
2 The role and evolution of the public company

Key points

- The public company model evolved to meet the challenge of accumulating the capital required to operate large-scale and complex production processes.
 - By separating investors' ownership from specialised managerial control, the public company structure facilitated access to large amounts of pooled capital.
 - This separation, however, gave rise to the potential for divergence of interests between owners and managers, known as the 'principal-agent problem'.
 - Executive remuneration is one area where the divergence between the interests of managers and owners has the potential to become especially acute.
- Various governance and regulatory arrangements have emerged to promote alignment of the interests of managers with those of investors/owners.
 - The primary alignment mechanism, which remains central today, is shareholders electing boards to oversee companies and represent their interests.
 - Regulatory frameworks emerged to underpin and reinforce the effective functioning of boards and these frameworks continue to evolve.
- Ultimately, a convergence of company, shareholder and community interests is achieved when companies maximise profits on shareholders' behalf, while taking into account any costs their activities might impose on the wider community.
- Public companies are an integral part of the Australian economy.
 - Australia's 2000 or so listed companies are responsible for more than \$1 trillion in shareholder and investment wealth.
 - Just over 40 per cent of Australians participated in the sharemarket in 2008, apart from the more extensive share ownership via superannuation funds.

2.1 Evolution of the public company

Fundamental to analysing executive remuneration is an understanding of why public companies exist and the respective roles of management, boards, and shareholders. The joint stock company model has existed since the 17th century, but

public companies as they are known today came to the fore after the industrial revolution. The ‘mass shareholding’ public company harnessed the incentives inherent in market economies in order to address a broad societal problem: how to accumulate the vast amounts of capital required to operate coordinated, large-scale and complex production processes. However, the resulting separation of ownership (the principals) from control (their agents) created other problems.

Separation of ownership and control

Modern companies evolved because the predominant pre-industrial revolution model of sole proprietors and/or partnerships providing the equity for, and running, businesses was ill-equipped to meet the challenges of more complex operations. Examples of such operations include obtaining economies of scale, specialisation in many areas (including management skills) and raising large amounts of capital.

Centralised and integrated company structures are more efficient because the transaction costs of conducting business, settling disputes, dealing with unforeseeable contingencies and enforcing contracts can be ‘internalised’ and thus reduced (box 2.1).

The Business Council of Australia (BCA) summarised these advantages thus:

The listed company provides an effective mechanism to aggregate large amounts of capital for investment, to efficiently allocate and manage risk, accumulate expertise and knowledge and minimise the costs of doing business. (sub. 101, p. 7)

For a public company to amass equity capital effectively, two attributes are required. These are the capacity for investors to:

- delegate the management of day-to-day company affairs
- provide equity under conditions of limited liability — that is, to be able to confine their losses to their equity stake only.

The concept of limited liability

The modern business model was founded on the separation of ownership and control through pooled capital based on the principle of limited liability. As CGI Glass Lewis and Guerdon Associates submitted:

The oil that lubricated the resulting and necessary separation of the ownership (by the scattered providers of the equity capital needed to fund) and conduct (by management and workers) of these businesses was the principle of limited liability. That limited the

liability of the owners to the amount of the capital they had agreed to contribute to the business ...

Partly in return for this limited liability of their risk but also because they did not, as owners of the capital, manage or work in the business and, therefore, had neither the expertise nor the requisite intimate knowledge of the business to make competent business decisions, those owners had no authority or power under the constitution of the business to make such business decisions. (sub. 80, p. 11)

Limiting shareholders' financial liability — typically through reduced dividends if company profit is impacted or, in the case of insolvency, the value of capital invested — has been central to encouraging the accumulation of capital.

Box 2.1 Benefits of the company structure

The theory of the firm in the academic literature, which starts with Coase (1937), posits that centrally coordinated and vertically-integrated structures facilitate production at lower cost than decentralised markets where different links in the production chain are performed by atomistic units. Internalising factors of production (such as people and capital) within a firm can result in higher productivity than attempts to coordinate decentralised production of inputs. This is because the transaction costs from settling disputes, dealing with unforeseeable contingencies and enforcing contracts can be reduced — an efficiency gain that can underpin expanded activity or trade.

Other economists have explored the source of the productivity advantage of companies over other organisational forms. Williamson (1985) considered that companies better handle the need for investments in human and physical capital and reduce protracted opportunistic behaviour and disputes about the distribution of the profit residual. This, in turn, promotes more efficient investment and better use of assets.

Internalising production processes within a firm does not eliminate transaction costs. For example, there are the costs of monitoring and encouraging productive effort by employees. As these costs rise, the advantage of the firm as an organisation diminishes, setting efficient limits to company size. But transaction costs are not immutable — for example, technological developments in communications have probably facilitated larger efficient firm size (and probably reduced the cost of decentralised supply as well).

Limited liability and the 'social contract'

There is a view that the legal framework underlying the company structure invokes a reciprocal social obligation from companies.

For example, Hamilton and Tozer state:

... corporations are granted rights as legal persons (citizens) under empowering legislation enacted by society's political representatives with the expectation of economic returns to investors, other businesses and society — provided the entities operate within the legal and moral boundaries applying to all 'citizens'. (2007, p. 2)

Consistent with this view, there is full liability on *companies* which, as legal entities, can be sued. Companies must also conform with numerous laws to protect public values, including environmental protection, occupational health and safety, workplace relations, consumer protection and human rights. Furthermore, the positional liability of company directors exposes these individuals to legal sanction — the Australian Institute of Company Directors noted that there are around '650 state laws making [directors] liable' (trans., p. 207).

Apart from legal obligations, many companies are electing to integrate broader social agenda (such as ethical standards and charitable work) into their charters. The St. James Ethics Centre has compiled a Corporate Responsibility Index for Australian companies since 2004, which assesses practices such as performance in social and environmental areas and the management of community and workplace issues (Corporate Responsibility Index 2009). Companies including ANZ, Boral, Foster's Group, and Suncorp-Metway have participated voluntarily.

Limited liability does, of course, protect shareholders from punitive damages or the extended reach of creditors. But, as shareholders are divorced from company decision-making, this should be uncontentious. If shareholders' assets beyond their equity stake (for example, their homes) were at risk, they would wish to take a more active interest in 'corporate behaviour'. However, this would compromise the capacity of companies to accumulate capital for productive purposes, which would leave society worse off.

In the absence of limited liability being 'conferred', a market solution could evolve through companies entering into a multiplicity of contractual relationships with individuals. Although this would facilitate access to equity, it would be unwieldy and involve substantially higher transaction costs than the shareholding model.

Reconciling the interests of managers and owners

With the separation of ownership of a business from its management, there is potential for managers (the agents) to act in ways that would not necessarily be in the best interests of investors (the principals). This is commonly referred to as the 'principal-agent problem'. For example, managers might have incentives to obtain perks, invest inappropriately, or exert lower levels of effort than they would if their

actions were consistent with the interests of investors (and consequently deliver suboptimal performance). However, one area of the principal–agent relationship where the divergence between managers’ and owners’ interests has the potential to become particularly acute is remuneration. Executives will naturally take a keen interest in their remuneration and the most senior executives will potentially have scope to exert influence over decisions. This highlights the importance of establishing independent processes for remuneration-setting, as well as appropriate monitoring and incentive mechanisms.

Attempts to overcome the principal–agent problem have led to the evolution of various mechanisms to align interests. The primary means of achieving alignment is through investors electing representatives (directors on a board) to oversee the business — including hiring and firing the CEO and ratifying the appointment and removal of company executives. If dissatisfied with the performance of directors, investors can replace them. This fundamental approach to aligning interests dates back to the first joint stock companies and remains an essential feature of the modern business corporation.

Principal–agent issues feature in the literature in ‘agency theory’ and ‘managerial power theory’:

- Agency theory starts from a presumption that the separation of managerial control from ownership means that the interests of the former may not necessarily be perfectly aligned with those of the latter. Hence, incentives and controls may be required in order to induce managers to act in the best interests of the company and its shareholders, and thus achieve a greater alignment of interests.
- The managerial power theory also recognises the potential agency problem between owners and managers of a firm, but contends that managers can often exert undue influence over the board of directors.

Implicit in both approaches, which are not mutually exclusive, is the role of shareholders as the effective ‘owners’ of the company. Notwithstanding the ‘nexus of contracts’ view (box 2.2), it is generally accepted that in practice the shareholder body — en masse and over time — ‘owns’ the company in the sense that they have a claim over the profit residual.

For boards to effectively form this bridge between owners and the company, it is important that directors:

- have sufficient information to enable them to monitor executives’ performance
- are able to devise incentive structures that can influence executives’ behaviour

-
- are sufficiently at ‘arm’s length’ from executives or have processes in place to overcome conflicts of interest
 - provide sufficient information to enable owners to understand and scrutinise how executive remuneration aligns with their interests
 - are subject to sanction through arrangements that enable owners to signal their satisfaction or otherwise with board performance, and ultimately to replace poorly performing directors.

Box 2.2 What do shareholders ‘own’?

Some economists suggest that the notion of a company’s shareholders as its ‘owners’ is either irrelevant or little more than a helpful metaphor. Fama argues:

... ownership of capital should not be confused with ownership of the firm. Each factor in a firm is owned by somebody. The firm is just the set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among inputs. In this ‘nexus of contracts’ perspective, ownership of the firm is an irrelevant concept. Dispelling the tenacious notion that a firm is owned by its security holders is important because it is a first step toward understanding that control over a firm’s decisions is not necessarily the province of security holders. (1980, p. 290)

Lipton and Savitt make a similar case:

Shareholders do not ‘own’ corporations. They own securities — shares of stock — which entitle them to very limited electoral rights and the right to share in the financial returns produced by the corporation’s business operations. Conceiving of public shareholders as ‘owners’ may in some instances be a helpful metaphor, but it is never an accurate description of their rights under corporate law. Shareholders possess none of the incidents of ownership of a corporation — neither the right of possession, nor the right of control, nor the right of exclusion — and thus have no more claim to intrinsic ownership and control of the corporation’s assets than do other stakeholders. (2007, p. 754)

However, others take the contrary view, such as Langois:

The shareholders ‘own’ the corporation because they have the final say: managers cannot change the nature or strategy of the corporation in a radical way without the consent of stockholders ... (2002, p. 31)

Hart argues:

A public corporation can still be usefully considered a collection of assets, with ownership providing control rights over these assets ... Although owners (shareholders) typically retain some control rights, such as the right to replace the board of directors, in practice they delegate many others to management, at least on a day-to-day basis. (1989, p. 1773)

The fact that shareholders possess certain crucial control rights, such as the right to replace directors, while delegating management of the company to senior executives (giving rise to the classic principal–agent relationship), reinforces the notion that collectively, over time, shareholders ‘own’ the company.

The importance of these points is further recognised in corporate governance frameworks that, among other things, confer voting rights to shareholders over matters of board representation and remuneration reports — though Australia progressed earlier and further down this path than the United States (section 2.4).

Ultimately, a convergence of company, shareholder and also wider community interests is achieved through maximising the net present value of a company's future profit streams (subject to any external social costs being taken into account). Maximising the net present value of a company's future profit streams is in the interests of shareholders (who are a subset of the wider community), as it allows them to realise capital gains on the shares they hold and enjoy higher wealth. Hence, while the *Corporations Act 2001* (Cwlth) specifies that directors have a fiduciary duty to act in the best interests of the company, ultimately, this is consistent with shareholders' interests. However, reflecting the heterogeneity of shareholders, there are issues about the appropriate time path for achieving this. Some shareholders will prefer higher profits in the short term, whereas others will want profit maximisation to be pursued over longer time frames. An additional consideration, where institutional investors are present, is the extent to which their interests are aligned with those of the individuals on whose behalves they invest — particularly given Australia's compulsory superannuation arrangements.

While the notion of a relatively stable shareholder group may have been apposite many years ago, this is no longer the case. For example, according to Macquarie Group director and Origin Energy chair Kevin McCann:

Macquarie Group has had 225 per cent of its share register turn over in the past 12 months and Origin had a 92 per cent turnover. (cited in Durkin 2009)

Rapid turnover of shareholdings obviously has implications for how companies engage with shareholders and underscores the importance of measures that can align company management with increasingly diffuse and changeable shareholder interests. All of this serves to reinforce the concept of shareholders as company owners only in a collective (average) sense and over time.

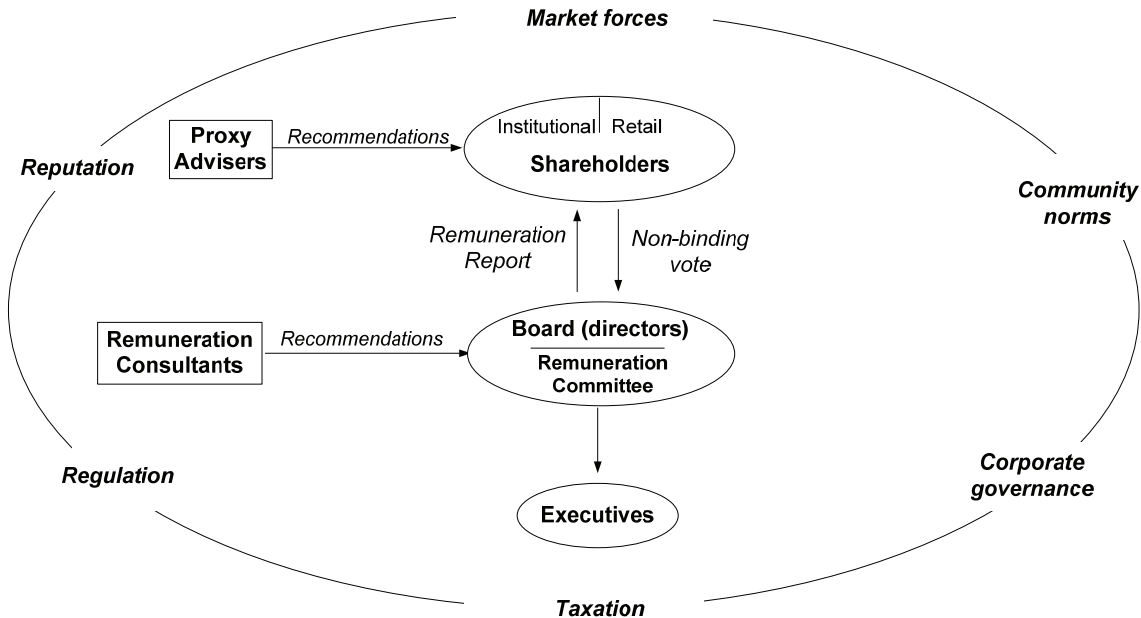
2.2 Aligning interests — the pivotal role of boards

As noted, the key formal mechanism for aligning ownership and control within a public company is the board of directors. Other influences also support this alignment (figure 2.1). For example, many executives will naturally take personal pride in doing a good job for the company and its shareholders. In addition, competition in the markets for a company's products imposes a discipline on managers by making poor performance apparent in the relative performance of the

company. Lack of attention to costs, innovation, or marketing put a company at a disadvantage relative to rivals and reduce market share and profits. Moreover, poor performance by managers can damage their reputation and reduce their scope for promotion or alternative employment. It may also lead shareholders to sell their stock, causing the share price to fall and exposing the company to takeover or merger threats, thereby threatening the executive’s position.

Nevertheless, sound oversight of management and the corporate governance framework that facilitates the relationship between boards and shareholders are central to achieving alignment in a systematic way. Ideally, boards act in the best interests of the company (as representatives of shareholders) and diligently and effectively monitor the actions of executives (as well as enacting mechanisms that achieve this objective). The board’s ability to discharge these responsibilities is complicated by the fact that it cannot directly observe every action undertaken by an executive, or the level of effort they exert in their role on a day-to-day basis. Assessing the effectiveness of the various relationships within companies requires consideration of the roles of the key parties in this process: boards, chief executives and senior executives, and shareholders, and ultimately, those who advise them.

Figure 2.1 Aligning interests: shareholders, board and management



The role of boards

As noted, the Corporations Act specifies that directors have a fiduciary duty to act in the best interests of the company. The Act further stipulates some of the primary responsibilities of directors — that directors should not improperly use their position to gain an advantage for themselves or someone else, or improperly use their position to cause detriment to the company.

Boards set goals, authorise major decisions, finalise budgets and deal with legal, regulatory and compliance matters. Essentially, boards oversee and advise, but do not manage, companies. As noted by the Corporations and Markets Advisory Committee:

The role of a board of directors is to direct a company on behalf of the shareholders. This includes setting the strategic direction and aims of the company, providing resources for their implementation, directing or overseeing the management of the company's business and compliance with its obligations. (CAMAC 2009, p. 12)

Some of the specific responsibilities of the board of directors, as noted by the Australian Securities Exchange (ASX) Corporate Governance Council, include:

- appointing and removing CEOs, and, where appropriate, ratifying the appointment and removal of senior executives
- reviewing, ratifying and monitoring systems of risk management and internal control, codes of conduct, and legal compliance
- providing input into, and final approval of, management's corporate strategy and performance objectives
- monitoring the performance of senior executives
- approving and monitoring the progress of major capital expenditure
- approving and monitoring financial and other reporting (2007a, p. 13).

While executive pay may not appear to loom large relative to many of the other board roles listed above, one of the most important roles is the selection of a CEO and oversight of his or her performance. This is directly related to remuneration — both its level and structure.

The role of the chief executive officer

Understanding why a CEO might be paid more than, or on a different basis to directors, other executives, or indeed, public office holders (box 2.3), requires consideration of what CEOs do and how much influence they can have on a company's performance and shareholder returns.

As the leader of the management team, the CEO has crucial responsibilities that require a range of high-level skills. As noted by Mercer:

... as leader, the CEO directly influences business decisions, resource allocation and operational practices that determine financial outcomes for the firm ... [and is] responsible for maintaining the confidence of shareholders and the investment community in the strategic direction and operational capacity of the company while also serving the internal role of maintaining effective relationships between the board and management. (sub. 41, p. 5)

Box 2.3 Are heads of companies ‘worth’ more than heads of governments?

Jonah Versteegan contended that CEOs should be on fixed pay because this is good enough for ‘the Governor General, the Prime Minister, the Chief Justice and all politicians and members of the Judiciary’ (sub. 12, p. 1).

The Remuneration Tribunal, the independent statutory body which advises on remuneration for Commonwealth officials, made observations of a similar nature:

... based on a consideration of similarities in roles and responsibilities at the most senior levels of each [private and public] sector, there is an argument that the remuneration of public offices should be accorded some weight in setting appropriate remuneration for senior private sector positions. (sub. 102, p. 1)

The Tribunal acknowledged:

... the position of [Departmental] Secretary (does) not have comparable accountability to that of a Chief Executive ... where those executives have traditionally been accountable for creating shareholder value with a primary focus on developing and implementing strategies to achieve growth in revenue, assets and profitability, with an increasing international footprint ... (sub. 102, p. 5)

Large public companies are complex, have multiple activities and can span continents. CEOs of major companies have considerable discretion in decision-making and operate in an environment where small differences in their capabilities can have large ramifications for companies and shareholders. Therefore, they can be crucial in determining the success or otherwise of a company. The implication is that, for major companies at least, the CEO position is as much about the calibre and qualities of the individual as the ‘job task list’.

The BCA attested to the CEO’s influence:

The defining characteristic of the CEO position is that the scope and size of the role and its accountabilities require significant personal latitude, judgment and responsibility. The complex mix of skills required to succeed as a public company CEO are often poorly understood in the public domain despite the presence of ample evidence pointing to the very public and often stark divergence in the performance of corporations during the tenure of different CEOs. (sub. 101, p. 8)

Given the dominance of the CEO in shaping the performance of a company over time, it is clearly important that CEOs are given appropriate incentives to act in the company's best interests. As noted previously, there are some inherent forces for alignment. Nevertheless, there is unlikely to be *perfect* alignment between CEO and company interests, and any differences could be significant in terms of outcomes — explaining the increasing movement towards providing more incentive-based pay (see chapters 3, 4 and 7).

The role of shareholders

According to an ASX study, a substantial proportion of Australians now participate in the sharemarket (table 2.1). The ASX reported that:

... 6.7 million people, or 41 per cent of the adult Australian population, own shares. This is down from 46 per cent two years previously and, undoubtedly, reflects investors' responses to current volatile market conditions after long periods of strong market performance. (2009c, p. 2)

The ASX also noted that:

... participation was either direct (via shares or other listed investments) or indirect (via unlisted managed funds). The level of direct participation was 36 per cent, or approximately six million people. (2009c, p. 3)

The ASX study covers direct investment (predominantly shares but also including other investments such as real estate investment trusts, options, and infrastructure funds) and indirect investment through unlisted managed funds. But it excludes the additional and widespread arm's length involvement of the workforce through compulsory superannuation contributions.

Table 2.1 **Australians 'actively' investing in shares**

	<i>Units</i>	<i>1997</i>	<i>2000</i>	<i>2002</i>	<i>2004</i>	<i>2006</i>	<i>2008</i>
Direct only ^a	'000	1 645	3 133	2 268	3 358	3 471	4 096
Direct and indirect	'000	1 177	2 563	2 774	3 066	2 524	1 802
Indirect only	'000	1 861	1 709	1 898	1 606	1 262	820
Total	'000	4 703	7 405	7 300	8 030	7 257	6 718
Population 18+	m					15.8	16.4

^a Direct investment relates to shares or other listed investments and, from 2008, self-managed superannuation funds. Indirect investment relates to unlisted managed funds. Excludes investments held in superannuation funds (other than self-managed funds).

Source: ASX (2009c, p. 7).

Earlier ASX studies indicate that in the late 1980s, fewer than 10 per cent of Australians were share owners. Part of the expansion, at least since the early 1990s, is attributable to a series of major privatisations and demutualisations. More recently, the number of Australians investing in shares has grown by two million since 1997 (table 2.1), with shareholders now representing nearly one-half of the Australian community over 18 years of age.

The primary motivation for individuals to own shares was analysed by the ASX in a survey conducted in 2008. The responses were categorised as follows:

- to make money — 33 per cent
- long-term capital gain — 27 per cent
- saving for retirement — 15 per cent
- for diversification — 12 per cent
- gifted, or from work — 8 per cent
- liquidity — 5 per cent.

Only five per cent of the investors surveyed considered themselves to be ‘very knowledgeable’ about shares. Forty-six per cent of shareowners considered themselves to be either not very, or not at all, knowledgeable (ASX 2009c, p. 27). This would suggest that most individual Australian shareholders have considerable confidence in the institutions of the sharemarket, with 78 per cent of respondents indicating a belief that the Australian sharemarket is ‘well regulated’.

The growing importance of institutional investors

It is important to note the distinction between ‘retail’ and ‘institutional’ investors. The former consist of individuals who buy and sell securities in the course of maintaining personal investment portfolios. Institutional investors, however, are specialised financial institutions that manage the collective savings of a number of small investors, with the aim of achieving particular risk, return and maturity objectives.

As noted by Davis and Steil (2001), institutional investors possess certain characteristics that are advantageous when trading securities. For example, they can provide a mechanism for risk pooling for small investors (by holding a large spread of domestic and foreign investments), thus allowing a better tradeoff between risk and return than individual investors alone might be able to achieve. Institutional investors also have a superior ability to acquire and process information than retail investors, and by trading large quantities of assets such as shares and bonds, may be

able to attain economies of scale, which can result in lower average costs for investors. Perhaps most importantly, the growing significance of institutional investors (across the world) should lead to deeper and better functioning financial markets, contributing to a more efficient allocation of household savings (CGFS 2007).

Institutional investors have a fiduciary duty to act in the best interests of their member investors. However, fund managers may not have incentives that completely align their interests with those of their members, giving rise to the need for monitoring and fees contingent on performance. One retail investor observed:

The problem is one of pure agency. Large superannuation and pension funds are simply not put under pressure by their members to act in their interests (many of whom are unaware of who they are ultimately investing in) and accordingly, fail to pursue members interests ... (David Beattie, sub. DD155, p. 1)

Examples of organisations classified as institutional investors include superannuation (pension) funds, life insurance companies, and investment companies, such as mutual funds. Superannuation funds collect and invest contributions made by workers and employers to provide post-retirement cash disbursements to workers. Life insurance companies collect premiums from selling life insurance contracts and annuities, which may be invested in order to meet the long-term contractual liabilities they incur. Investment companies typically pool assets for investment purposes, and often differ from other institutional investors in that liabilities, such as retirement income needs, are usually not a direct operational concern after investments are made (CGFS 2007, p. 4).

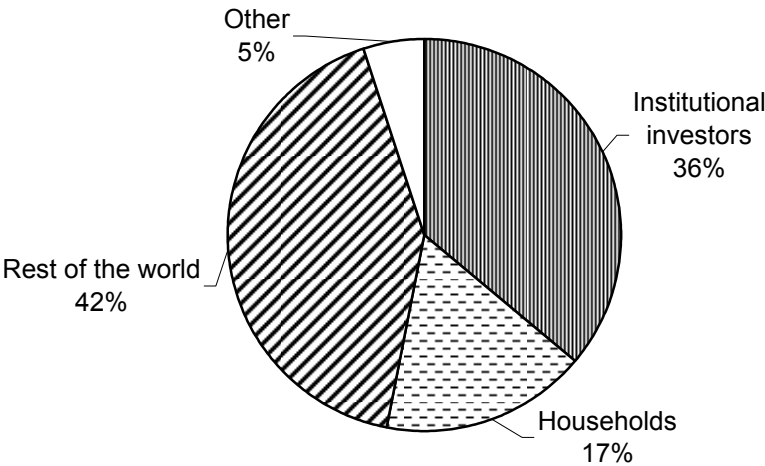
The combination of Australia's compulsory superannuation system and the use of equities as an investment tool by superannuation funds (see below) means that the number of Australians who have an interest in the performance of the sharemarket comprises a significant proportion of the population. The ABS (2009e) estimates that, in 2007, approximately 11.6 million Australians had superannuation coverage, of the 16.4 million persons in the population aged 15 and over. Furthermore, this significance has increased over time, given the growth in the share of the population with superannuation coverage. For example, the ABS estimates that, in 1974, 28 per cent of persons aged 15 and over had superannuation coverage, rising to 66 per cent by 1993, and to 71 per cent by 2007 (ABS 2009d).

Australian institutional investors hold a significant proportion of total listed shares and other equity in Australia (figure 2.2), accounting for over a third of the total on issue in June 2009 (around \$390 billion worth). By contrast, households held approximately \$189 billion of listed shares and other equity, or around 17 per cent of the total value. Foreign investors purchasing equity listed on the ASX also hold

substantial amounts — \$452 billion worth, equivalent to roughly 42 per cent of the total value issued (ABS 2009b). This amount is likely to reflect, in large part, the holdings of Australian equity by overseas institutional investors. Foreign retail investors are unlikely to rely heavily on a strategy of purchasing securities issued in several different countries to diversify their portfolios, due to the informational and transaction costs they would face in doing so.

The data cited above relate only to holdings of equity listed on the ASX. Institutional investors (including superannuation funds) diversify their portfolios through purchases of equity in companies listed on foreign securities exchange markets, so that the total value of all securities held by institutional investors is greater than the value of Australian-issued securities alone.

Figure 2.2 Ownership of listed shares and other equity in Australia^{a, b}
Total proportion, June 2009



^a 'Institutional investors' includes: superannuation funds, life insurance corporations and financial intermediaries (not elsewhere classified). ^b 'Other' includes private non-financial corporations, banks, other insurance corporations, national general government, and state and local general government.

Source: ABS (2009b).

Data also indicate that equity comprises a significant share of the total assets held by Australian superannuation funds. In the June quarter 2009, for example, superannuation funds held around 30 per cent of their total assets in the form of Australian trading corporation and financial sector shares (this proportion is higher if investments held in the form of units in trusts are included, which share some of the characteristics of equity but are not strictly classified as equity). Furthermore, superannuation funds held approximately 16 per cent of their assets overseas (ABS 2009f), part of which is in the form of equity listed on foreign securities exchange markets.

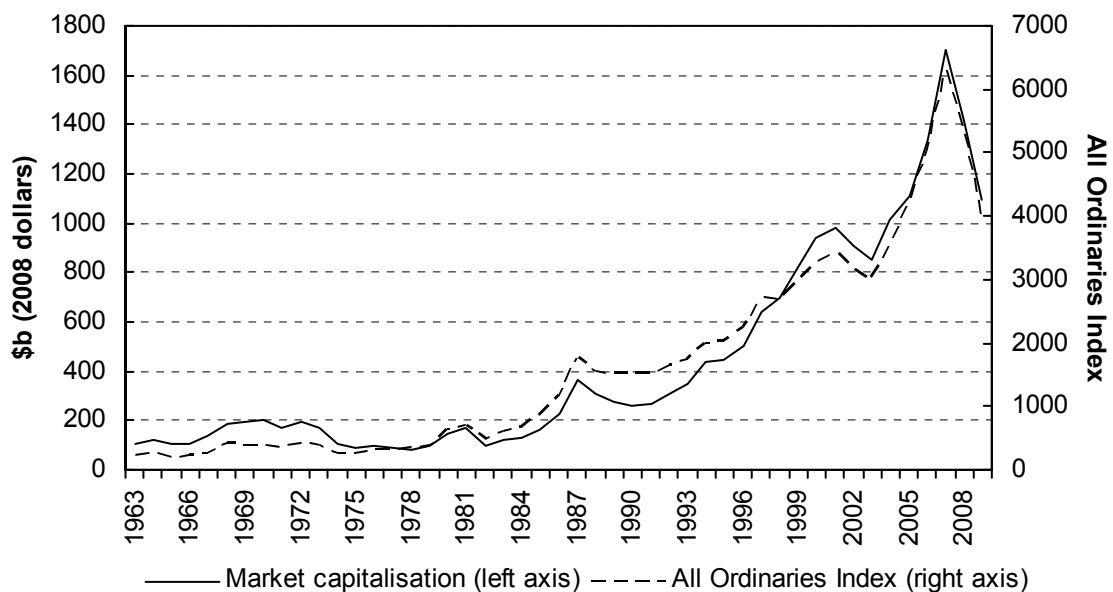
The high proportion of the population with funds invested in superannuation, the significant quantity of funds owned by institutional investors, and the significant weight given to shares in the portfolios of such investors, all demonstrate the importance that the performance of listed companies has for the wealth of individuals. Even if a person does not individually own shares, their superannuation fund will likely hold some shares in an investment portfolio managed on their behalf, and most individuals are therefore — either directly or indirectly — owners of shares.

2.3 The contribution of Australia’s public companies

The public company has proven an effective organisational form and an important means of producing goods and services and providing employment, generating significant wealth in Australia.

The market capitalisation of Australia’s listed companies was at low levels in the 1960s and 1970s, but rose sharply from the 1980s into the 2000s, reaching a peak of around \$1.7 trillion (in real terms) by the end of June 2007, before the global financial crisis took its toll (figure 2.3). The All Ordinaries Index follows a similar path to market capitalisation over time.

Figure 2.3 **Historical stock market data**
Market capitalisation^a and the All Ordinaries Index, 1963 to 2009^b



^a Expressed in 2008 dollars, deflated by the GDP implicit price deflator. ^b End of June values.

Sources: ABS (*GDP Implicit Price Deflator*, Cat. no. 5206.0); ASX (2009b); Economagic (nd); RBA (1997); Yahoo! Finance (2009a).

Despite the effect of the global financial crisis, Australia's nearly 2000 listed companies were responsible for over \$1 trillion in shareholder and investment wealth (as measured by market capitalisation) at the end of June 2009. This is a significant increase on the corresponding value at the end of June 1963, which was approximately \$100 billion (in real terms). More recently, the number of entities listed on the ASX has risen by approximately 47 per cent since 2002 (table 2.2).

Table 2.2 ASX listed companies^a, 2002–09

	2002	2003	2004	2005	2006	2007	2008	2009
Number of listed companies	1 351	1 360	1 459	1 570	1 758	1 892	2 008	1 980

^a Year ended 30 June.

Source: ASX (2009e).

There has been relatively little research into the contribution of companies to the Australian economy. One study published by the Department of Foreign Affairs and Trade in 2002 examined the contribution made by the top 100 domestic and foreign businesses in Australia (box 2.4) (drawn from the Business Review Weekly's listing of the largest enterprises based on worldwide revenue, and using ABS data). It reported that, in 1999-2000, these companies accounted for around 20 per cent of the nation's total revenue, 11 per cent of the nation's employment, 35 per cent of Australia's merchandise exports, 48 per cent of Australia's export of non-travel services and 90 per cent of the total stock of Australian foreign direct investment abroad.

A BCA study of 71 of its members (all large corporations), indicated a contribution of similarly large magnitude (BCA 2004a, 2004b). The BCA reported that in 2001-02 its member companies:

- returned \$18.4 billion in dividends to shareholders (of those that were publicly listed in Australia)
- employed more than 900 000 Australians
- exported goods/services of \$47 billion
- paid a third of all corporate taxes, collected a third of all Government GST receipts and paid a further \$13 billion in other taxes, royalties and duties
- expended \$16 billion in new business investment.

Although the Department of Foreign Affairs and Trade study and BCA survey encompass only the upper echelon of Australia's nearly 2000 listed companies, it is apparent that the fortunes of Australian companies and overall community

wellbeing are inextricably linked. Further insights come from ABS data. In total, across a wide range of industries, large businesses (defined as those that employ 200 or more persons) accounted for substantial shares of employment (27 per cent), wages and salaries (39 per cent), and industry value added (39 per cent) in 2007-08 (ABS 2009a), though they obviously include a wider range of businesses than publicly listed companies.

Box 2.4 Australia's top 100 enterprises — findings for 1999-2000

The top 100

The top 100 domestic and foreign businesses accounted for:

- 20 per cent of the nation's total business revenue and 11 per cent of the total workforce
- 70 per cent of the total capitalisation of the ASX
- 35 per cent of Australia's merchandise exports and 48 per cent of Australia's export of non-travel services
- 90 per cent of the total stock of Australian foreign direct investment abroad.

As a group, the top 100 derived almost a quarter of their revenues offshore.

The 26 companies in the top 100 that have a top 100 asset *and* employment ranking

These 26 companies accounted for:

- nearly 60 per cent of domestically-generated and worldwide revenues of the top 100
- around 60 per cent of the capitalisation of the ASX
- over 80 per cent of the total stock of Australian foreign direct investment abroad
- nearly 90 per cent of the revenue derived from offshore operations by all the top 100.

On average, these 26 companies derived 35 per cent of their revenues offshore.

The 31 majority foreign-owned companies in the top 100

These 31 companies accounted for:

- around 37 per cent of the revenues of all foreign-controlled companies and around 22 per cent of the revenues of the top 100
- 6 per cent of the nation's revenue
- approximately 20 per cent of Australia's merchandise exports
- more than a quarter of the stock of foreign direct investment in Australia.

Source: DFAT (2002).

2.4 The evolution of the regulatory framework

As noted, Australia's system of corporate governance is based on a combination of 'black letter' and 'soft' law, as well as a number of non-regulatory guidelines. This regulatory and corporate governance framework sets the parameters within which company boards determine director and executive remuneration (discussed in more detail in chapter 5).

It is important that regulatory and governance arrangements address the two potential sources of agency problems — between managers and shareholders on the one hand, and between managers and boards on the other. Ensuring that these problems are addressed has involved regulatory initiatives. Modifications to corporate governance arrangements have arisen from time to time to improve the alignment of interests.

The evolution of Australia's corporate governance framework can be gleaned from the following milestones, a number of which have acted to increase the 'say' of shareholders:

- 1998: Detailed pay disclosure required for individual company executives (box 2.5).
- 2003: The ASX Corporate Governance Council 'Principles and Recommendations' released — with compliance on an 'if not, why not' basis.
- 2004: The non-binding shareholder vote on companies' remuneration reports was introduced.
- 2005: Amendment to the ASX listing rule to remove the need for shareholder approval for granting equity to directors that is purchased on market.
- 2009: Legislation introduced to change the threshold and scope for shareholder approval of termination benefits.

Part C has a more detailed treatment of Australia's regulatory and corporate governance framework.

Remuneration for directors and executives in the United States is generally an order of magnitude higher than the levels that prevail in Australia for companies of comparable size (see chapter 3). RiskMetrics observed that:

... Freeport-McMoran two years ago, its executive chairman was being paid \$US70 million and the person running BHP, which was six times larger, was getting \$10 million, and half of that was actually an accounting value that was very hard to get. (trans., p. 377)

One posited reason for this difference is that corporate governance arrangements vary markedly between the two countries. For example, a non-binding vote on companies' remuneration reports has become an integral element of Australian arrangements, but generally does not apply in the United States. US corporate governance arrangements are also built on a more 'director-centric' basis (Lipton and Savitt 2007), reflecting the influence of the corporate law in the state of Delaware, where more than 50 per cent of all publicly traded companies have their legal home (Delaware Division of Corporations 2009).

Box 2.5 Changes to the requirements to disclose remuneration

Requirements for disclosure of director and executive remuneration in Australia have widened significantly since the 1980s:

- Prior to October 1986: firms were required to disclose the collective remuneration (in bands) paid to all executives earning over \$100 000.
- 1986–1987: firms had to identify all directors and their remuneration and the five highest paid executives and their total remuneration. As noted by Hill (1996) these regulations were objected to by a number of business organisations, which may account in part for their 'brief legislative life'.
- 1987 – 30 June 1998: listed companies were required to report the total annual 'emoluments' (cash and non-cash remuneration) received by executives earning over \$100 000 (in \$10 000 bands), but did not have to identify the executives. Directors' remuneration had to be disclosed in \$10 000 bands.
- 1 July 1998 – 30 June 2004: listed companies were required to disclose in the annual report the remuneration packages (including base salary, short- and long-term incentives and other payments and allowances) of all directors and the five most highly paid executives.
- Since 2004-05: an expanded information set covering a wider range of directors and executives has been required in a remuneration report (which forms part of the annual directors' report) and on which shareholders have a non-binding vote.
- 30 June 2003: the Australian Securities and Investments Commission issued guidelines requiring companies to place a reliable valuation on options granted as part of remuneration packages. The guidelines allowed companies to choose from a number of valuation methods (Black–Scholes, lattice (binomial) or Monte Carlo simulations).

Sources: Hill (1996); Merhebi et al. (2006).

An outspoken academic critic of executive remuneration in the United States, Lucian Bebchuk, in testimony before the US House of Representatives Committee of Financial Services, proposed regulations that would move the United States towards an Australian-style system of corporate governance:

... shareholders' rights in US public firms are significantly weaker relative to the UK and other common law countries. In addition to introducing advisory say-on-pay votes, it is important to strengthen shareholder rights in a number of other ways. In particular, it would be desirable to dismantle existing impediments to shareholders' ability to replace directors and shape companies' corporate governance arrangements. (Bebchuk 2009, pp. 6–7)

One area where Australia, the United States and United Kingdom are similar is in their unitary structure for board governance, whereby executives and non-executive directors sit on one board. Some European countries have instituted a dual board system with non-executive directors on a 'supervisory' board, and executives on a separate 'management' board. (The operation of boards in Australia is discussed in chapter 5.)

Australia's corporate governance framework is highly regarded internationally. A survey by GovernanceMetrics International in 2008 ranked Australia fourth in the world out of 38 countries (GovernanceMetrics International 2008). That said, the evidence is not conclusive about the impact of particular elements of corporate governance on company performance. For example, while many highlight that US board structures appear to lack the degree of independence that typifies Australian boards, the comparative track record of US companies for wealth generation stands up well. The literature suggests that corporate governance can be very context-specific. Indeed, there are many examples to suggest that companies with high levels of managerial ownership operate at least as effectively as those with more diverse and independent board structures. These issues are also explored in this report.

Australia's regulatory and corporate governance framework with its mix of 'black letter' law bolstered by 'if not, why not' guidelines, has evolved over time and reflects various 'rules of thumb' that attempt to balance prescription with flexibility. As all of these changes involved a degree of judgment, it would be surprising if current arrangements could not be improved.