**Productivity Commission**

# Inquiry into Regulation of Director and Executive Remuneration

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This submission relates to Scope item 4:

> *Consider any mechanisms that would better align the interests of boards and executives with those of shareholders and the wider community...*

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## Preface

In the commercial world today, there are essentially two fundamental views relating the relationship between the corporation and its owners. The first, termed the "Social Entity" view maintains that the corporation is a "social entity" that is 'independent' of all other entities. Thus its destiny and outcome are determined by its directors and managers and the outcomes for its shareholders are entirely determined by its managers. This view is the dominant view and may represent 80% (my estimate) of corporations.

The second view is termed the "Property View". This view maintains that despite its legal framework and accountability, the corporation is owned by its shareholder for legal and ethical purposes and outcomes determined by those shareholders. Thus all that the corporation does, must, in one form or another, contribute to shareholder-defined outcomes which vary between shareholder and share registry.

We profess to operate in a Capitalist society. Capitalism is about the private ownership of the means of production. However, it is my view that the cause of the economic crisis has in large part been due to:

- Over the last 150 or so years, the owners of the means of production have become more distant from those means of production. This was inevitable as the corporation grew in size and grew nationally and then internationally.
- In the first instance, in order to maintain control of and over their corporation, owners appointed managers to manage the corporation under the owner's direction.
- As the corporation grew, owners had to appoint directors to oversight the corporation on their behalf as it had become too complex to manage 'remotely'.
- As public shareholding grew, the concept of 'ownership involvement' became too hard and impractical to operationalise.
- This caused "ownership" to morph into "investment".
- At this point, directors (but particularly executive managers) assumed the "custodianship" of the corporation.
- With custodianship, came the view that *"whatever management (and directors) considered as appropriate for shareholders, then that is what they would receive, and if they didn't like it then the investor could take his investment elsewhere."*
- The cause of the current crisis then, is that modern management has proxied itself into the position of owner of the corporation and has helped itself in the following ways:
    - It has determined key performance outcomes (KPOs) that do not align themselves with shareholder objectives;
    - It has assessed its own performance against the criteria it has itself determined;
    - *It has granted itself benefits, rewards, salaries and protectionist barriers that are not only excessive (and obscene to some) but are directly at the expense of shareholders without shareholders having any meaningful input or control;*
    - It has made both strategic and operational decisions that have placed the corporation at risk along multiple risk-dimensions. This risk is ultimately borne by shareholders and not with the managers and directors that create the risk.
- Thus the principal cause of the financial collapse can be fairly attributed to the "Social Entity view of the corporation, notwithstanding a range of other contributing issues, such as regulation and governance.

These comments and recommendations herein are based on doctoral research entitled: *Reframing the Relationship Between the Corporation and its Shareholder Owners: Implications for Modern Organisations.*

Along similar themes is the book on the same theme entitled: *"Corporate Crap: Stupid management myths that destroy shareholder value"*, (2008) Fairfax Publishing, Sydney http://www.smhshop.com.au/details.php?id=1036

The research in this submission demonstrates, argues for, and provides significant evidence for the adoption of the Property View of the corporation and its benefits to all parties including to the corporation.

This submission provides evidence of the research, analysis and arguments for the adoption of a Property view to the relationship between the corporation and its shareholders.

Also included is the author's CV.

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# Abstract

This study maintains that in order to justify an organisation's existence and its owners' investment, corporate goals must be aligned with owner/shareholder goals. To establish such an alignment, boards and management must understand what their owners want, that is, what are their real and quantifiable objectives, and cannot rely on some well-meaning generic set of outcomes. These quantified objectives form the basis for moulding the corporation's vision and its specific corporate goals, strategies and actions. This is radically different from existing practice which largely relies on the interpretations of management and directors to shape a corporation's destiny and outcomes. The study's view promotes shareholders as owners of corporations (the 'property' view) and rejects the 'social entity' view that sees the corporation as distinct from its owners/shareholders.

It is contended that the existing relationship between management and directors and the corporation's owners rest on two key assumptions: firstly, that all shareholders desire the same outcome; and secondly, that managers and directors always work for the well-being of shareholders. The following diagram summarises this relationship.

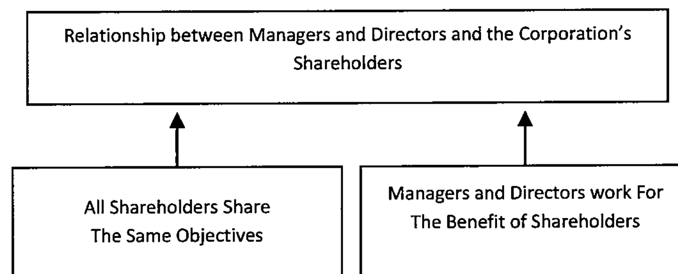


*Figure 1: The assumptions upon which the existing relationship between managers, directors and the corporation's shareholders is based*

The study examines these two assumptions and presents evidence which refutes both. As a result, a case for a new relationship between management and owners is proposed which enables the corporation to ensure more effectively the optimisation of shareholder objectives - whatever they may be. From a managerial perspective, the proposed model ensures that management decisions, and corporate outcomes, are aligned with owner objectives by involving the board's directors at critical ratification milestones in an organisation's planning process. From a board perspective, the proposed model establishes the need for, and a method to quantify owner objectives. Such quantified objectives are to be interpreted by the board using their knowledge of the organisation, the industry and the context, to ensure that corporate goals and objectives are such that they optimise owner objectives.

The relationship model proposed establishes the primacy of owner objectives as the definer of corporate outcomes. It therefore supports the 'property' perspective against the 'social entity' perspective which currently prevails in corporate circles. These two perspectives represent the key schools of thought related to the accountability of organisations to shareholders/owners. The model asserts that boards and management

are entrusted with the responsibility of navigating the corporation through a course that delivers those outcomes, not the outcomes that management has determined through its own subjectivity, and notwithstanding its well-meaning intent. Owner objectives and corporate mission are thus one and the same, save for the interpretive filtering role of the board which must adjudicate optimal outcomes when confronted with a range of quantified objectives from a diversified shareholder population.

To test this idea, the study examines the on-market behaviour of shareholders across five banks and discovers that shareholders do not have generic and common objectives despite a high degree of ownership overlap between the five banks studied. This, coupled with the subjective nature of decision-making by management, raises serious questions about management and board ability and motivation to satisfy owners.

In the proposed model, the quantified outcomes derived directly from owners are used to drive and assess all that is undertaken by the corporation. Initiatives, programs and investments are assessed against this benchmark in order to ensure that all corporate activity, one way or another, contributes to the attainment of the owners' objectives. Optimisation of funds and employment of resources are therefore easier, as that activity which has the greatest impact on the desired objectives is adopted over those initiatives with lesser outcomes.

The model also establishes a clear decision-making hierarchy within corporations. It asserts that:

- owner objectives determine corporate objectives and deliverables;
- are instrumental in determining the markets from which those deliverables must be secured;
- which are instrumental in defining the product and service options used in those markets to extract the deliverables;
- which are instrumental in defining the methods and channels used to bring the products and services to the market;
- which are instrumental in defining the resources (human, technological and knowledge) needed to achieve these outcomes;
- which are instrumental in defining and structuring the organisation needed to operationalise these decisions.

These decisions mould the financial and other outcomes of the corporation. These corporate outcomes must deliver the outcomes sought by owners.

The implications of this study call into question some of the fundamental models used by management and boards. They suggest that corporations should question the way that they manage the interdependencies between elements of their organisation and the decision processes used by them. Adoption of the model initiates a rigorous assessment of all strategies, techniques and tools used by corporations against quantified shareholder-based outcomes rather than against often subjective criteria established by managers or

directors. The potential for radical realignment of focus, rationalisation of non-value adding (to shareholders) and substantial cost and investment savings is profound.

Probably the most innovative and potentially most powerful implication of the proposed model, is its impact on Corporate Governance. Adoption of the model provides for the identification of owner objectives as the corporation's key drivers, and these metrics and the ability of corporations and their CEOs to deliver them, provide the baseline against which corporations can be assessed by shareholders, managers, analysts, regulators and investors.

# 1. Introduction

## 1.1 Overview

It is becoming increasingly common to hear shareholders discuss their difficulty in maintaining control over their organisations (Deans 1997, 35; *Australian Financial Review* 1997), particularly in ensuring that their organisation delivers what its owners expect (Deveson 1995, 5; Deans 1997, 35), especially in an environment where managers do not own equity in the corporation for which they work (Fama 1980, 288).

The consequences of the excesses of the 1980s have drawn attention to the importance of this issue and reinforce the need for a mechanism to ensure that organisations reflect more reliably the interests of shareholders and directors (Deveson 1995, 4). Sykes reinforces this point by noting that 'the 1980s saw a rash of professional liability cases in which directors were sued for huge sums for allegedly failing to properly oversee their chief executives' (Sykes 1996, 46). In other words, the vision and goals of corporations when fulfilled should satisfy owner goals.

Business has undergone many changes in style and practice during the 20th century. Most of the changes have promised increased effectiveness and efficiency. The focus has traditionally been on directors and management, because they have been perceived as the controllers of corporate destinies (Francis 1997, 30). When most business was small and operated with the daily involvement of its owners, this was an appropriate perspective as the distinction between owners and managers was minimal.

However, the face and structure of industry have changed, as has the average corporation which has grown in size and complexity. The relationship between owner and manager has therefore also changed. For all intents and purposes, and notwithstanding employee share structures, owners, particularly owners of large corporations, are rarely the same individuals and entities who make the daily management decisions which impact on the performance and destiny of organisations (Fama 1980, 289).

This has led to a fundamental difference in perspective as to the role and relationship that the corporation plays regarding its shareholders. Francis (1997) has provided an excellent discussion of the two views: the 'property' view which sees the corporation as a vehicle intended to advance the purposes of its owners; and the 'social entity' view which sees the corporation as an institution, an 'entity separate from its owners, one that pursues its own lawful economic interests and objectives separate from and, at times, even contrary to those of shareholders' (Paul Rona quoted in Francis 1997, 34).

The social entity view further contends that 'owners' do not own the corporations in which they invest because they have proxied managers to operate the corporations, and in so doing have lost their 'right to operate and manage, the right to sell, dispose, pledge, encumber, or hypothecate, the

right to create lesser titles in interest, such as leases, licences, easements, or covenants, and the right to bequeath' (Paul Rona quoted in Francis 1997, 34).

Fama, among others, supports this view when he states

> 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 (Fama 1980, 290).

The social entity view has been the dominant view in corporate circles and has been consistently supported through the courts in the United Kingdom, the United States and in Australia (Francis 1997, 37-40), and has been reinforced by the alleged desire of politicians to 'buck-pass' their own policy failures (The *Economist* 1996, 13).

The social entity view, despite the apparent endorsement of directors, managers and the courts, and despite its contemporary appeal, raises some serious questions and issues. If shareholders lose their 'ownership' by virtue of the loss of their 'right to operate and manage, the right to sell, dispose, pledge, encumber, or hypothecate, the right to create lesser titles in interest, such as leases, licences, easements, or covenants, and the right to bequeath', then who owns the corporation? The implication that one draws from the proponents of the social entity view is that either no one owns the corporation, or it is perhaps owned by some unspecified entity or people - such as management or the stakeholder collective. The concept of managerial or stakeholder ownership is simply unsupportable from an observation of commercial practice or examination of court and legislative practices. It is also inconceivable that no one legally owns the corporation because that is also not validated by practice nor could it be sustained in law. How does one transact property without owners?

There would be little argument (even by the social entity proponents) that someone or some other corporation or entity which owns 100% of the corporation's scrip is the legal and practical owner of the corporation. If that owner sells only 0.001% of the script to some other entity, does the original owner lose the *right of ownership*? Certainly not, except that now directors have an obligation to satisfy the desires of more than one owner thus potentially limiting the benefits to certain owners. The benefits are qualified in this context, *and not the fact of ownership*. The key issues here are the degree of ownership or critical mass that gives the owner the ability to exert influence over the corporation; and the delegation by the shareholder to directors and managers to make the above decision on the behalf of the legal owner.

The social entity proponents would struggle to argue that the holders of sufficient critical volume of scrip in a corporation do not have the ability to materially, significantly and legally change the ownership of the company. One only needs to examine the actions and behaviours of companies who make voluntary or compulsory bids to buy out minority shareholders. Once bought, these new owners

are quite within their corporate and legal rights to do with the company what they like (within legal, regulatory and ethical constraints). Although their behaviours may not be popular or in the best interests of all stakeholders, they do have the ability and legal right to exert their will over the organisation. This would not be possible if the new 'owners' did not have legal ownership of the entity.

The issue of ownership rests on the form of relationship that an owner agrees to accept when ownership in a multiple shareholding corporation is sought. The proxy to directors and management of the rights referred to above are a condition of the relationship, and *not the trigger that invalidates ownership*. In fact, the proxy to skilled and capable management is often the motivation that attracts shareholders because of their ability to enjoy the benefits of ownership without the concerns of daily operations. They are prepared to give their proxy to directors and managers, *and pay them for their skills to manage,* in order to secure their desired benefits. There is no prescriptive that declares that one can only own an asset if one exerts immediate and direct control over it. Ownership gives the owner the right to proxy control to whomever the owner desires. In the case of a corporation, that is to the directorship and management. At times, new large volume shareholders exercise this right by divesting existing directors of shareholder proxy and installing other directors with different and improved skills or a different set of instructions for corporate performance and direction. It is the ownership status of the shareholder that bestows upon them the right *and power* to act in this way.

The social entity proponents secure strength to their argument, in part, from the powerlessness of small shareholders who are unable to exert influence over the corporation (Davidson 1997, 9). Because such shareholders are unempowered, they do not exhibit the same characteristics of care and concern for the well-being of the organisation as the conventional owner who actively behaves and acts in such a manner. However, the small shareholder delegates these responsibilities to directors and managers. The ability of the shareholder, large or small, to directly impact the corporation in which their equity resides is not the issue - particularly since the shareholder still has the legal ability and responsibility to change the directors, and through them, management, and so impact corporate performance and well-being.

In many ways, the law protects non-shareholding stakeholders ahead of shareholders. This means that shareholders carry a greater risk than other stakeholders. This risk is an owner's 'right' and 'obligation'. Whether the shareholders decide to affect their ownership through an entity that they directly control, or through an entity in which *it is understood* that operational control is proxied to directors and management, it is irrelevant to their status as owners. Davidson insightfully noted that:

> the answer revolves around the type of risk and contract entered into. Stakeholders, other than shareholders, enter into what are called 'hard' contracts. The terms of the contract (especially payment) are usually spelt out in detail and the consequences of a breach of the contract are spelt out. The clauses of the contract are enforceable in a court of law. Shareholders on the other hand, enter into a 'soft' contract. They get whatever is left over after all the payments to other

> stakeholders have been made. They contract for the residual, hence they are the residual risk bearers. In order to get them into the contract, they are 'given' control over the firm. Due to the 'business judgement rule' many aspects of the 'contract' between shareholders and the firm (management) cannot be enforced in a court of law. To argue that stakeholders (other than shareholders) should also have a share of the residual, over and above the payment specified in their hard contract, is to give them a 'second bite of the apple' (Davidson 1997, 12).

The social entity proponents create an anomaly in the financial reporting process by apparently condoning the use of the term 'shareholder funds' in the balance sheet rather that the use of the term 'investor funds' or some other label aligned with the social entity philosophy. One might speculate that the enduring use of 'shareholder funds' is because investors generally accept specific and agreed returns while shareholders accept the risk associated with the unspecified returns associated with ownership. The shareholder funds are the owners' benefit from taking the risk and are not available to those who 'invest' in the same corporation through non-equity instruments.

Viewed from the perspective of a proponent of the 'property' perspective, the 'social entity' movement is no more than an attempt to break the obligations and responsibilities a corporation and its office bearers have to those who employ them and to whom they owe their primary obligation. It is an attempt to cut the ties of obligation and accountability which allows directors and managers to direct and steer the corporation according to their own perspectives and whims and to provide themselves with benefits, advantages and career securities which they consider appropriate without the obligation to justify those decisions from a shareholder benefit perspective. This criticism may be a bit too harsh, particularly since malicious or self-serving intent is not the motivation behind the vast majority of directors and managers. However, this study supports the contention that those directors and managers who actively pursue and practise the 'social entity' philosophy within their organisations are more vulnerable to these accusations - sometimes with justifiable cause. Linden and Lenzner (1995, 64), for example, discuss some of the excesses that directors have been known to take at the expense of shareholders.

*The Economist* summed up this view when it stated:

> A lot of managers in Anglo-Saxon firms have become detached from the interests of their increasingly dispersed shareholders, most of whom are ordinary citizens, not cigar-puffing plutocrats. These managers are insufficiently accountable to anybody in particular. That is why the next surprising thing you will hear is a lot of bosses enthusiastically embracing the language of stakeholder. And it is why everybody else's interest is to insist, however unfashionably, on shareholder value (*The Economist* 1996, 14).

It also went on to discuss in some detail why stakeholder capitalism in both Germany and Japan is facing a *'crop of troubles'*, and why

> after two decades of relative under-performance, the American and British economies have for the past decade performed as well as or better than those of Japan and continental Europe. Moreover, the stakeholder version of capitalism

> that these evangelists seek so fervently to propagate has itself come under unprecedented strain (*The Economist* 1996, 21).

Recognition of shareholder rights however, is starting to emerge around the globe. Salz-Trautman, and Dwyer (1995, 20), as an example, write of this emerging trend in Germany. Even as far back as 1993 *Fortune* magazine trumpeted the dominance of the shareholder when it pronounced that 'booted bosses, ornery owners, and beefed-up boards reflect a historic shift in corporate power. The imperial CEO has had his day - long live the shareholder' (Stewart 1993, 20).

It has not been uncommon for shareholders and directors of medium-to-large corporations to complain that management has 'hijacked' the organisation (*The Economist* 1996, 65; *The Age* 1995, 21) and that the direction management has set is not consistent with the board's (let alone the shareholder's) vision, even though the board is the final arbiter of organisational policy and direction.

There are many reasons for the disparity between owner, director and manager interests. For example, directors are generally part-time and have other diversions (Nicholls 1996, 3), while managers are totally focused on the corporation. While management has a range of specialist skills to call on when making the decisions that it presents to the board for ratification, it is difficult for the board to verify in detail the information, assumptions, calculations and conclusions made by management, because they do not have ready access to the same resources (Millstein 1995, 15).

Zajac terms this 'information asymmetry' and states that

> the principal has less information than the agent about: (1) the characteristics of the agent, e.g. ability, risk aversion, or propensity to leave an organisation, and (2) the decisions made and the actions taken by the agent... (Zajac 1990, 220).

Allanson reinforces this view in his discussion on information to be considered by the board; he observed that poor information quality in the boardroom 'is limiting the director's ability to recognise key information, which can open up the company director to unnecessary risk' (Allanson 1995, 37).

The difficulties faced by owners are even more acute, with recent initiatives in the corporate governance sphere beginning to address this issue (Millstein 1995). An owner's, or even a director's, call for a second opinion or detailed questioning on assumptions and figures, is perceived by management as a vote of no-confidence, distrust or undermining (Salmon 1993, 69), even though management will concede that it is the director's responsibility to question and probe and an owner's right to do so.

The dilemma facing directors is real. Directors are there to protect and further the interest of all shareholders and other stakeholders in the corporation's legal and regulatory context, and are seen in law as having this responsibility (Francis 1997, 45). Yet they are not always fully in control of the information flows and deliberation processes, which makes their responsibilities difficult to execute and, in certain circumstances, fraught with personal risk (Francis 1997, 42, 46).

What then is the appropriate relationship between the owners of a corporation and the managers they appoint to operate it? Is it possible to identify a solid relationship between the two groups that

enables both to fulfil their roles and perform to expectations? How do we divide their responsibilities? And what impact does this relationship have on setting the vision and goals for a corporation?

The planning process, and the assumptions that underpin it, is the process which either enables or hinders the relationship between owners and managers, and the fundamental mechanism which facilitates the fulfilment of a corporation's core objectives (Steiner 1979, 3).

Within the planning process, the structure, orientation and commitment to an organisation's future is made. It is against these plans that an organisation's performance is managed and measured. And it is against the skill sets identified within plans that personnel are recruited, retained, rewarded and removed; resources, systems and processes developed, acquired and managed; contingencies planned for; and opportunities capitalised upon. An integral part of the planning process - the expected and actual performance of the organisation - attracts or repels investors and financiers.

An organisation is ultimately assessed by what it has achieved and the probability of attaining that which it is striving to achieve. The business/corporate/strategic plan, and the strategic objectives embedded within it, is the document that encapsulates organisational striving - the process which tells employees, owners and other interested parties how past and current difficulties will be overcome and how future goals will be achieved. It should be the definitive reference for assessing an organisation's performance against its promises, and for assessing its skill in pre-empting and determining its future.

Parker summarised this by stating that strategic objectives are

> crucial foundations for corporate planning and control. They provide the basis for communication and motivation. Without them, corporate activity can stray into unintended and counterproductive directions. If well specified, promoted and adhered to, they can guide decision-making, improve corporate efficiency and effectiveness and provide the basis for longer term performance evaluation (Parker 1996, 57).

Those who control the planning process, and its underlying assumptions, are inevitably those who control the destiny of the organisation. Owners want a plan that enables their goals and needs to be satisfied while managers want a plan which enables them to manage the business and control its resources and contingencies. As Millstein stated:

> management is the key to corporate performance. Managers have, since the advent of the industrial revolution, been the difference between an enterprise's success or failure. The stockholder's interest (as well as that of the other corporate dependents) is best secured by having in place the best managers available (Millstein 1995, 6).

## 1.2 Research Objectives and Value

The research examines the existing relationship between corporations, their managers and their boards in relation to shareholder objectives.

The need for such an examination arises because the plethora of academic and popular management writing, despite acknowledgment of the importance of the shareholder, give precious little guidance (or even emphasis) on the need to establish definitively quantified shareholder objectives. To some extent, it is suspected that both managers and boards have presumed that the establishment of definitive shareholder objectives is unnecessary because 'all shareholders have *generally* the same objectives' (Band 1992), or that the shareholder isn't that important (Francis 1997, 37-40).

Where managers and boards have acknowledged that shareholder objectives vary, then they resort to three key arguments to justify their need to make fundamental business-outcome decisions on behalf of owners without universally consulting those owners. They either maintain that in a diversified share registry it is impossible to gauge every shareholder's objectives (and implied in this is the 'impossibility' of satisfying everyone), and therefore there is no point in trying. This argument rests on the notion that it is impossible to gain information on all shareholder objectives. This research refutes this argument and presents a methodology that enables the organisation to collect and quantify all shareholder objectives.

Alternatively, it is sometimes argued that due to the size of large share registries, and since all shareholders have similar (same) objectives, it is sufficient to maintain close contact with institutional investors, brokers and analysts. By maintaining this contact, it is argued, the board and managers are aware of what all shareholders want. This argument rests on the assumptions that all shareholders have very similar objectives and that institutional shareholders have very similar objectives to small investors. The research attempts to test this assumption by examining the correlation between Top-20 shareholders in companies within a homogeneous industry and their on-market responses (behaviour) to a range of business stimuli. This examination enables certain observations and conclusions to be drawn regarding non-Top-20 shareholders which support the contention that the assumption of uniformity of objectives by shareholders is ill-founded.

The third argument used by boards and management to justify the use of their judgement on behalf of owners, is their belief that owners either 'don't know what they want' and/or 'don't have enough knowledge to make an effective decision'. It is probably quite true that not all shareholders invest for a range of complex reasons. Many shareholders, particularly many smaller shareholders, but also many larger shareholders, have fairly straight-forward and uncomplicated reasons for investing their funds in equities. These reasons may be any combination of characteristics associated with value, benefit, growth and risk and may be influenced by ethical, social, economic, political, environmental or other issues.

Irrespective of the simplicity of the decision-making process, there is always at least one reason why a sane and rational[1] shareholder invests. This reason may vary between shareholders; and for any one

[1] Rational from the perspective of their own needs and desires. It is not intended to argue the sanity or rationality of shareholders. Rather, it is suggested that shareholders choose a course of action, or an investment, from largely a subjective perspective. In the context of the shareholder's subjectivity, the investment is rational, assuming the investor is sane. In any case, who is to say that any

shareholder, may vary between investment targets. Coverage in business and the general media over recent years regarding shareholder activism and demands for more stringent disclosure and accountability requirements support the view that shareholders of all sizes have a strong view of what they want and are prepared to agitate until they obtain it (James 1994, 80).

The argument that shareholders have 'imperfect knowledge' and therefore management and boards need to make decisions relating to corporate outcomes on their behalf is flawed. Certainly, shareholders on the whole do not have complete knowledge and information about a corporation's activities, products, suppliers, customers, markets, strategies, competitors, regulations, environment, etc. And it is largely for that reason that owners proxy management who are skilled performers and who have access to the necessary knowledge, to operate the corporation on the owners' behalf.

But shareholders do not require 'perfect knowledge' to determine what they as shareholders require from their investment in their company. 'Perfect', or at least superior knowledge, is required to manage the company. Shareholders in large listed corporations do not manage the company - managers do. If a shareholder has a strong dividend requirement but no view on risk, for example, one might reasonably assert that risk is not a key issue for that shareholder. One cannot assert however, that the absence of a view on risk disqualifies one from having a view on an outcome or on the benefit that one requires from the organisation, and that therefore the shareholder shouldn't be asked.

This then, epitomises the fundamental dilemma now facing modern business. Do management and boards determine the outcomes that an organisation is to deliver to its shareholders, or do shareholders determine the minimum outcomes that an organisation must deliver?

It seems that modern business is therefore torn between, on the one hand, those boards and management of organisations who define their own organisational destinies and who interpret what is in the shareholders' best interest, and on the other hand, those who believe they exist solely to satisfy shareholders (Francis 1997, 37). The former asserts that if shareholders don't like what management delivers, then the shareholder can withdraw his/her investment and go elsewhere (Koutsoyiannis 1982, Sawyer 1979). Supporters of this view point to the efforts made by corporations, such as the appointment of Investor Relations Managers, to communicate with their shareholders in order to explain the strategies, issues and outcomes the corporation is dealing with and striving toward.

On that basis, they argue, the investor is able to match his/her objectives and desired outcomes with the striving of the corporation. On face value then, there appears to be an attempt to match shareholder desires with corporate effort. There are a number of fundamental flaws in this approach

investor is 'wrong' in making a subjective decision when such a decision is legitimised by the very subjectivity which created it. To argue the sanity and rationality of shareholders would force boards and managers to psychoanalyse their shareholders, or to totally ignore them. Most corporations choose the latter.

which lead to the under-optimisation of corporate performance and therefore shareholder satisfaction. These include:

- Interviews[2] with the CEOs, the chairs of boards and the managers of major Australian corporations have confirmed their reliance on a handful of institutional investors, analysts and brokers as their principal sources of shareholder intelligence. It appears also that their desire to get close to the larger investor is motivated by their desire to minimise any destabilisation to their corporation that dissatisfaction might cause, rather than from a motivation to satisfy the shareholders' needs. Shareholders are often regarded as a necessary burden that all organisations must bear rather than the reason that the corporation exists. On the basis of this logic, major corporations make little to no effort to understand the needs of the smaller shareholder, principally because the smaller shareholder, acting alone, can't impact the corporation. This position is further strengthened by the flawed argument that all shareholders desire the same set of outcomes, so why not communicate with those who are easiest to communicate with, and use their objectives as a proxy for all shareholders? Using this logic, a corporation argues that it satisfies its directors' statutory obligation to operate in the best interests of all shareholders. What impact is there on this logic if evidence supports the contention that shareholders have varying objectives? Who if anyone, can the corporation rely on to represent the optimal proxy view of all shareholders?

- A major limitation and therefore risk from the view of corporate primacy over accountability to the shareholders, is the trust that its proponents must place in the hands of directors, managers and staff. The subjectivity of humans has been comprehensively documented over many years in virtually every walk of life and in almost every profession or interest area. Directors, management and corporations do not escape the pervasive reach of individuality, subjectivity, self-interest and self-preservation. To trust management and directors to always optimise situations for the betterment of the corporation and shareholders is not only naive, but it is to imbue them with a unique quality and impartiality that has no evidence in reality. But this is not to deny that directors, management and staff try very hard to achieve that very outcome.

- The writer's experience in the areas of management and strategic and corporate planning over nearly 25 years has overwhelmingly reinforced the view that managers, and not directors, define corporate destinies. Most reference and academic books on the subject

[2] Interviews were conducted with the CEO, chairperson, directors or senior manager of a range of Australian Top 100 companies, investment institutions and business, commercial and shareholder associations related to the establishment of an independent 'Owner Accreditation' program. Within that process interviewees were exposed to the preliminary research findings of this study and their reactions were sought. Extensive and detailed discussions with over 150 large and small corporations relating to shareholder relationships and corporate performance improvement over 25 years of consulting practice and management experience have been used to provide background and context for this study. The names of corporations and organisations interviewed, at their request, have been withheld.

confirm the manager's responsibility to guide and steer the corporation. Francis noted that directors saw that the focus of their responsibilities was 'for assuring the management of operations...' (Francis 1997, 300). If, as the previous point contends, managers and directors are merely human with human perceptions, attitudes, propensities and fears, then it is further contended that the 'human' and quite normal attributes of men and women will shape corporate operations, policies and practice. As Mintzberg (1991, xii) observes, 'our behaviour is guided by the systems of ideas that we have internalised over the years'. This shaping may not be in the best interests of either the corporation or its shareholders. Under the influence of such subjectivity, management may choose performance measures that are convenient rather than practical, and in doing so, secure an outcome that is other than optimal. The choice of an inappropriate performance measure can be disastrous since activities, projects, initiatives and investment are assessed against their contribution to the selected measure/s.

- The key issue with management defining the corporation's mission, and therefore selecting the performance measures that will deliver that mission, is that management defines the very performance criteria that they will be measured against. This is akin to students choosing the questions they want on the examination paper before the exam. The measures that management and boards choose must be meaningful not only to them, but must be the measures which enable a fair and *impartial* assessment of management and board performance in relation to the delivery of a corporate outcome wanted by shareholders.
- Lastly, the proponents of the view of corporate primacy over shareholder accountability are asking for the trust of shareholders, stakeholders, regulators and others in the ability and good intentions of directors and management. Any cursory observation of modern corporate trends would identify the increasing reaction to such pleadings: disclosure regulation and legislation has tightened; onus of responsibility for directors has become more severe; disqualification of 'notorious' directors has almost become common; and shareholder agitation and dissatisfaction is aired almost daily in the business media. To some extent, these trends have been a reaction to the heady days of the late 1980s and early 1990s. They have also been a reaction to the growing belief among shareholders, regulators and others that organisations and their office-bearers cannot be trusted to *always* operate in the best shareholder (stakeholder or community) interest.

On the other hand, this conflicts with those regulators, shareholders and others who maintain that the organisation only exists to satisfy shareholders and that management and boards are employed to deliver very specific outcomes to those owners. In this latter view, boards and management are merely the enablers who translate owner objectives into tangible outcomes.

They also see other stakeholders as means to an owner-defined end rather than ends in themselves. This position maintains non-owner stakeholders are only satisfied to the extent or level that will allow

shareholders to fulfil their own objectives. This is a minimalist level that can be rephrased to read 'only give them what you need to, to get what you want'. This view runs directly against recent trends and movements espousing the maximisation of stakeholder objectives; particularly those related to community, employees and the environment since under such a view, maximisation of non-shareholder objectives is inconceivable.

A further implication from the research is the proposal of a relationship between corporations, their managers and boards which will optimise organisational responses to shareholder objectives. This research will argue that management decisions are largely or at least partially subjective. Such subjectivity colours the assumptions which underpin managerial decision making processes. It is argued that as a result, the tools and techniques chosen by management may seriously impact on a corporation's ability to deliver shareholder satisfaction (Jensen 1976).

The proposed model presents a relationship between the shareholder, boards and management which remains, it is suggested, rock-solid irrespective of changes in tools and techniques used by management. It responds to changes in outcomes desired by shareholders, and is clearly focused on delivering shareholder satisfaction as defined by them.

## 1.3 Research Questions

The core research questions that this study attempts to answer relate to the relationship between shareholders and the corporations in which they invest, and the implications that such relationships may have on the performance, strategies and operations of those corporations.

Specifically, the questions for which clarification is sought are:

- *How can management reconcile differing shareholder objectives within the context of their own corporation's objectives?* Shareholder activism and volatile share prices are often a result of the lack of congruence between what shareholders want and what the corporation is, and/or is seen to be doing. An ability to make shareholder objectives congruent with corporate striving will decrease shareholder dissatisfaction and decrease time required by the organisation to manage the incongruence. In the terminology of Agency Theorists, congruence will decrease transaction costs incurred by the organisation thus increasing the value of the shareholders' investment in the corporation.

- *To what extent are commonly used industry-wide performance ratios inappropriate as a means for assessing corporate and CEO performance?* If shareholder objectives can be shown to differ between firms in the same industry, or if the reaction to any particular industry-based performance measure differs between shareholders in different organisations in the same industry, or even by the same investor in different companies in the same industry, then the question must be asked about the appropriateness of the industry-based ratio/measure as a suitable measure by which to assess corporate performance without detailed knowledge of shareholder objectives. As an example, if shareholders want short-term dividend maximisation and the corporation is striving to deliver this outcome (assuming it knows what shareholders want), then why assess the performance of the corporation against its ability to achieve some other outcome? Should an organisation striving toward a specific outcome as its principal deliverable be assessed in the same way as an organisation which has that outcome as only its second, third or lower priority?

- *To the extent that industry-wide performance ratios are inappropriate, then what are more appropriate measures for assessing corporate and CEO performance?* If industry-wide performance measures are sub-optimal ways of assessing performance, then what is a better method that ensures independence of the measure from the manipulation of ill intentions or misguided management, and still provides shareholders, regulators and analysts with a better method for assessing corporate performance?

- *How can the organisation undertake quantification of shareholder objectives in an efficient and effective manner?* What practical and inexpensive method can be used to quantify shareholder objectives?

- *To what extent do executive remuneration structures based on management incentives threaten the enhancement of shareholder wealth that such incentives are meant to engender?* Executive remuneration tied to corporate performance is not new. If management is subjective and such subjectivity moulds corporate objectives, strategies and directions, then what are the implications on shareholders of management being rewarded for chasing outcomes that those managers have determined in isolation from shareholder needs?