

What do the report from the IRG and the ASX Corporate Governance Council's response mean for companies?

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General guidance

The Recommendations are not prescriptive – disclosure is the key

- 1) The Recommendations are not prescriptive.
- 2) The Recommendations provide a framework to help companies provide meaningful and comparable disclosure about their governance practices. The Recommendations are aspirational statements, but will not represent best practice for all companies in all situations.
- 3) Companies should not adopt the Recommendations without first considering what constitutes best practice in its own particular circumstances.
- 4) Best practice evolves over time. You should seek to improve your governance practices, having regard to changing market needs and changing circumstances.
- 5) Your only obligation is to disclose to what extent you have not followed the Recommendations and why.
- 6) If you choose to implement alternative governance practices, you are encouraged to disclose how these practices embody the spirit and intent of the overarching Principle.

Listed companies need only disclose against the Recommendations

- 1) There are 3 levels of information provided in the guidelines:
 - The 10 Principles
 - The 28 Recommendations; and
 - Commentary and guidance intended to help companies understand the intended scope of the Recommendations.
- 2) Listing rule 4.10.3 requires companies to report only against the Recommendations in their annual reports¹. You do not need to disclose against the commentary and guidance, although you are free to do so as this provides an additional level of information for investors.
- 3) Box 2.1 is included in Recommendation 2.1 by way of a footnote and so each indicator contained in this box should be reported against in the annual report.
- 4) All other boxed information is included simply as commentary and guidance, except where disclosure is indicated in the 'guide to disclosure' at the end of each Principle.
- 5) Whilst the listing rules only require exception reporting, the Council encourages companies to report against all the Recommendations, not just the ones they depart from either in their annual report or on their web site.²

Specific guidance

Principle 2: Structure the board to add value

Determining independence

- 1) The determination of independence remains a matter for the board's judgement.

¹ For financial years beginning after 1 January 2003

² Listing Rule 4.10.3 only requires companies to report the extent to which it has followed the Council's Recommendations and disclose which Recommendations it has not followed and why.

- 2) Use the 'indicators' contained within Box 2.1 as a framework for your disclosure. Your explanation of the board's determination should include discussion of its reasoning and how specific relationships were determined as either material or immaterial.
- 3) The existence of a specific relationship does not automatically mean that a director has lost the ability to ability and willingness to operate independently and objectively and to challenge the board and management: the board can determine a director to be independent **notwithstanding** the existence of relationships listed in Box 2.1.

You should disclose the nature of the relationship and outline the reasons behind the board's decision so that investors are provided with sufficient information to enable a reasoned assessment of the likelihood that independent judgement will be exercised.

Materiality

- 1) Determining materiality requires the exercise of judgement and is a matter for the board. The board should discuss appropriate materiality thresholds.
- 2) Note that as circumstances change, the materiality of specific relationships or even the appropriate thresholds may also change.
- 3) Your board needs to consider quantitative, qualitative and cumulative factors when determining the materiality of a specific relationship. Also, materiality thresholds for customers and suppliers viewed from 'both sides of the equation' – the supplier/customer's and the company's.
- 4) Quantitative: AASB 1031 provides guidance in relation to a quantitative assessment of materiality. An item is presumed to be immaterial if it is equal or less than 5% of the base amount. It is presumed to be material (unless there is evidence to the contrary) if it is equal to or greater than 10% of the appropriate base amount. This would seem a reasonable starting position for consideration by your board in determining thresholds for the company and its directors.
- 5) Qualitative: The following are examples of some factors your board might consider.
 - The diversity of the company's customer or supplier base and the type of relationship.
 - The nature of the director's relationship to that customer.
 - Any level of direct financing of the business by a director-related entity. The financial condition of the company will influence what might be considered material and this will vary during the life of the company. For example, a director's relationship with the company's banker may become more problematic if the company is in financial distress.
 - The nature and extent of the advisor's role as well as the nature of the director's relationship to that advisor.
- 6) Where a number of individually immaterial relationships exist, the cumulative impact may be material.

Smaller companies and board independence

- 1) The aim of Principle 2 is to achieve an appropriate balance between achieving a desirable level of board independence and maintaining sufficient relevant experience and competence for the board to fulfil its objectives.

- 2) If you consider that a majority of independent directors may not be the optimal composition to add value to your company, you should disclose the reasoning behind this decision. The following factors should be considered for discussion:
- The value to the company of the knowledge, experience or expertise of its directors given the stage of growth or nature of the company. Your board should consider providing more fulsome disclosure in relation to the skills, experience and abilities of its directors and how the company benefits from this.
 - The risk profile of the company and the impact this has on desirable board membership. For example, your board may wish to discuss the entrepreneurial nature of the business.
 - How other governance practices have been strengthened to support the competent and objective operation of your board and to provide investor assurance in relation to board decision-making. For example:
 - Procedures to manage conflicts of interest;
 - Enhancements to the nomination process or nomination committee in line with Principle 2;
 - Changes to codes of conduct for your board and key executives in accord with Principle 3;
 - Processes to achieve effective assessment of board and management performance in line with Principle 8;
 - The alignment of the remuneration structure with the longer-term interests of shareholders in line with Principle 9.
 - Whether the board has a plan to review its governance structures, including the level of independent directors, as the company develops and changes to ensure that it continues to meet effective governance for the circumstances of the company.

Principle 4: Safeguard integrity in financial reporting

Recommendation 4.3: structure of the audit committee

- 1) ASX proposes to amend Listing Rule 12.7 so only the top 300 companies will be required to have an audit committee which is composed according to Recommendation 4.3. Subject to ministerial disallowance, this change is scheduled to come into effect on May 3 2004. The top 500 companies will still be required to have an audit committee, but its composition will not be prescribed. This is in keeping with the current draft of CLERP 9.
- 2) If you decide not to have a separately constituted audit committee the following items may be considered for disclosure:
- Reasons for this decision to help investors to form their own view on suitability.
 - How the functions of the audit committee are otherwise incorporated into your governance structure.
 - If the board meets as the audit committee, whether it meets under any special conditions (eg. change of chair) or if any directors are excluded.
 - Whether elements of an audit committee charter are incorporated into the board charter?
- 3) You may consider using independent external expertise if you are otherwise unable to compose an audit committee with sufficient expertise to fulfil its role and objectives. The use of external expertise should not be seen to reduce your board's overall responsibility for the committee's role. The reasons for using external expertise and the scope of their role

within the audit committee should be disclosed. Investors should also be made aware of the method for determining the external experts independence.

Principle 7: Recognise and manage risk

Recommendation 7.2: CEO and CFO sign-off on risk management systems

- 1) Additional guidance has already been given in relation to Principle 7 and can be located at http://www.asx.com.au/about/pdf/Principle7_additionalguidance.pdf
- 2) Your board needs to ensure that it has thought through the implications of the 'sign-off' and the dynamics of the information flow between the CFO and the board. For example, it may be necessary for the CFO and CEO to have access to board deliberations on financial matters in order to be in a position to provide an effective 'sign-off'. This may be achieved by inviting the CFO or CEO to board meetings, subject to appropriate exceptions for issues relating to personnel and compensation

Principle 9: Remunerate fairly and responsibly

Nature and scope of disclosure

- 1) You need to determine the simplest and clearest way to disclose remuneration information. One option is to cross-reference brief information in the Corporate Governance statement required by listing rule 4.10.3 to detailed corporate governance information in the Director's Report and information required by the Corporations Act.
- 2) It may be useful for a large multi-divisional organisation to comment on regional and divisional remuneration policies where there are significant variations.

Valuation of options

It would help investor understanding if companies gave concrete examples of the implications of a share or option plan, for example:

- How the performance hurdles will affect remuneration according to different company growth scenarios.
- The impact of share price movements within selective ranges on the dollar value received by executives.
- This should include the impact of increases as well as decreases in share price. This information is specifically relevant to establishing how the remuneration structure aligns executive interests with those of shareholders.
- Other information on the dilutionary impact of share and option plans and how this might translate to changes in EPS or other useful measures.

Options issues to non-executive directors of smaller companies

- 1) If you use options for non-executive directors you need to disclose to investors how the spirit of Principle 9 is embodied in your remuneration plan and how non-executive directors' interests are aligned to long-term benefits for investors. You should consider providing detailed information in respect of:

- why this remuneration structure is necessary and appropriate for the particular non-executives;
 - what other safeguards exist to ensure that the alignment of such directors with the executive position does not cloud their objectivity or engender short-termism (it may be appropriate to discuss performance measures, evaluation etc);
 - qualitative detail as to the rewards that these directors can expect in certain circumstances;
 - discussion of the need to review the reward structure with the evolution of the company
- 2) IFSA provides guidance in its Blue Book that option schemes for non-executive directors should be under a separate scheme from executive options. The Blue Book also gives guidance on how the scheme should be structured to minimise investor concerns, including hurdles and size of grant.

Recommendation 9.4: Ensure that payment of equity-based executive remuneration is made in accordance with thresholds set in plans approved by shareholders

The intended scope of Recommendation 9.4 is in relation to issues of new shares. This is to provide the necessary protection to shareholders against their holdings being diluted. This does not diminish the entitlement of shareholders to proper disclosure of the entirety of the remuneration framework and its link to performance.

The Council's Guidelines, the IRG's report, the Council's response and this document are all available from the [ASX website](http://www.asx.com.au) (www.asx.com.au).