Corporate Edge

PKF
Chartered Accountants
& Business Advisers

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Corporate Governance Principles and Recommendations – 2nd Edition

Introduction

The Principles of Good Corporate Governance and Best Practice Recommendations issued in March 2003 were revised by the ASX Corporate Governance Council and released on 2 August 2007.

These revised Corporate Governance Principles and Recommendations – 2nd Edition, reflect the contributions of more than 100 public submissions and will be effective for financial years commencing on or after 1 January 2008.

The requirements of the Corporate Governance Principles and Recommendations – 2nd Edition are summarised below:

ASX listing rule

Under ASX Listing Rule 4.10.3, companies are required to provide a statement in their annual report, disclosing the extent to which they have complied with the Recommendations of the 2nd Edition of the Corporate Governance Principles and Recommendations in the reporting period.

Disclosure period

The change in the reporting requirement applies to the company's first financial year commencing on or after 1 January 2008.

Disclosures will be required for the financial year. Where a company's financial year begins on 1 July, disclosure will be required in relation to the financial year 1 July 2008 – 30 June 2009, and will be made in the annual report for the year ended 30 June 2009.

Where a company's financial year begins on 1 January 2008, disclosure will be required in relation to the financial year 1 January 2008 – 31 December 2008, and will be made in the annual report for the year ended 31 December 2008.

The ASX Corporate Governance Council has encouraged companies to make an early transition to the revised Principles and Recommendations and to consider reporting in their corporate reporting for the 2007-2008 year.

What entities are affected?

The Recommendations are directed at listed entities, listed management investment schemes (trusts), listed stapled entities, and listed foreign entities.

Listed collective investment entities are popular investment choices for retail investors and hence the ASX Corporate Governance Council considers it important for these listed investment vehicles to follow the spirit of the Principles, particularly with respect to independence, remuneration and their governance structures.

Corporate Governance Principles and Recommendations

Under the 2nd Edition, eight core Corporate Governance Principles, including Recommendations to assist with implementation have been developed by the ASX Corporate Governance Council. These Principles reflect international good practice.

Each Principle is of equal importance. Recommendations are not mandatory or prescriptive but are guidelines, designed to produce an outcome that is effective and of high quality and integrity.

The "if not, why not" approach

If a company considers that a Recommendation is inappropriate to its particular circumstances, it has the flexibility not to adopt the requirement but to explain why – the "if not, why not" approach.

Effective "if not, why not" practices involve:

- Identifying the Recommendations that have not been followed
- Explaining why the Recommendation was not followed
- Explaining how the company's practices accord with the spirit of the relevant Principle

Therefore if an alternative approach is adopted, a well reasoned "if not, why not" explanation from a company is a valid response to a Recommendation.

Where a company is considering widespread structural changes the company is encouraged to prioritise its needs and to set and disclose practical goals against an indicative timeframe for meeting them.

It is only where a Recommendation is not followed or where a disclosure requirement is specifically identified that a disclosure obligation is triggered. Each Recommendation is clearly identified as a disclosure obligation.

ASX suggested disclosure approach

Companies can simplify their corporate governance statements by dealing with Recommendations consecutively on a Recommendation-by-Recommendation basis, and using clear cross references to the location of information not included in the corporate governance statements but located elsewhere in the annual report.

Separate corporate governance section on the entity website

Certain general information is required to be presented in a separate corporate governance information section on the entity's website with a reference in the annual report to navigate to the website to enable shareholders to gain access to this information.

Key changes from The Principles of Good Corporate Governance and Best Practice Recommendations issued in March 2003

These key changes have been extracted from the ASX Media Release on 2 August 2007 - Revised Corporate Governance Principles Released.

- 'Best practice' has been removed from the title and the text of the document – to be known as the ASX Corporate Governance Council's Corporate Governance Principles and Recommendations - to eliminate any perception that the Principles are prescriptive, so as not to discourage companies from adopting alternative practices, and 'if not, why not' reporting where appropriate.

- There are now eight Principles instead of ten with Principle 8 amalgamated into Principles 1 and 2, and Principle 10 amalgamated into Principles 3 and 7. These changes make the document more user-friendly by structuring the guidance more logically.

- **Guidance to Principle 2**: "*Structure the Board to Add Value",* sets out a list of "relationships affecting independent status" that a company should take into account when determining the independence of a director rather than providing a definition of independence. Companies are required to disclose their reasons for considering a director 'independent' notwithstanding the existence of one of these relationships.

- Council recommends that companies' trading policies should prohibit hedging unvested options and that any hedging of vested options should be disclosed to the company under Principle 3: Promote Ethical and Responsible Decision-Making. Council's position complements the Government proposal to amend the Corporations Act to require companies to disclose their policy on hedging of options.

- **Principle 7**: "*Recognise and Manage Risk*", now makes it clear that material business risks involve both financial and non-financial risks. Companies are encouraged to adopt appropriate risk oversight, management policies and internal control systems rather than disclosing specific material business risks. Submissions overwhelmingly opposed disclosure of specific risks.
  - Recommendation 7.2 now deals with "material business risks" in broad terms. Where a company has risks relating to sustainability or corporate social responsibility (CR), that are material to its business they should be considered in the context of the revised Recommendation 7.2.
  - Recommendation 7.3 contains a revised version of the existing "assurance" or "sign-off" on financial reporting risks. The Recommendation requires the board to disclose that it has received assurance from the CEO/CFO that the declaration under section 295A of the Corporations Act is founded on a sound system of risk management and internal control which is operating effectively in all material respects in relation to financial reporting risks.
- Recommendation 9.4 has been deleted and instead commentary has been added to Recommendation 8.2 suggesting companies may wish to consult shareholders about equity-based incentive plans involving the issue of new shares to executives, other than directors, prior to implementing them.

Other major findings to emerge from the review:

- Strong support for the 'if not, why not' reporting approach and general agreement that there should be no exemption from the Principles for small and medium-sized entities.
- Significant interest in sustainability and CR issues, although submissions indicate that sustainability/CR has a wide variety of meanings. The bulk of submissions focussed on the risk and risk management aspects of sustainability/CR. Many submissions said that any new Recommendation should avoid constraining the ability of companies to adopt approaches that best suit their circumstances and the needs and interests of their investors and stakeholders, and should not restrict their ability to comment on other aspects and objectives of their sustainability/CR activities.
- Council considers that sustainability/CR issues are best reflected in the 'mainstream' of corporate governance activities; that is, through strengthened risk management processes and reporting.
- The importance of material business risks, including those related to sustainability/CR, should be clarified and recognised. Companies are encouraged to establish appropriate risk management and oversight policies and structures, and to disclose a description of those policies in the context of Principle 7.

The Corporate Governance Principles and Recommendations are summarised below:

Principle 1 – Lay solid foundations for management and oversight

Companies should establish and disclose the respective roles and responsibilities of board and management.

- **Recommendation 1.1**: Companies should establish the functions reserved to the board and those delegated to senior executives and disclose those functions.
- **Box 1.1**: Content of a director's letter upon appointment
- **Recommendation 1.2**: Companies should disclose the process for evaluating the performance of senior executives.
- **Recommendation 1.3**: Companies should provide the information indicated in the Guide to reporting on Principle 1.

Principle 2 – Structure the board to add value

Companies should have a board of an effective composition, size and commitment to adequately discharge its responsibilities and duties.

- **Recommendation 2.1**: A majority of the board should be independent directors.
- **Box 2.1**: Relationships affecting independent status
- **Recommendation 2.2**: The chair should be an independent director.
- **Recommendation 2.3**: The roles of chair and chief executive officer should not be exercised by the same individual.
- **Recommendation 2.4**: The board should establish a nomination committee.
- **Recommendation 2.5**: Companies should disclose the process for evaluating the performance of the board, its committees and individual directors.
- **Recommendation 2.6**: Companies should provide the information indicated in the Guide to reporting on Principle 2.

Principle 3 – Promote ethical and responsible decision-making

Companies should actively promote ethical and responsible decision-making.

- **Recommendation 3.1**: Companies should establish a code of conduct and disclose the code or a summary of the code as to:
  - 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.
- **Box 3.1:** Suggestions for the content of a code of conduct
- **Recommendation 3.2:** Companies should establish a policy concerning trading in company securities by directors, senior executives and employees, and disclose the policy or a summary of that policy.
- **Box 3.2:** Suggestions for the content of a trading policy
- **Recommendation 3.3:** Companies should provide the information indicated in the Guide to reporting on Principle 3.

Principle 4 – Safeguard integrity in financial reporting

Companies should have a structure to independently verify and safeguard the integrity of their financial reporting.

- **Recommendation 4.1:** The board should establish an audit committee.
- **Recommendation 4.2:** The audit committee should be structured so that it:
  - consists only of non-executive directors
  - consists of a majority of independent directors
  - is chaired by an independent chair, who is not chair of the board
  - has at least three members.
- **Recommendation 4.3:** The audit committee should have a formal charter.
- **Recommendation 4.4:** Companies should provide the information indicated in the Guide to reporting on Principle 4.

Principle 5 – Make timely and balanced disclosure

Companies should promote timely and balanced disclosure of all material matters concerning the company.

- **Recommendation 5.1:** 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.
- **Box 5.1:** Continuous disclosure policies
- **Recommendation 5.2:** Companies should provide the information indicated in the Guide to reporting on Principle 5.

Principle 6 – Respect the rights of shareholders

Companies should respect the rights of shareholders and facilitate the effective exercise of those rights.

- **Recommendation 6.1:** Companies should design a communications policy for promoting effective communication with shareholders and encouraging their participation at general meetings and disclose their policy or a summary of that policy.
- **Box 6.1:** Using electronic communications effectively
- **Recommendation 6.2:** Companies should provide the information indicated in the Guide to reporting on Principle 6.

Principle 7 – Recognise and manage risk

Companies should establish a sound system of risk oversight and management and internal control.

- **Recommendation 7.1:** Companies should establish policies for the oversight and management of material business risks and disclose a summary of those policies.
- **Recommendation 7.2:** The board should require management to design and implement the risk management and internal control system to manage the company's material business risks and report to it on whether those risks are being managed effectively. The board should disclose that management has reported to it as to the effectiveness of the company's management of its material business risks.
- **Recommendation 7.3:** The board should disclose whether it has received assurance from the chief executive officer (or equivalent) and the chief financial officer (or equivalent) that the declaration provided in accordance with section 295A of the

Corporations Act is founded on a sound system of risk management and internal control and that the system is operating effectively in all material respects in relation to financial reporting risks.

- **Recommendation 7.4**: Companies should provide the information indicated in the Guide to reporting on Principle 7.

Principle 8 – Remunerate fairly and responsibly

Companies should ensure that the level and composition of remuneration is sufficient and reasonable and that its relationship to performance is clear.

- **Recommendation 8.1:** The board should establish a remuneration committee.
- **Recommendation 8.2:** Companies should clearly distinguish the structure of non-executive directors' remuneration from that of executive directors and senior executives.
- **Box 8.1:** Guidelines for executive remuneration packages
- **Box 8.2:** Guidelines for non-executive director remuneration
- **Recommendation 8.3:** Companies should provide the information indicated in the Guide to reporting on Principle 8.

Should you require assistance or additional information, please contact your Engagement Partner or:
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