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ASX Corporate Governance Principles and Recommendations (Third Edition)

Summary report

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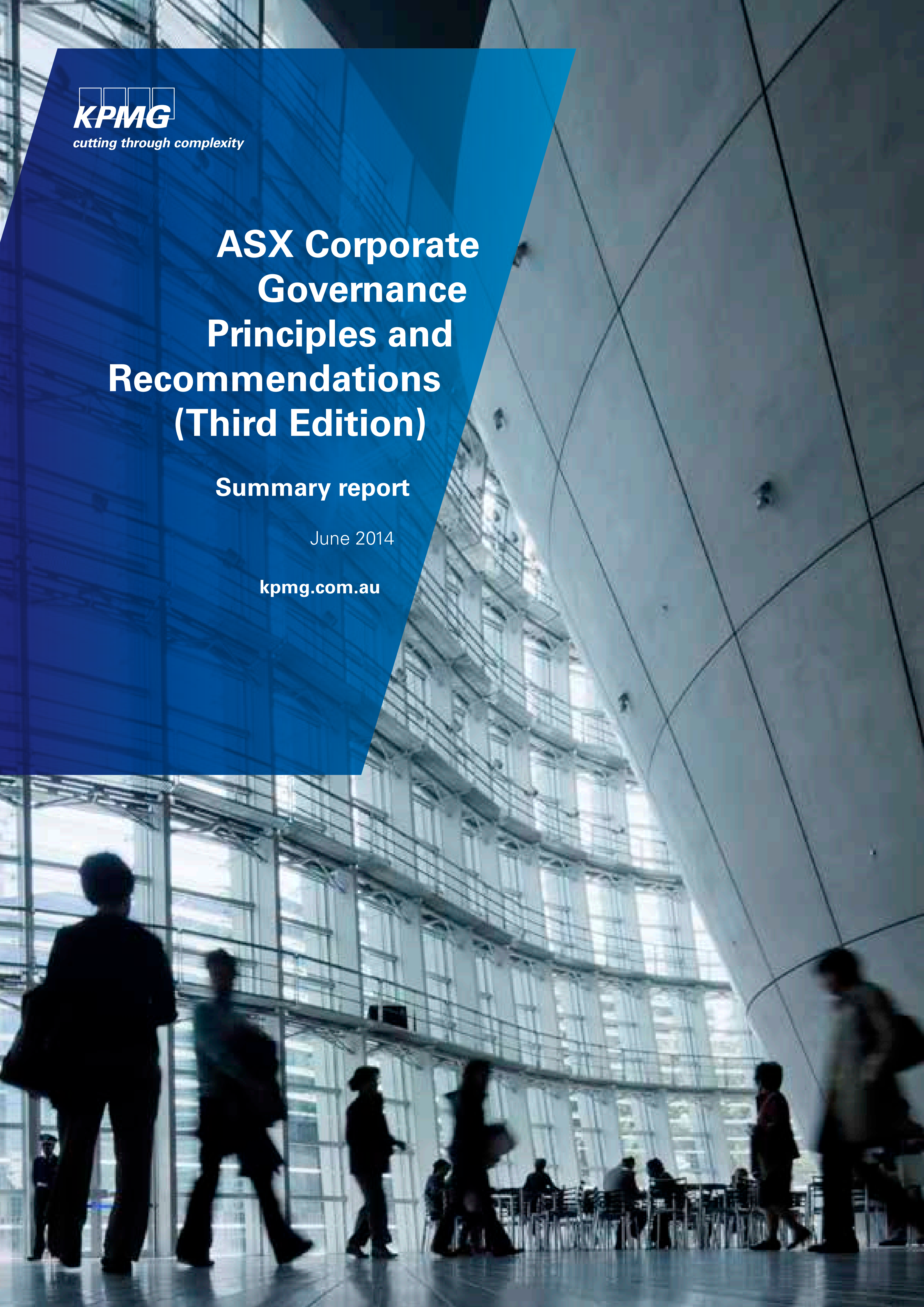

ASX Corporate Governance Principles and Recommendations (Third Edition)

The ASX Corporate Governance Council's principles and recommendations have become the benchmark for good corporate governance in Australia. The third edition, which takes effect on or after 1 July, 2014, marks its latest evolution.

Following a review by the Council in 2012/13, this most recent version incorporates important shifts in corporate behaviour and governance codes learned during the global financial crisis (GFC). Of particular note is a new recommendation that requires listed entities to disclose the details of their internal audit function – or lack thereof (Recommendation 7.3). Also significant is the Council's move towards greater disclosure over economic, environmental and social sustainability risks (Recommendation 7.4).

"Risk is now one of the dominant discussions in the boardroom of many of Australia's top companies. As the global economy becomes more interconnected, companies are facing more complex risk than ever before."

Sally Freeman
National Managing Partner, Risk Consulting

An overview

The corporate governance principles and recommendations have undergone substantial modification over the past decade. The Council released the first edition in 2003. This was followed by a second edition in 2007, which saw a major overhaul of the principles and recommendations. In 2010, new recommendations on diversity and the composition of the remuneration committee were added as amendments to the second edition.

The ASX's third edition represents further significant changes – mainly to the definitions of the eight principles and the recommendations within them.

It is worth noting, however, that there has been no change to the definition of what corporate governance entails, being: "The framework of rules, relationships, systems and processes within and by which authority is exercised and controlled within corporations. It encompasses the mechanisms by which companies, and those in control, are held to account."

It should also be noted that the third edition maintains a principles-based approach. This means the focus continues to be on outcomes rather than processes, thereby circumventing prescriptive, step-by-step rules. KPMG welcomes this approach as it avoids an additional layer of regulation.

The latest version continues to provide a certain degree of flexibility, recognising that smaller and multi-national listed entities may adopt different practices to achieve good corporate governance outcomes as suited to their size and composition.

"In line with other jurisdictions, Australia has favoured the use of principles and guidelines to re-build confidence and trust in our corporate governance regime. This is much less onerous than a regulated compliance regime, such as the US Sarbanes Oxley, and places trust in our Boards to set minimum standards or risk public exposure."

Sally Freeman

If not, why not

Nonetheless, the principles and recommendations continue to ensure that all listed entities are bound by certain practices. Still required is the inclusion of a corporate governance statement in a company's annual report (or URL links to where this statement is located).

The Council further maintains the view that delivery and adherence to a recommendation requires more than simply stating that fact. Rather, the listed entity should explain what policies and practices it has in place in that regard and, where applicable, point readers to where they can find further information about those policies and practices.

At the same time, the third edition has reduced flexibility surrounding the 'if not, why not' reporting approach applied in disclosing information on the principles and recommendations.

Whereas previously the Council supported companies in seeking to meet the 'spirit' of the principles through whatever means they believed were most appropriate to their business, the third edition provides a rather more succinct approach in delivering this message.

The more contemporary view point adopted by the Council is that a company must explain why it has not adopted the recommendation, its explanation ensuring that the market receives an appropriate level of information about the entity's governance so:

- security holders and other stakeholders in the investment community can have a meaningful dialogue with the board and management on governance matters
- security holders can factor that information into their decision on how to vote on particular resolutions and
- investors can factor that information into their decision on whether or not to invest in the entity's securities.

Despite the increased emphasis on clear communication and openness, KPMG is pleased to see the Council has not recommended listed entities disclose their material business risks and mitigation strategies. This would have involved disclosure of commercially sensitive information.

> "Risk is often the inverse of strategy and an entity that clearly documents and manages its risk appetite, known risk and mitigating strategies, is optimising its commercial positioning in the market."
>
> **Sally Freeman**

Key points of difference

Principle 1

This principle aims "to lay solid foundations for management and oversight." It states that "a listed entity should establish and disclose the respective roles and responsibilities of its board and management *and how their performance is monitored and evaluated.*" Note that disclosure as to how a company assesses the performance of its board and management has been newly introduced into the third edition.

There are other additions as well. Recommendation 1.2 provides further checks and balances around the election of a director. It states that a listed entity should:

(a) undertake appropriate checks before appointing a person, or putting forward to security holders a candidate for election, as a director; and

(b) provide security holders with all material information in its possession relevant to a decision on whether or not to elect or re-elect a director.

Recommendation 1.3 has also been added, directing a listed entity to have "a written agreement with each director and senior executive setting out the terms of their appointment."

The newly included Recommendation 1.4, meanwhile, states that a company secretary "should be accountable directly to the board, through the chair, on all matters to do with the proper functioning of the board."

Recommendation 1.5 requires a listed entity to establish a diversity policy with measurable objectives to assess gender diversity set by the board or a committee. It should be pointed out, however, that this is not new. Rather, in the 2010 amended version, it was included in Principle 3 which relates to acting "ethically and responsibly."

What differs in the 2014 version is that there is no longer a recommendation comparable to the 2010 Recommendation 3.4, which states that "companies should disclose in each annual report the proportion of women employees in the whole organisation, women in senior executive positions and women on the board."

Lastly, Recommendations 1.6 and 1.7 build on the 2010 Recommendation 1.2 which required companies to disclose the process for evaluating the performance of senior executives.

The 2014 recommendations require the formulation and disclosure of a process for "periodically evaluating" the performance of a listed entity's "board, its committees and individual directors" (Recommendation 1.6) and its senior executives (Recommendation 1.7). In addition, a listed entity should disclose each reporting period whether it has carried out a performance evaluation during that period "in accordance with that process."

Principle 2

The second principle aims "to structure the board to add value." This requires a listed entity to have regard to its board's skills as well as its size, composition and commitment, to enable it to discharge its duties effectively. It should be noted that "skills" is newly included here.

There are also a number of additional recommendations. These include Recommendation 2.1 which proposes that a listed entity's board have a nomination committee that:

(1) has at least three members, a majority of whom are independent directors; and

(2) is chaired by an independent director, and disclose:

(3) the charter of the committee;

(4) the members of the committee; and

(5) as at the end of each reporting period, the number of times the committee met throughout the period and the individual attendances of the members at those meetings.

In the event that a listed entity does not have a nomination committee, the Council requires it to outline the alternative means it employs to address issues of board succession and "to ensure that the board has the appropriate balance of skills, knowledge, experience, independence and diversity to enable it to discharge its duties and responsibilities effectively."

Recommendation 2.2 is also new. It focuses on the need for a mix of skills and diversity on a board. To this end it requires a listed entity to "have and disclose a board skills matrix setting out the mix of skills and diversity that the board currently has or is looking to achieve in its membership."

Recommendation 2.3 has been added as well, stating that a listed entity should disclose:

(a) the names of the directors considered by the board to be independent directors;

(b) if a director has an interest, position, association or relationship of the type described in Box 2.3 (below), but the board is of the opinion that it does not compromise the independence of the director, the nature of the interest, position, association or relationship in question and an explanation of why the board is of that opinion; and

(c) the length of service of each director.

Box 2.3: Factors relevant to assessing the independence of a director

Examples of interests, positions, associations and relationships that might cause doubts about the independence of a director include if the director:

- is, or has been, employed in an executive capacity by the entity or any of its child entities and there has not been a period of at least three years between ceasing such employment and serving on the board;
- is, or has within the last three years been, a partner, director or senior employee of a provider of material professional services to the entity or any of its child entities;
- is, or has been within the last three years, in a material business relationship (eg as a supplier or customer) with the entity or any of its child entities, or an officer of, or otherwise associated with, someone with such a relationship;
- is a substantial security holder of the entity or an officer of, or otherwise associated with, a substantial security holder of the entity;
- has a material contractual relationship with the entity or its child entities other than as a director;
- has close family ties with any person who falls within any of the categories described above; or
- has been a director of the entity for such a period that his or her independence may have been compromised.

In each case, the materiality of the interest, position, association or relationship needs to be assessed to determine whether it might interfere, or might reasonably be seen to interfere, with the director's capacity to bring an independent judgement to bear on issues before the board and to act in the best interests of the entity and its security holders generally.

Recommendation 2.6, meanwhile, introduces the idea of providing further education for a board's directors. To this end, it requires that a listed entity has "a program for inducting new directors and provide appropriate professional development opportunities for directors to develop and maintain the skills and knowledge needed to perform their role as directors effectively."

Principle 3

This principle requires a listed entity to "act ethically and responsibly." It differs perceptibly from the 2010 amended version which states that "companies should *actively promote* ethical and responsible decision-making."

The third edition includes just one recommendation, 3.1. This states that a listed entity should:

(a) have a code of conduct for its directors, senior executives and employees; and

(b) disclose that code or a summary of it.

In contrast, the 2010 amended version also set out what this should entail, namely:

- the practices necessary to maintain confidence in the company's integrity
- the practices necessary to take into account their legal obligations and the reasonable expectations of their stakeholders
- the responsibility and accountability of individuals for reporting and investigating reports of unethical practices.

It is also worth noting that Principle 3 no longer refers to the issue of gender diversity. Instead this has been moved to Principle 1.

Principle 4

This principle aims "to safeguard integrity in *corporate* reporting." This sits in contrast to the 2010 version which referred to safeguarding integrity in *financial* reporting. However, beyond this the latest version of the recommendations does not differ greatly from its predecessors. Additions include Recommendation 4.2 which states:

The board of a listed entity should, before it approves the entity's financial statements for a financial period, receive from its CEO and CFO a declaration that, in their opinion, the financial records of the entity have been properly maintained and that the financial statements comply with the appropriate accounting standards and give a true and fair view of the financial position and performance of the entity and that the opinion has been formed on the basis of a sound system of risk management and internal control which is operating effectively.

Recommendation 4.3 is also new. It states that: "A listed entity that has an AGM should ensure that its external auditor attends its AGM and is available to answer questions from security holders relevant to the audit."

This underlines the perceived importance of active dialogue between the external auditor, the company and its stakeholders if an effective 'three lines of defence'[1] is to be maintained.

[1] The three lines of defence are:

1. Business operations – day-to-day risk management and control
2. The oversight function – drafting of policies and procedures to guide and direct a company's risk management framework.
3. Internal and external audit – ensuring an independent challenge to the levels of assurance provided by the business operations and oversight function.

Principle 5

This principle requires listed entities "to make timely and balanced disclosure". In the 2010 amendment it states: "Companies should promote timely and balanced disclosure of all *material* matters concerning the company."

The word "material" has been omitted in the 2014 version. Instead it reads: "A listed entity should make timely and balanced disclosure of all matters concerning it *that a reasonable person would expect to have a material effect on the price or value of its securities.*"

This would appear to bring the principle up to date with the current view point that companies should act in a manner that is considered reasonable by the general public. Essentially it gives companies more guidance regarding what is considered to be a material matter that should be disclosed.

Principle 5 has only one recommendation, namely that a listed entity should:

(a) have a written policy for complying with its continuous disclosure obligations under the Listing Rules; and

(b) disclose that policy or a summary of it.

This is more succinct than the 2010 amended version which places emphasis on the responsibility of senior executives, stating:

Companies should establish written policies designed to ensure compliance with ASX Listing Rule disclosure requirements and to ensure accountability at a senior executive level for that compliance and disclose those policies or a summary of those policies.

Principle 6

This principle seeks "to respect the rights of security holders." This differs to the original version which refers to stakeholders.

In addition, the 2014 version includes considerable detail about how an entity may demonstrate such respect, providing a list of recommendations to ensure adequate communication and disclosure of information. This includes making available electronic means of communication. Principle 6 states:

A listed entity should respect the rights of its security holders by providing them with appropriate information and facilities to allow them to exercise those rights effectively.

- Recommendation 6.1: A listed entity should provide information about itself and its governance to investors via its website.
- Recommendation 6.2: A listed entity should design and implement an investor relations program to facilitate effective two-way communication with investors.
- Recommendation 6.3: A listed entity should disclose the policies and processes it has in place to facilitate and encourage participation at meetings of security holders.
- Recommendation 6.4: A listed entity should give security holders the option to receive communications from, and send communications to, the entity and its security registry electronically.

Principle 7

This principle aims to "recognise and manage risk" and details the requirements for a sound risk management framework, which includes reviewing the framework's effectiveness.

The third edition differs from previous versions in a number of its recommendations and can be viewed as the most significant reform of the 2014 corporate governance principles.

Recommendation 7.1 sets out the need for a company's board to have a risk committee or committees. More particularly it states that the board of a listed entity should:

(a) have a committee or committees to oversee risk, each of which:

   (1) has at least three members, a majority of whom are independent directors; and

   (2) is chaired by an independent director, and disclose:

   (3) the charter of the committee;

   (4) the members of the committee; and

   (5) as at the end of each reporting period, the number of times the committee met throughout the period and the individual attendances of the members at those meetings; or

(b) if it does not have a risk committee or committees that satisfy (a) above, disclose that fact and the processes it employs for overseeing the entity's risk management framework.

Recommendation 7.2 focuses on a company's risk management framework. It states that the board or a committee of the board should:

(a) review the entity's risk management framework *at* least annually to satisfy itself that it continues to be sound; and

(b) disclose, in relation to each reporting period, whether such a review has taken place.

Of particular note is Recommendation 7.3 which pertains to a company's internal audit function. It states that a listed entity should disclose:

(a) if it has an internal audit function, how the function is structured and what role it performs; or

(b) if it does not have an internal audit function, that fact and the processes it employs for evaluating and continually improving the effectiveness of its risk management and internal control processes.

KPMG views the inclusion of Recommendation 7.3 on the role of internal audit as a welcome introduction. Says Sally Freeman, Head of Risk Consulting, KPMG Australia: "It recognises the importance of an internal audit function in providing assurance over material business risks."

In fact, a KPMG survey (KPMG's 2013 Global Audit Committee Survey, Audit Committee Institute) of more than 1,800 audit committee chairs demonstrated an overwhelming desire to extend the role of internal audit beyond checking the veracity of financial controls, to include key risks facing the business. However, only half those surveyed said their internal audit had the right skills and resources currently to be effective in this role.

In meeting the requirements of Recommendation 7.3 a company will need to set up an internal audit function year round, points out Freeman. "This might mean supplementing the skills of a company's existing internal audit function through strategic alliances, outsourcing or co-sourcing."

Recommendation 7.4 is also significant. It states that a listed entity "should disclose whether it has any material exposure to economic, environmental and social sustainability risks and, if it does, how it manages or intends to manage those risks."

KPMG supports this move towards greater disclosure over economic, environmental and social sustainability risks. Says Freeman: "This is a rapidly evolving area of practice. Our analysis indicates 82 percent of the ASX100 reported environmental and social sustainability information in either in their 2012/2013 Annual Report or as a separate Sustainability Report."

However, KPMG believes greater commentary around the Council's expectations of the level of disclosure would be welcomed by listed entities to provide this Recommendation with a solid foundation.

Principle 8

This principle focuses on remuneration, the aim being to ensure that it is fair and responsible. The 2014 version differs to a significant degree from previous versions. Rather than ensuring that the level and composition of remuneration is "sufficient and reasonable and that its relationship to performance is clear", as set out in 2010, it says a listed entity should "pay director remuneration sufficient to attract and retain high quality directors and design its executive remuneration to attract, retain and motivate high quality senior executives and to align their interests with the creation of value for security holders."

It also goes into considerable detail in its recommendations. According to Recommendation 8.1, the board of a listed entity should:

(a) have a remuneration committee which:

  (1) has at least three members, a majority of whom are independent directors; and

  (2) is chaired by an independent director, and disclose:

  (3) the charter of the committee;

  (4) the members of the committee; and

  (5) as at the end of each reporting period, the number of times the committee met throughout the period and the individual attendances of the members at those meetings;

If it does not have a remuneration committee, a listed entity should "disclose that fact and the processes it employs for setting the level and composition of remuneration for directors and senior executives and ensuring that such remuneration is appropriate and not excessive."

Recommendation 8.2 requires a listed entity to "separately disclose its policies and practices regarding the remuneration of non-executive directors and the remuneration of executive directors and other senior executives."

Recommendation 8.3, meanwhile, states that a listed entity, which has an equity-based remuneration scheme should:

(a) have a policy on whether participants are permitted to enter into transactions (whether through the use of derivatives or otherwise) which limit the economic risk of participating in the scheme; and

(b) disclose that policy or a summary of it.

Building better frameworks

KPMG recognises and actively promotes the importance of sound risk management and an effective three lines of defence in protecting all stake holders' interests.

We believe the third edition of the ASX Corporate Governance Council Principles and Recommendations is an important response to the lessons learned in the GFC.

As companies continue to improve their risk management frameworks, bringing them into line with international best practice, the Council's latest principles may provide timely guidance necessary to meet the expectations of today's market place.

Contact

Adelaide

Justin Jamieson
Partner
Internal Audit Risk & Control Services
+61 8 8236 3191
0402 380 169
jjamieson@kpmg.com.au

Brisbane

Mitchell Petrie
Partner
Internal Audit Risk & Control Services
+61 7 3233 3164
mpetrie@kpmg.com.au

Melbourne

Sally Freeman
National Managing Partner
Risk Consulting
+61 3 9288 5389
sallyfreeman@kpmg.com.au

Perth

Kevin Smout
Partner
Internal Audit Risk & Control Services
+61 8 9263 7105
ksmout@kpmg.com.au

Sydney

Margaret Smylie
Partner
Internal Audit Risk & Control Services
+61 2 9335 7107
msmylie@kpmg.com.au

kpmg.com.au

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