

## CORPORATE ACCOUNTABILITY - AN IMPACT ON COMMUNITY EXPECTATIONS

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### Abstract

This paper anticipates proposals developed by the 'Corporate Governance Council' set up by the Australian Stock Exchange (ASX) to advise on new guidelines. It identifies the invalidity of the assumptions implicit in the Sarbanes-Oxley Act in the US and the recommendations of the Higgs report in the UK into the role of non-executive directors. The conflicts of directors relying on management information to assess management and the business are considered. Also, the conflicts from the ASX trading its own shares and their requirement that corporations continuously disclose price sensitive information without permitting the market to be continuously informed about the identity of share traders. Ways of ameliorating these problems are suggested based on *A New Way to Govern: Organisations and Society after Enron*.

**Keywords:** conflicts, corporate governance, democracy, disclosure, oligarchy, plutocracy

### **A New Way to Govern: *Because “world best practices” are the problem not the solution***

Last year the Australian government incurred liabilities over a billion dollars to compensate workers and insurance policy holders in failed businesses. These businesses were regulated by the government and failed without warnings from its regulators, the auditors or directors. The loss in tax revenues from associated businesses made the government a two times looser.

Without adopting *a new way to govern*, taxpayers will remain exposed to future losses because regulators, policy advisers, pundits and practitioners are in serious denial about the deep-seated flaws in the current corporate governance system. The result is ever-increasing ineffectual intrusive prescriptive rules and a raft of so called “best practices” based on myths and rhetoric that the average citizen rightly sees as a diversionary delaying activity from recognising the core problem.

Ordinary citizens excluded from the values and norms of corporate society see what the experts do not. However, governments make themselves captive to advisers like the ASX with vested interests, ideology and values that are spreading a cancer in capitalism. Karl Marx may well be proved right that capitalism will destroy itself.

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Enron and the HIH Royal commission have exposed the futility of spending taxpayer money on the existing system riddled with a cancer of regulatory failure. “World’s best practice” in corporate governance has now become the problem not the solution. Consider the following.

Minority investors have not and/or cannot discipline boards. Non-executives have not, and/or cannot, control management. So called “independent” directors have not had the information, will, and/or power to act to protect themselves, let alone investors and stakeholders. Audit committees have not worked or made auditors independent. Auditors do not report fraud and are not required to by law or accounting standards. In any event, accounting standards are ignored. When whistle blowers emerge they are also ignored. Regulators act too little too late if at all.

*A new way to govern* is required based on the science of governance. The science is illustrated in all living things that must become self-regulating to exist. However, lawyers and economists who become regulators and government policy advisers are not educated in the science of governance. Nor are the politicians who make the laws unless they are from the very small minority that have been educated as control engineers or biologists.

Biota with far less intelligence than a lawyer, economist or any other human can achieve self-regulation and become self-governing. The DNA of trees governs their growth in a balanced way so that they are unlikely to fall down. It is the self-regulatory strategies of nature that company law needs to follow rather than pretend that company directors are good stewards and fiduciaries. Without *A New Way to Govern*, both company directors and regulators will have an impossible task in prudently overseeing complex organisations.

### **Why best practices are the problem and the solution is *A New Way to Govern***

So called “best practices” are enshrined in the US Sarbanes Oxley Act and the UK report of Derek Higgs are based on the myth that non-executive directors (NEDs) can (a) be **independent** and (b) have the power to protect shareholders, regulators and the stakeholders governments seek to protect. However, both scholarly research and recent high profile failures do not support these myths.

The reasons are simple to understand. To begin with it is only common sense that the more independent a director is then the less knowledge and authority she or he has to carry out their fiduciary duties with due diligence and vigilance to monitor either management or the business. *A New Way to Govern would overcome this problem by establishing stakeholder advisory Councils to provide NEDs with expert information independently of management on the business and management Strengths, Weaknesses Opportunities and Threats (SWOT).*

Another problem of “World Best Practices” is that it is impossible for directors to be **independent** with a “winner takes all” system of voting. Over half of all listed companies in Australia have a dominant investor with the power to determine the appointment of both the board and the auditor! *A New Way to Govern would introduce cumulative (proportional) voting for directors to allow minority shareholders to appoint directors who are not beholden to a dominant investor or chairman.*

When there is not a dominant investor, directors still cannot be **independent** because they hold their position at the grace and favour of the chairman. This is because Australian corporate constitutions give the chairman of directors, sole and absolute power to determine the method of their election and the conduct of shareholder meetings. *A New Way to Govern would not allow any director or officer to determine the method of electing directors or the conduct of a shareholder meeting by being its chair.*

In any event, NEDs cannot protect shareholders, regulators, employees and other creditors unless they have (i) the **information** to act, (ii) the **will** to act and (iii) the **power** or capability to act.

NEDs typically have no systemic way of obtaining **information** about the qualitative performance of management or the business independently of management. *A New Way to Govern would establish self elected and so politically independent separate advisory councils of employees, customers and suppliers respectively to inform NEDs*

NEDs do not have the **will** to act because they hold their board position at the grace and favour of the chair. *A New Way to Govern would avoid this problem with cumulative voting for directors.*

NEDs do not have the **power** to act when there is a dominant shareholder and/or when they do not have the support of a board majority. *A New Way to Govern would avoid this problem by shareholders electing on a one vote per shareholder basis a watchdog board with the power to veto any related party transaction with a dominant shareholder or with any director.* Even a single director would then obtain the power act. She only needs to privately seek a veto from the internal watchdog board controlled by minority shareholders. The watchdog board would have no power to veto any activity in which there was no conflict of interest by a director. Thus it could not frustrate any value adding operations. The veto would only be available when there was a conflict of interest such as approving the remuneration and options for executive directors or any other related party transactions of directors that could extract excessive value from the enterprise. Even for these situations the veto could be overturned by shareholders voting on the normal plutocratic method of one vote per share. However, if majority shareholders reversed the veto to oppress minority investors the share price would become the final arbiter on whether the activity was perceived to be in the best interest of the company.

Other myths of “Worlds’ Best Practices” that represent false and misleading conduct are reliance on accounting standards, accountants, audit committees and auditors.

Neither accounting standards nor Australian law requires accountants or auditors to report fraud and malfeasance in the private sector. This fact is not commonly known by the public who rely on published accounts, nor is it known by even some very high profile company directors! As management control the auditor it is not practical to even request auditors to report any frauds perpetuated by their clients. *A New Way to Govern would avoid this problem by the auditor being controlled by a separately elected watchdog board as practiced in Russia and in some other places.*

Accounting information relies to a large degree on judgements made by management on changes in value of assets and liabilities between reporting periods. Even historical accounting requires managers and their directors to be fortune-tellers to estimate the useful life of assets to determine at what rate to write off their value. Accountants have little knowledge, experience or authority to make such estimates or to determine when debtors, stocks, plant, machinery, equipment, furniture and fittings need to be written down. The calculation of insurance and other liabilities can also involve judgements.

Judgements are made in a political context of what is the most desired result as competitors in Olympic ice skating, diving and gymnastics know well. *A New Way to Govern would create independent political relationships to create opposing biases.* This would be achieved through the way directors are elected, by the accounting practices accepted and the auditor being subject to the standards set by a watchdog board independent of management.

Audit committees are another “World Best Practice” that represents false and misleading conduct for a number of reasons. First, they do not change the political relationships between the auditor and the company to require auditors to report fraud, misrepresentations and non-compliance with standards. Secondly, even if they are composed of only NEDs the NEDs

cannot be independent for the reasons described above. Thirdly, they provide a way to bond auditors to directors rather than to shareholders and so be counter-productive in protecting the interest of investors, employees and other stakeholders. All these problems are avoided with *A New Way to Govern*.

However, the leading accounting firms are vocal advocates of audit committees and make a business out of advising companies how to set them up and how they should operate. Stock exchanges and pundits around the world support audit committees and the concept of independent directors in spite of the research evidence that they do not work. Professional bodies in Australia are intimidated by world opinion and feel that they must follow like lemmings to destroy the system they are supposed to be working to improve. Ironically, it is the ASX that is leading the charge over the cliff to prove the prediction of Karl Marx.

Australia holds itself out as a world leader in its continuous disclosure regime for corporations. However, if corporations and the ASX were serious about leading the world with *A New Way to Govern to minimise insider trading and the creation of false markets then they would also introduce a continuous disclosure regime for shareholders as well as for corporations*. The nature of shareholders and traders is price sensitive information like those corporations are required to disclose.

By exposing the ultimate beneficial owners and/or controllers to the sunlight of the market place, insider trading would be exposed and/or make insiders subject to tracing. This would introduce a self-regulating market, as the public would obtain the basis for seeking legal restitution from any dealing with any insiders who did not disclose their position before executing a trade. It would substantially reduce the cost for both the ASX and ASIC in monitoring and investigating unexplained changes in share prices.

Corporate constitutions could make Sunlight trading a condition for their shares to be traded. The current system of covert capitalism allows brokers to secretly take advantage of their clients. Its time the ASX walked its talk to create a genuine transparent and fair market. Sunlight trading would also allow corporations, directors and management to learn whom they are serving. This is a problem that was raised by the Institute of Company Secretaries to a Senate committee inquiring into the regulation of the ASX in 2001.

### **Why we need *A New Way to Govern***

There are both political and scientific reasons why we need *A New Way to Govern* as outlined below. You do not have to be a rocket scientist to realise that the political problem is as old as the invention of democracy. Power corrupts and the absolute power of directors to manage their own conflicts of interest can corrupt absolutely both them and the business undertakings. This has been forcefully illustrated by the high profile business failures throughout the Anglophone world.

The solution is simple - a division of power. This solution was adopted in the US constitution but not in the constitution of Australian corporations, the Stock Exchange or their regulators. Modern business institutions have become too complex and fast moving to be reliably managed centrally by a single board or regulator. Distributed intelligence is required to decompose decision making labour, reduce information overload and bounded rationality to match the limited ability of humans to process information. All these objectives can be achieved by distributed power created by constitutional checks and balances within and between institutions. The concentration of economic power has insidiously hollowed out political democracy in Australia. Just ten investment managers control two thirds of the \$660 billion or so of Australian superannuation investment. There are huge economies of scale in the investment management business so its profits are mostly determined by the size of the funds under management.

The name of the game is then to increase the funds under management. It is the directors of the large corporations and their representative that can veto the appointment of the fund managers of their corporate or industry superannuation funds. This explains why fund managers are so reluctant to vote against corporate resolutions to make managers accountable. Less than 1% of institutional votes are against management. Any vote against management can be a vote against either retaining a client or obtaining the company as a future client. However, when institutions do vote they have a very limited mandate. This is because as fiduciary agents, investment managers and/or trustees are legally forbidden to vote on any social, environmental, political or any other matter unless it affects the bottom line. The result is that Australia has both a negligent and covert form of capitalism where owners do not exercise their votes as shareholders, and the nature of the owners are unknown. This explains why inclusive regulation of corporations by shareholders rather than by government regulators cannot be expected with the present system. But the dire predicament of Australian capitalism is much worse than this.

Just four men in Australia who chair the four largest banks have the power to determine the composition of the board that appoints them for the reasons explained above. As the four banks create 20% in value of all domestically traded companies in Australia their power and lack of economic, social, environmental or political accountability must be a concern to not just their shareholders, depositors and regulators but to all citizens of Australia. But it even gets much worse than this!

The four banks in turn manage around one third of all funds under management in Australia! The funds under management would include some shares in most companies listed on the ASX including the 20% in value of the four banks. The four chairmen can thus determine how their fund managers' with voting discretion vote their shares held in the largest listed companies in Australia including the four banks! In addition the four banks are the biggest providers of credit to businesses in Australia. This in turn creates all sorts of conflicts of interest from banks managing both the equity and debts of most listed companies. Can we still describe Australia a democracy when economic power and influence is so tightly controlled by such a small cabal of directors without political legitimacy?

However, a division of power is not required just to introduce political checks and balances on any insensitive, self-indulgent and self-deluding hubris of those who exercise power. It is also required to allow corporate leaders, regulators and governments to manage efficiently and effectively the dynamic complexity of a modern society. The human mind just does not have sufficient information processing ability to manage, control, regulate or govern modern society without breaking down its complexity into simply parts.

Nature builds complexity in living things by using almost self-regulating components. Because the components of complex systems are almost self-regulating the volume of information required to control them is prodigiously reduced. *A New Way to Govern* is based the strategy used by nature to decompose complexity to within the capability of humans to manage.

Self-regulation is the key to *A New Way to Govern*. Self-regulation cannot work and will not work with the current system of governing and regulating corporations. The reasons are set out in my public policy pocket book. It was published in London by the New Economics Foundation that was also voted the leading "Think Tank" in the UK last year. The booklet was commissioned as a result of concerns over unexpected corporate failures and especially those of recently privatised enterprises.

*A New Way to Govern* is based on the science of governance also described as "cybernetics" or "system science". It was my PhD research that showed how cybernetics, defined as the science of information and control in animal and machine, could also be applied to social organisations.

A basic law of the science of governance states that it impossible to directly amplify regulation. This is why communism, socialism and other forms of dictatorships based on command and control systems of governance fail to be efficient let alone maintain their integrity of purpose or be socially satisfying. However, as demonstrated in all living things, the science of control and communication does allow regulation to be amplified *indirectly* through a process described as “supplementation”.

Supplementation is partly based on the principle of subsidiary function that states that no activity that can be achieved at a lower level should be undertaken at a higher level. But for supplementation work a division of power is required to provide alternative sources of information and control to break the hegemony of centralised power.

Both science and common sense explains why it becomes impossible for governments to directly regulate the complexity of corporate activity to meet the community expectations that concern this Symposium. Likewise, it becomes impossible for a single board to directly regulate the scale and scope of complex organisations in the private, public or non-profit sectors. Governments must follow the practice of nature by imprinting the DNA of self-regulation into the constitutions of social institutions. This would radically reduce the size, cost and intrusiveness of government and enrich the texture of democracy. As well and/or alternatively CEO's and/or their shareholders could adopt constitutions that facilitate self-regulation and self-governance to supplement the role of regulators. This would greatly simplify the complex, costly intrusive, one size fits all prescriptive laws and practices while meeting community expectations much more effectively and efficiently. It would also make business more competitive and sustainable.

### **Why current practices cannot work**

Current practices cannot work to protect shareholders and the stakeholders governments seek to protect because they are intrinsically unethically and facilitate corruption.

Anglo corporate law and practices are designed on the assumption that company directors are good people who will act as good stewards and become diligent fiduciary agents. Adam Smith and the framers of the US constitution made the opposite assumption. This is why the US constitution has a division of power to create checks and balances against corruption. However, Anglo corporate constitutions do not except for worker owned firms. Centralised power is incompatible with sustainable non-trivial worker owned firms. The ethical dilemmas created by centralised power through a unitary board are outlined in Table 1. A detailed discussion of the conflicts of interest is available from my paper ‘Why a unitary board is not best practice: The case for a compound board’.

It should be noted that none of the powers that create director conflicts of self interest directly effect their ability appoint, retire, manage, monitor and control the CEO and the business. Any regulator or Stock Exchange that permitted shareholders to provide directors with such excessive powers fails to justify their existence in protecting the interest of shareholders, stakeholders or the public. Fish rot from the head and so do corporate ethics. The ASX leads the rot in corporate ethics by its own constitution and practices and with listing rules that perpetuate covert capitalism. Because its own shares are listed on its exchange it compounds the rot to create a stinking mess of conflicts!

It reveals that the government, its regulators and the ASX are irresponsibly naïve, ignorant of the insights of Adam Smith, ignorant of ethics, and act inconsistently with the framers of the US constitution.

It is impossible for the ASX to pass a “smell test” from any informed citizen. The government and its regulator compounds the rot and becomes party to legitimising these stinking arrangements by allowing the ASX to form and control a “Corporate Governance Council” to

advise the nation on best practices! This illustrates how experts use their authority to become quasi-official advisers to set standards to protect their own interests.

**Table 1.** Corrupting powers of a unitary board

**Directors have power to:**

A. Obtain private benefits for themselves (and/or control groups who appoint them) by:

- (a) Determining their own remuneration and payments to associates
- (b) Directing business to interests associated with themselves
- (c) Issuing shares or options at a discounted value to them selves and/or associates
- (d) Selling assets of the firm to one or more directors or their associates at a discount
- (e) Acquiring assets from one or more directors or their associates at inflated values
- (f) Trading on favoured terms with parties who provide directors with private benefits
- (g) Using firm resources and/or their status in other ways.

B. Maintain their board positions and private benefits by:

- (a) Reporting on their own performance and influencing “independent” advisers by:
  - (i) Selecting auditors and other “independent” advisers
  - (ii) Determining their fees
  - (iii) Controlling the process by which auditors are appointed by shareholders
  - (iv) Terminating the appointment of auditors and other “independent” advisers
  - (v) Paying additional fees for work which is not required to be “independent”
  - (vi) Determining the terms of reference on which “independent” advice is provided
- (b) Determining the level of profit reported to shareholders by:
  - (i) Selecting the basis for valuing or writing off trading and fixed assets
  - (ii) Determining the life of assets and so the cost of depreciation
  - (iii) Selecting the basis for recognising revenues and costs in long term contracts
  - (iv) Selecting accounting policies within accepted accounting standards
  - (v) Selecting, controlling and paying “independent” valuers and determining the basis on which valuations are to be carried out
- (c) Not disclosing full pecuniary or non-pecuniary benefits even if required to do so
- (d) Determining how any conflicts of interest are managed
- (e) Filling casual board vacancies with people who support their own positions
- (f) Nominating new directors who support them at shareholder meetings
- (g) Controlling the nomination and election procedures and processes
- (h) Controlling the conduct of shareholder meetings
- (i) Appointing pension fund managers for the firm who also provide them proxies
- (j) Voting uncommitted proxies to support their own election
- (k) Not allowing the firm to compete with related parties who can vote for them.

Parliament is at fault as much as regulators and the ASX for allowing directors to obtain absolute power to corrupt themselves, businesses ventures and the integrity of employee entitlements and insurance claims of millions of voters. This is because Parliament rejected the proposals put forward by Senator Andrew Murray in 1999 for publicly traded companies to transfer the powers listed in Table 1 to a democratically elected Corporate Governance Board. The HIH debacle might well have been avoided if whistleblowers could have privately alerted a CGB of the problems management were not willing to disclose. In nearly all unexpected corporate collapses there are people who could have provided warnings but had no safe way to do so because of the hegemony of information controlled through the centralised power of

a unitary board. It is significant that in Russia, audit committees are separately elected by shareholders to counter the corruption of centralised power.

Millions of decent ordinary Australian know that the right thing to do when they chair a meeting of the local sporting club is to step aside and allow somebody else to take the chair when discussion on their performance or their own election is before a meeting of members. However, our leading corporate lawyers ignore such common sense ethical behaviour when they write the constitutions of publicly traded companies. They make legal, unethical behaviour by specifying that the chairman of directors can chair meetings of shareholders. The lawyers who write corporate constitutions then make it impossible for any shareholder to dispute any unethical behaviour or ruling by the chair. In addition the chair of the meeting obtains absolute and sole power to determine the conduct of shareholder meetings, the method for electing directors and in practice the power to vote proxies! It would be unthinkable for such powers to be provided to the chair/speaker of a house of parliament!

All directors lose their independence to the will of the chair when she or he determines the method of their appointment. This makes it nonsense to talk about ANY directors being truly independent on any publicly traded company when the chair has such power.

Politicians and pundits meanwhile talk about ways for shareholders to become more active in regulating corporations to take the responsibility away from government regulators. Rather than forcing institutional investors to vote they should make it illegal for any publicly traded or regulated company to operate with an unethical constitution. Just as importantly they should require corporations and their regulators to adopt a governance architecture that is consistent with the laws of nature.

### **Applying the science of governance to corporations and regulators**

The science of governance provides the design criteria for establishing *A New Way to Govern* not just corporations but the whole of society. The role of government would be radically changed.

Instead of direct intervention and masses of detailed prescriptive laws and regulations the government would substantially reduce its size, cost and interventions by following the strategy of nature to act indirectly. This would be achieved by requiring the DNA of self-regulation and self-governance to be imprinted into the constitutions of social institutions as a condition for them to exist. Evolution has honed this strategy over billions of years and no other strategy is likely to provide a more efficient or reliable way to regulate or govern the complexity of modern business.

The 150 self-governing firms created around the town in Mondragón in Northern Spain have illustrated and proved this strategy over the last 45 years. The self-governing firms who own their own Bank will not provide finance to start up new firms unless they adopt a constitution that follows the principles found in the US constitution. That is a constitution that separates the executive (Management board), from the legislature (Supervisory board), and the judiciary (Watchdog board). The Mondragón employee owned firms have proved to be extraordinary successful with less than 1% of new start up companies failing compared with over 75% for Australian firms. In addition, a World Bank study found that these firms that have proven to be internationally competitive are more efficient than investor owned firms

Like living things the information and control architecture of the Mondragón self-governing firms have adopted the design rules of nature with distributed intelligence to decompose decision making labour to avoid information overload and bounded rationality. Distributed intelligence is dependent upon a division of powers that also provide requisite variety of information and control channels to regulate complexity. As stated above, complexity can only be regulated with requisite variety of complexity.



Australian regulators simply do not have sufficient variety of complexity to regulate the complexity of the businesses they are supposed to regulate. Nor do boards of directors have sufficient variety of information and control channels to regulate the complexity of the larger and more complex business undertakings. Auditors suppose to supplement the role of regulators but cannot in the present system.

If company directors do not have sufficient information and control to regulate a complex business then regulators have no hope. Stakeholder councils are required to not only to provide directors with requisite variety of information and control channels to regulate the complexity of their business but to also supplement regulation by government watchdogs. They provide feedback information on how successful a firm if being managed as well as providing feed-forward information on future prospects to sustain the business and reduce risks. It is thus in the interest of both company directors and regulators to change corporate constitutions to establish watchdog boards and stakeholder councils as described as part of *A New Way to Govern*. Indeed, it is scientifically impossible for them to RELIABLY carry out their fiduciary responsibilities with due diligence and vigilance unless they adopt *A New Way to Govern*.