal assumptions with appropriate notes. This will usually include a pro-forma balance sheet showing the impact of the acquisition.

Another feature of UK documents is that they include a responsibility statement. As well as the company itself, the directors (and those who have agreed to become directors) and other persons authorising the contents of the document are required to take responsibility for the information. Such a responsibility statement certainly helps directors to "focus the mind" on the information being presented to the market, and gives them a high regard for the level of due diligence required.

The UK system also specifies that authorised share capital can be increased only to the extent necessary to satisfy a particular issue of new shares. Thus, a blanket approval for a $1 billion increase in authorised capital could not be put to shareholders for approval other than in connection with a specific transaction that would, in most cases, require authorisation by shareholders under the class test. No such control of authorised capital exists in Australia: here, the issue of new capital as consideration for a material acquisition is totally beyond the control of shareholders.

The UK transaction class test has

no equivalent in the Australian listing rules. Rule 3(s) does provide for shareholder approval on the disposal or acquisition of major assets. Rules also apply where an acquisition will change the control of a listed company. But the content of the circular to shareholders is not nearly so rigidly prescribed as in the UK. Thus, in Australia, substantial transactions can take place without the need for shareholder approval. This could not occur in the UK.

It is a contention of this paper that shareholders should have the opportunity to vote on material transactions. Giving shareholders the vote will force companies to quantify the financial impact of such deals. It will not reduce the ability of the company to undertake major or innovative deals; it will merely make shareholder approval necessary where the deals are of such a size as to potentially dissipate wealth. The Stock Exchange rules such as 3J(3) provide ample precedent for the form of shareholder mandate. The rules could easily be broadened to cover all material transactions, not just those involving associated parties.

This requirement will go some way to avoiding the problem of regulating transactions with associates, or of companies paying excessively for assets, causing significant earnings dilution or a reduction in the quality of the balance sheet. In the UK, if the directors cannot show the availability of adequate working capital for the company following an acquisition, it does not get to a vote.

Similarly, consideration could be given to the United States practice of giving shareholders the right to query any aspect of the company's activities and receive a considered, detailed response which is published in the annual proxy statement. It is curious that individuals have greater access to knowledge about the activities of government, through Freedom of Information legislation, than they have about companies of which they are nominally the owners. Commercial sensitivities and protection of valuable trade secrets could easily be accommodated as they are in freedom-of-information legislation.

The decade of the shareholder

The growth in international stockmarkets over the past 100 years has been driven by the growth in funds under management by institutional investors. In the UK in 1988, investments into pension funds, insurance companies and unit trusts were £26 billion, more than the entire GDP of New Zealand. In America the inflow was $US225 billion, in relative terms slightly more than the British figure. In Australia, it is expected that the national flow of funds into superannuation over the next 10 years will be between $A250 and $A500 billion, over the existing base of about $A100 billion. Something approaching half of institutional inflows are put into equities.

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The institutional holdings are growing with staggering speed. Today, America's public pension funds account for one quarter of all institutional holdings in America and for 10 per cent of the value of all publicly quoted shares. Few institutions however, have thought of themselves as owners. As previously mentioned, *The Economist* recently described them as the "punter-capitalists". They face the dilemma of being unable to influence companies in the long term and are limited to attending annual meetings and voting on resolutions put before them.

Luckily for the institutional shareholder in Australia today, the scene is changing rapidly. Following the total failure of disclosure enforcement in the Australian market, the institutional fund manager is now demanding—and, in my view, will get—a new level of responsiveness from the board and management of the companies in which he invests. Backed by the inevitable new wave of relevant disclosure requirements and shareholder controls, he will invest in opportunities where the "proprietor-capitalist" is granted full recognition.

Warren Buffett, the chairman of Berkshire Hathaway, an Omaha, Nebraska, company that has enjoyed a 23 per cent compound rate of growth over the last 15 years, epitomises such an investment approach. His investment criteria demand "a diversified group of businesses that generate cash and consistently earn above-average returns on capital... reflecting an opinion about the long-term business prospects". One of Buffett's principles: "When we own shares in outstanding businesses with outstanding management, our favourite holding period is forever."

The corollary of the Buffett philosophy is that the lengths to which the institutional shareholder will go to protect his investment and improve its value have increased considerably. It is obvious that the major institutional investors in this country, like their counterparts in the US and the UK, will increasingly behave like real owners rather than passive investors.

They will demand a series of new checks and balances to ensure their involvement in the companies they own and invest in. These will no doubt include, in addition to the changes already mentioned:

- regulating terms of office for directors and auditors;
- a majority of non-executive directors on boards;
- control over any increase in authorised capital without a specific purpose;
- the distribution of a considerable proportion of cash generated in any one year to avoid it being dissipated by management; and
- the requirement that acquisitions or other significant capital expenditure be put to the vote of fully informed shareholders.

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CORPORATE CONDUCT

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ector must take all reasonable steps to ensure that no only do his or her actions comply with the letter of the statute law but also that they are in full compliance with his/her general fiduciary duties. At all times, in their observance of the law and their duties, directors should remember that there is, above all, a standard if ethical behaviour by which all their actions should be judged.

"If there is the slightest doubt as to whether a director, in engaging in a particular activity, is complying with any aspect of his or her fiduciary duties, then he/she should take competent and independent advice and be prepared to rely upon that advice."

The launch on December 10 of the Corporate Practices and Conduct Paper coincided with the first of two conferences on the subject, held in Sydney and Melbourne, sponsored by the member organisations of the working group.

The organisers of the conferences said in an overview of their purpose: "The reputation of Australian business has been impaired by the behaviour of a small number of people during the 1980s boom. It is imperative that we clean up our corporate image.

"Legislative responses are required but the whole matter cannot and should not be left to government. It is important that Australian business is seen to be taking positive action. Standards of business practice and conduct need urgent revision. Unless this is done voluntarily, extensive legislation can be expected with attendant costly compliance requirements."

The conference, chaired by Mr Bosch, expanded on the material canvassed in the Corporate Practices and Conduct Paper and also covered the importance of ASX listing rules, the independence of auditors and their role as company watchdogs, and further issues for financial institutions.

The guest speaker, on the subject of the role of Federal Parliament in company reform, was Senator Barney Cooney, chairman of the Senate committee which reported on company directors' duties. □

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The impact on the Stock Exchange will be considerable. If it wishes to retain control of the regulatory environment for listed public companies, it will need to rewrite the listing rules. The patchwork approach to changes over the past few years has created a confusing and unworkable set of guidelines for companies. Often, meaningless pieces of paper emerge from companies providing one-line or single-paragraph answers to listing requirements; these may be unintelligible to ordinary shareholders, who in any case must rely on the press for this information.

Many company announcements are not published; others may be distorted by journalists to improve their readability and impact, but often at the cost of information to shareholders.

Consider the requirement to set out the terms for an issue of new shares. Details of a placement will often not be circulated to shareholders. Details of a rights issue could be sent to shareholders accompanied by meaningless statements, attributed to the chief executive, that a fund-raising is essential "to reduce debt" or for "general corporate purposes". Such an explanation in the event of an opportunistic capital-raising is inadequate.

Conclusion

The Stock Exchange must take a proactive role in encouraging a new attitude to disclosure, in regard to both its materiality and timeliness, if we are to ensure that the rights of shareholders are met and that they are recognised as proprietors and not merely "punter-capitalists". Shareholders are entitled to wider powers in respect of material transactions.

Rules governing disclosure by issuers of listed securities will help private and institutional investors to take decisions or seek advice. Further, advisers to companies will be able to rely on the rules for a degree of certainty about what is expected from their clients when planning issues and corporate developments.

The Stock Exchange must seek to maintain the quality of financial information on which investors make their assessment of the value of securities.

To do that job effectively, it must move immediately to adopt international disclosure standards. □