

ACCSR Turning Point Conference

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Understanding the CSR Landscape – the Australian Perspective - ASX Corporate Governance Council

Presented by

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1 Overview of ASX Corporation Governance Council

The Council was formed on 15 August 2002, bringing together 21 groups from disparate business backgrounds and carrying the varying aims and priorities that accompany those constituencies.¹ The Council is chaired by ASX, which also provides it with premises for conduct of its meetings and a secretariat.

Despite their differing perspectives, the Council's overriding mission is commonly held and that is to develop and deliver an industry-wide flexible framework for corporate governance which can:

- provide a practical guide for listed entities, to enable them to enhance the transparency of their existing practices; and
- encourage boards and investors to consider the appropriateness of governance practices.

The role of the Council is also underpinned by two listing rules:

- LR 4.10.3 which requires each listed entity to set out in its annual report a statement disclosing the extent to it has followed the Council's recommendations in the reporting period. If it has not followed a recommendation, the entity must identify the recommendation and give its reasons for not following it.
- LR 12.7 which requires entities in the S& P All Ordinaries Index at the commencement of their financial year to have an audit committee (this

¹ The members of the Council are: Association of Superannuation Funds of Australia Limited (ASFA), Australasian Investor Relations Association (AIRA), Australian Council of Superannuation Investors (ACSI), Australian Financial Markets Association (AFMA), Australian Institute of Company Directors (AICD), Australian Institute of Superannuation Trustees (AIST), Australian Securities Exchange Limited (ASX), Australian Shareholders Association (ASA), Business Council of Australia (BCA), Chartered Secretaries Australia, CPA Australia, Financial Services Institute of Australia (FINSIA), Group of 100, Institute of Actuaries Australia (IA Aust), Institute of Chartered Accountants in Australia (ICAA), Institute of Internal Auditors Australia (IIA-Australia), Investments and Financial Services Association (IFSA), Law Council of Australia (LCA), National Institute of Accountants (NIA), Property Council of Australia and Securities & Derivatives Industry Association (SDIA).

covers roughly 500 companies). The top 300 entities must also comply with the Council's recommendations with respect to composition, operation and responsibilities of audit committees.

In August 2003, the Council published its first edition of the Principles of Good Corporate Governance and Best Practice Recommendations (Principles). There are currently 10 Principles and 28 Recommendations.

The central tenet of the Principles is that they operate on an "if not, why not" basis². That is: the Principles are not designed to be prescriptive; they must accommodate the very different situations of the range of listed companies. Market disclosure is the cornerstone.

At the time of the release of the first edition of the Principles, it was recognised that this would not be the last word, that the governance debate would evolve and the Principles would be subject to review. To be robust, any corporate governance regime must be sufficiently flexible to cope with the constantly changing environment.

Since then, considerable consultation and review has occurred concerning how the principles and recommendations operate in practice and whether they need to change. These include:

- the work of the Implementation Review Group which was convened in 2003 and reported twice to the Council since then;
- review by ASX of disclosures against the Principles by listed companies in 2005 and 2006, and a review by ASX of disclosures by listed trusts in 2006;
- user research conducted in 2005;
- working groups of representatives of Council members which comprehensively reviewed the principles and recommendations and issues surrounding corporate social responsibility/sustainability reporting over 12 months before release of the Exposure Draft and Consultation Paper on 2 November 2006.

2 Exposure Draft and Consultation Paper

The deadline for submissions on the Exposure Draft and Consultation Paper is 9 February 2007. The Council would welcome all input to assist it to finalise revision of the Principles.

The proposed changes to the Principles are designed to:

- remove areas of regulatory overlap between the equivalent provisions of the Corporations Act and the Accounting Standards;
- refine the Principles to take into account feedback from the Council review groups and users of corporate governance information; and
- promote understanding of the application of certain Principles by merging principles and recommendations that cover common areas of governance.

² With the one exception of those companies required to comply with LR 12.7 with respect to audit committees.

Likely to be of most interest to participants in this Conference are:

- the proposed treatment of Principles 3, 7 and 10; and
- the Consultation Paper which deals with the recognition and disclosure of corporate social responsibility/sustainability issues.

One of the most difficult issues in this area is that of definition. For ease of reference, I will refer to “CSR” to cover the gamut of corporate social responsibility and sustainability issues

3 Important changes in landscape

While the seeds of many recent developments were sown long before the emergence of the Principles in March 2003, there have been significant developments in the CSR debate since then. One of the most prominent changes is a greater discussion of the role of CSR issues in any discussion about risk and its management (recognised in the name of the recent PJC report as one example).

Contributing to the changed landscape include:

- the report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation issued by the Commissioner David Jackson QC in September 2004;
- the inquiry by the Parliamentary Joint Committee on Corporations and Financial Services (PJC) in relation to corporate responsibility and triple bottom line reporting issues commenced in June 2005 and the submissions made to it. Interestingly, the final report of the PJC issued in June 2006 was named *Corporate Social Responsibility: Managing risk and creating value*;
- the reference to the Corporations and Markets Advisory Committee (CAMAC) in March 2005, the extensive and useful Discussion Paper issued in November 2005 and the report issued in December 2006 entitled *The Social Responsibility of Corporations*;
- developments in the understanding of and practices in risk such as the revised Basel II framework – see the *International Capital Framework*;
- an approach to the Council on the issue of sustainability reporting by Senator Campbell, the Minister for Environment and Heritage in September 2005 relation to how Australian companies might be encouraged to report on sustainability issues;
- the release by the UN of the *Principles for Responsible Investment*. Some Australian superannuation funds are signatories to these principles; and
- reviews of implementation of the Principles which have demonstrated that while entities generally have systems for recognising and managing financial reporting risks, there is considerable variation in the understanding of and practices adopted for recognising, managing and reporting on other material business risks.

The Council is concerned to ensure that its current consultation is not seen as yet a third review of CSR issues. The PJC and CAMAC processes were extensive and

thorough and the Council has used them as a background to consultation on what its next steps should be in this area.

4 Removal of Principal 10

The major vehicles for CSR discussion in the Principles are:

- Principle 3: Promote ethical and responsible decision making,
- Principle 7: Recognise and manage risk; and
- Principle 10: recognise the legitimate interests of stakeholders.

Many listed entities have been confused about how they should respond as between these existing Principles. For this reason, Council has decided to delete Principle 10 and to distribute the material which had been there between Principles 3 and 7.

This in no way represents a step back by the Council on the need to recognise the legitimate interests of stakeholders, and this is reiterated in the redrafting of both Principles 3 and 7 with statements along the following lines: If Australian corporations are to be successful, they must have regard not only to the fulfilment of their legal obligations, but also to the interests of a range of stakeholders including shareholders, employees, business partners, creditors, consumers, the environment and the broader community.

Principal 3

All material dealing with codes of conduct has been located in Principle 3 in line with the findings of the *ASX 2005 Analysis of corporate governance disclosure*. The need to disclose the code has been emphasised, and the commentary places emphasis on both the board's need to set the ethical tone of a company and senior executives' responsibility to implement practices consistent with the code.

The suggested content of codes of conduct is an amalgam of material previously in Boxes 3.1 and 10.1, with some new material dealing with facilitation payments, whistleblowers and hedging of options.

Principal 7

Council considers that the material previously in Principle 10 relating to the need to take a broad range of stakeholders into account, particularly in the context of risk management, fits better in Principle 7.

Principle 7 deals with the need for a framework for identifying, managing and disclosing risks and internal audit. The revision of this Principal, together with consideration of CSR reporting issues, is the one which has consumed the greatest time of the Council's working group over the past year.

Two internal reviews undertaken by the Council have concluded that companies were experiencing difficulties with the Principle including:

- the way listed entities were reporting against Principle 7;
- confusion about the nature of the risks covered by Principle 7 – primarily whether it was intended to be confined to “financial reporting risks” or a broader field. From the Council's perspective, it has always been intended to cover a broader field.

- what the sign off under the current Recommendation 7.2 should cover, and the nature of the assurances required to support the sign off.

Recommendation 7.1 will continue to require entities to establish a sound system of risk oversight, risk management and internal control.

Council has decided to revise the drafting of recommendation 7.2 to make it clear that “material business risks” include:

- risks which relate to potential material error in financial statements; and
- other material business risks such as operational, environmental, sustainability, compliance, strategic, ethical conduct, reputation, brand, technology, product or service quality and last but not least human capital.

Financial reporting risks will be dealt with in recommendation 7.2. They will require the CEO and CFO to state to the board that the statement given by them under section 295A of the Corporations Act³ is founded on a sound system of risk management and internal control which implements the policies established by the board in relation to financial reporting risks, and that the system is operating effectively in all material respects

Other material business risks will now be dealt with explicitly in recommendation 7.3 which will require the CEO and other responsible senior executives to state to the board in writing that there is a sound system of risk management and internal control for material business risks which are not financial reporting risks and which comply with policies adopted by the board and that that system is operating effectively in all material respects. It will be for the board to determine who should provide this statement in addition to the CEO. It will be for the board to determine what the other material business risks are and the risk management policy.

5 Some important questions

Against the background of these changes in the landscape and the proposals to amend the Principles set out in the Exposure Draft, Council is left with some important questions about its role in CSR and these are raised in the context of whether there needs to be a new recommendation 7.4.

Threshold issue

The threshold issue is whether the Council should have a role in CSR reporting, given that the Council was formed to develop Principles which relate to governance issues and some CSR issues may fall outside the scope of the Principles.

Clearly Principle 7 - with its focus on both financial reporting risks and other material business risks – traverses some of the area relevant to CSR reporting. It is highly likely that this will encourage greater recognition of other material business risks, and lead to greater reporting in this area.

³ This sign off relates to whether the financial records of the entity have been properly maintained, whether the financial statements comply with accounting standards, whether the financial statements provide a true and fair view, and other matters as may be specified in regulations.

Important purposes of the Consultation Paper are:

- to expose to the boards and senior executives of listed entities the levels of demand by investors for CSR information and the degree of interest by government in this question by the discussion of the landscape contained in the paper. This includes reference to the fact that there appears to be a correlation between transparency about CSR information and positive market ratings for companies; and
- to expose to investors and the broader community the issues which the listed entities confront.

The Council hopes for submissions from all relevant groups to get as accurate an understanding of their practical needs and imperatives as possible.

Options

If Council does have a role, what is it?

Council has rejected, and did not expose for consultation, the possibility of adopting a standardised reporting framework because it considered this step premature. The PJC concurred with this view.

Council has also decided not to adopt the suggestion by the PJC that companies should inform investors of the material non-financial aspects of their risk profile by disclosing their top five sustainability risks (unless they demonstrate they have fewer). By this approach, the PJC was trying to ensure that listed entities had flexibility in their reporting. However, the Council considered this is likely to be unworkable because of:

- potential exposure of directors and officers for liability if they incorrectly priorities risks in their disclosure, which is likely to make them reluctant to adopt this practice;
- any top 5 will be at a point in time, and as such may be considered arbitrary; and
- there may be legitimate competitive reasons for not disclosing some risks (within the parameters of the requirements of the continuous disclosure regime established by Listing Rule 3.1).

In making submissions about whether the Council has a role in this area, and if it has a role, which Option it should adopt, it would be useful if some practical issues are addressed including:

- what information do investors really need and how will they use it?
- what are the real costs to companies of engaging in CSR reporting, and how does this balance against the potential benefits, which might include investor confidence, community confidence, greater employee and customer satisfaction.
- how feasible would it be for ASX to monitor compliance with any recommendation 7.4?

Option A

The first option being considered by Council is that it releases additional guidance in the context of Principle 7 with no additional reporting obligations for companies.

Despite the hackneyed phrase, Council recognises that there is a cultural journey for companies to go through in reaching a fully developed system for recognising and reporting on material business risks which are not financial reporting risks. While many larger companies are considerably advanced in the journey, some companies, particularly smaller companies, are only beginning. Guidance would be designed to encourage companies along this way by:

- suggesting topics or issues the company may wish to take into account;
- practical guidance in relation to the development of CSR reporting practices and presentation; and
- reference to guidance currently available in this area.

Option B

The second option is for Council to introduce an additional “if not, why not?” reporting requirement as recommendation 7.4.

At a minimum, this would require companies to address their minds to all “material business risks” facing the company. Recommendation 7.4 could include:

- a recommendation that companies disclose their other material business risks and the steps they are taking to manage those risks;
- commentary and guidance to the effect that:
 - material business risks are determined by the board, and include the risks in the company’s risk profile; and
 - some companies may elect to disclose in accordance with an established framework.

If public consultation indicates that CSR reporting should be incorporated into the Principles and related guidance, Council will be concerned to ensure that it is tailored to the specific circumstances of Australian companies. It will take into account:

- the existing legal framework (for example s299A of the Corporations Act)⁴;
- the need to maintain an affordable cost of capital; and
- the need to arrive at an appropriate balance between investor demand for this type of reporting and increasing the regulatory burden and costs to listed entities of any CSR reporting recommendation.

6 Conclusion

My personal view is that some things are clear:

- for Australian companies to be successful, they must not only observe their legal obligations but also have regard to the broad range of stakeholders;

⁴ This requires companies to include in the directors’ report information members would reasonably require to make an informed assessment of the company’s operations, financial position, business strategies and prospects for future financial years.

- recognition of this is a critical element of any risk management strategy because it is fundamental to reputation and brand, and therefore to the confidence of investors and the willingness of communities to do business with and support entities;
- what gets measured usually gets valued, so the development of systems for reporting on CSR issues⁵ – either simple or complex – is likely to be necessary to advance effective oversight and management of material business risks which are not financial reporting risks;
- very many companies already have a focus on CSR issues, but methods for reporting vary vastly. If the number of companies which issue sustainability reports is the sole criterion used (as it sometimes is), then the statistics unfairly under represent the actual degree of engagement.
- transparency pays, but there is a cost and benefit element to the scope and form of reporting having regard to the nature of the business of individual entities, their size and complexity. This can and should also be reflected in the risk premium which investor extract for their capital.

What is less clear, given that honest minds can differ, is how to achieve practical outcomes which will be satisfactory to the constituencies on which the Council is primarily focussed, being listed entities and the wider investment community. The Council is not attempting to usurp the role of parliament in relation to broader CSR issues.

All submissions will be gratefully received. The deadline is 9 February 2007.

⁵ At the very least for internal management consumption, but also more broadly.