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Oversight of corporate reporting by company directors

The Journey to Better Business Reporting Continues

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In brief

Boards should respond to the 2014 changes in the *ASX Corporate Governance Council's Principles and Recommendations (ASX CGC Principles)* by:

- **disclosing the composition of the corporate reporting portfolio and the level of oversight provided by the board**
- **publishing much of the Corporate Governance Statement on the corporate website**
- **highlighting the material strategic issues and risks that were considered during the period and actions taken in the actual report**
- **using the change in requirements as an opportunity to reduce the volume and complexity of current corporate reporting**
- **considering whether further assurance from external parties is required to match any extension of oversight responsibilities under the ASX CGC Principles.**

Foreword

Corporate reporting reform is well underway in Australia and around the world, and directors have a critical role in driving the change agenda.

This publication outlines recent changes and recent trends in improving the quality of information provided to the capital markets. We focus on the recent change to ASX Corporate Governance Principle 4, which brings all corporate reporting within the realm of director oversight, and explain the director's role in developing a corporate reporting portfolio which better meets the needs of investors, whilst removing clutter, duplication and misalignment across the current multitude of reports.

We note current director concerns regarding potential director liability for forward-looking statements. The Chairman of the Australian Business Reporting Leaders Forum[1] recently recommended to the Australian Federal Government that it ask directors and investor groups to come together on this matter so that the Government can deliver a legislated solution to this issue.

We discuss the opportunity to develop a 'flagship' report, at the centre of the portfolio which explains how the company has created value to date, and importantly how it is set up to deliver value over the short, medium and long term. The flagship report would be based on the International Integrated Reporting Council's (IIRC) International Integrated Reporting <IR> Framework. This framework is already being adopted by over 1,000 global companies, and we see the trend growing.

Directors should seize the opportunity to use the recent changes to ASX Corporate Governance Principles to streamline their company's corporate reporting portfolio, better enabling investors to make decisions about the company's capital requirements, while at the same time reducing the volume and complexity of current corporate reporting. Directors should also consider reading the aligned KPMG publications about corporate reporting reform from a CFO and investor perspective.

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1 BRLF is the Australian Business Reporting Leaders Forum and is a multi-stakeholder group to promote and drive the development and implementation of a strategy-aligned, integrated business reporting framework.

2 McKinsey Global Institute Report - *Infrastructure productivity: How to save $1 trillion a year*, 2013 www.mckinsey.com/insights/engineering_construction/infrastructure_productivity

Does your audit committee have oversight of all your corporate reports?

The Third Edition of the ASX *Corporate Governance Council's Principles and Recommendations* (ASX CGC Principles), released in March 2014 for application from 1 July 2014 contains a seemingly minor, but in practice important, change in the governance over how listed companies in Australia report to their shareholders and other external stakeholders.

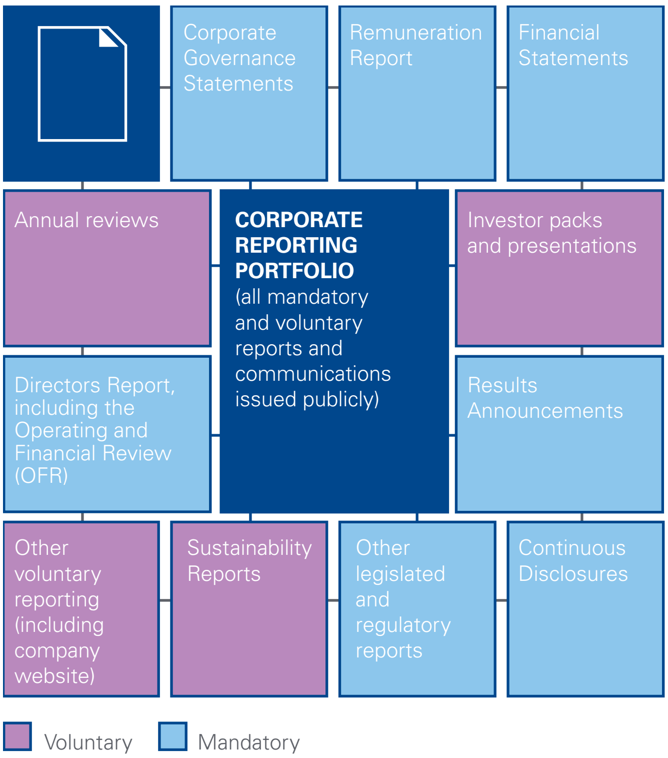
The reference to 'financial reporting' in Principle 4 has been replaced with 'corporate reporting':

"Principle 4: Safeguard integrity in corporate reporting

A listed entity should have formal and rigorous processes that independently verify and safeguard the integrity of its corporate reporting.

Recommendation 4.1: The board of a listed entity should (a) have an audit committee … or (b) if it does not have an audit committee, disclose that fact and the processes it employs that independently verify and safeguard the integrity of its corporate reporting …"[3]

The corporate reporting portfolio



The rewording broadens the portfolio of reports requiring oversight by directors and the audit committee, to encompass:

- all corporate reporting content
- processes employed to independently verify and safeguard the integrity of corporate reporting.

This change recognises that 'corporate reporting' today extends far beyond financial reporting prepared under the International Financial Reporting Standards (IFRS) and Australian Accounting Standards (AAS) and covers all components of a company's corporate reporting portfolio.

The revised Principle 4 does not define the term 'corporate reporting', leaving it up to individual boards to determine the boundaries of their corporate reporting portfolio.

For reports and communications that are included in the corporate reporting portfolio, directors may need to extend their current financial reporting focused oversight framework. For other reports, such as sustainability reporting, investor relations packs, diversity reporting, health and safety reporting and integrated reporting (<IR>), if the board did not oversee their preparation and was not involved in their approval, directors will now need to consider whether effective management oversight has been provided.

The diagram on the left sets out a typical corporate reporting portfolio for a listed Australian company, highlighting the mandatory and voluntary based reports used by stakeholders in their various decision making activities.

3 The Third Edition of the ASX Corporate Governance Principles and Recommendations released in March 2014, for application 1 July 2014.

Corporate reporting – critical to good corporate governance

The amendment to Principle 4 reflects the reality that financial reporting is no longer the primary corporate reporting tool underpinning capital market analysis and capital allocation decisions. Reasons for this shift include the following.

- Intellectual capital and other intangibles, not captured on the company balance sheet, have become more important in the measurement of value creation. US research by Ocean Tomo[4] showed that net assets of S&P 500 companies represented only about 19 percent of market capitalisation in 2009 compared to 90 percent in the 1970s.
- Traditional financial reporting is not centred on an entity's strategy and business model, is not forward-looking, and gives only limited attention to intellectual property and other vital intangibles.
- Traditional financial reporting has become unwieldy in terms of volume and complexity.

As a result of the shift, listed public companies no longer seek access to financial markets through disclosure of financial information alone, rather via:

- various voluntary reporting formats, including investor packs, presentations and media releases prepared by internal investor relations professionals
- presenting more informative content in the operating and financial review
- sustainability reporting, considering matters such as the impact of the company's supply chain on long-term value creation
- the use of social media with (or instead of) more traditional reporting channels.

On a global scale, Governments are also considering what this shift means for access to funds, specifically how to meet the growing demand for infrastructure development. It has been estimated by McKinsey and Standard and Poors that US $3.2 trillion will be needed each year for the next fifteen years to fund infrastructure development[5]. However, the shortfall in available funds is significant – estimated at $500 billion annually.

The Business 20 (B20), which brings together business leaders from the G20 countries, in 2013 asked the six largest international accounting networks to analyse the issue and develop practical recommendations that would promote more long-term investment from non-government sources in infrastructure.

Those networks wrote to the B20 in June 2014, recommending that the B20, along with the G20, actively promote corporate reporting innovations and initiatives that provide investors with a longer-term and broader perspective on shareholder value creation to complement the historical financial performance and current financial position perspective provided by financial statements. They noted the particular relevance of integrated reporting, however realised that each G20 nation will need to find their own pathway to adoption of integrated reporting.

Some regulators are already taking action. For example, the UK Financial Reporting Council has established a reporting laboratory where companies can 'experiment' with the structure and content of their corporate reports and seek investor feedback on their usefulness and structure. They also developed a program to encourage and support companies wanting to 'cut clutter' in their annual reports by removing immaterial disclosures and restructuring reports to be more user-friendly. They have also instituted a task force to try to reduce the volume of disclosures required for remuneration reporting.

In Australia a non-mandatory model, based upon the Johannesburg Stock Exchange's 'apply or explain' rule, may work well in the years to come. To this end the Chairman of the Business Reporting Leaders Forum (BRLF) recently recommended to the Federal Government that it form an independent task force to consider how to reduce the volume, complexity and 'red tape' in specific areas of current disclosure to complement other aspects of corporate reporting reform, including consideration of <IR>[6].

Some aspects of corporate reporting other than financial disclosures are already subject to various legislative and regulatory requirements (for example, continuous disclosure and capital raising laws in Australia), but there is no overall framework to underpin or govern the integrity of 'corporate reporting'.

4 Ocean Tomo is a US intellectual capital merchant bank. This research, conducted in 2010, remains relevant today as it looked at trends over the four decades to 2010. It was released via the company's website: www.oceantomo.com/media/newsreleases/Intangible-Asset-Market-Value-Study-Release.

5 McKinsey Global Institute Report - 'Infrastructure productivity: How to save $1 trillion a year', 2013www.mckinsey.com/insights/engineering_construction/infrastructure_productivity

6 Letter available on the BRLF website at www.ske.org.au/BRLF

Actions for Directors in 2014

Boards should reveal the components of their corporate reporting portfolio in their annual Corporate Governance Statement, and explain how directors provide oversight over the integrity of the portfolio.

Directors may use the revision to Principle 4 as an opportunity to consider reducing the volume and complexity in current voluntary, legislated and regulated reporting in 2014, by closely reviewing and reassessing the application of relevant materiality requirements and taking a fresh look at the clarity and flow of existing reports.

The updated ASX CGC Principles also provide listed entities with flexibility to include much of their corporate governance statements on their websites rather than as part of their annual reports. While not diminishing the importance of the annual report in promoting investor confidence, the corporate website can provide more detail on standing data and specific frameworks and charters. It can also be easily updated so that the information it contains is always current.

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An integrated report as the corporate reporting flagship

Corporate reporting continues to lack a widely recognised 'flagship report' based upon a rigorous underlying framework around which all other corporate reporting revolves. <IR> achieves this.

<IR> has gained significant momentum over the last couple of years:

- **International Integrated Reporting Council (IIRC) –** established in 2010 as a global coalition of regulators, investors, companies, standard setters, accounting professionals and non government organisations
- **The International Integrated Reporting Framework (<IR> Framework) –** released in December 2013, was rigorously developed, with over 3 years of multi-stakeholder consultation[7]
- **<IR> works in practice –** IIRC's pilot businesses and South African listed public companies have proven that the <IR> Framework can be successfully introduced and that <IR> yields significant business performance improvements as well as excellent and valued corporate reports.
- **<IR> Framework is fit-for-purpose –** Good progress was made in Australia in 2013 on enhancing OFRs under *ASIC's Regulatory Guide 247 Effective disclosure in an operating and financial review* (RG247) which is consistent in many areas with the <IR> Framework.

An integrated report is a separately identifiable communication, one which may be subsumed into an existing report such as an Operating and Financial Review (OFR) in Australia, or be a standalone report. It does not add another layer of reporting.

The <IR> Framework also makes it clear that there is no requirement to prepare a sustainability report (unless required by law or demanded by key stakeholders).

However, it is important to understand that the integrated report is primarily prepared for investors, and so there may be good reason to also prepare a sustainability report or make data available on the corporate website to satisfy the specific needs of other important stakeholders, such as employees, customers and the broader community.

The changes to the ASX CGC Principles align well with the <IR> approach. A companion paper in this series directed at CFOs outlines in more detail possible pathways for Australia to move from *RG247*-influenced OFRs to OFRs improved with reference to the <IR> Framework, ultimately getting to a position where an integrated report becomes the corporate reporting flagship, redundant reports have been removed, and detailed information in support of the flagship report is housed on corporate websites.

The integrated report will be the initial report for investors, analysts and other key stakeholders to use in understanding the company's view on its value creation story. Investors and analysts will still need all the underlying data (financial and non financial) to input to their enhanced and broad based models, which can be accessed via the corporate website. All of this is achievable by 2017 or earlier.

Resolving the issue of director liability is an essential prerequisite in enabling more forward-looking material[8] to be included in OFRs and encourage the full application of the <IR> Framework.

The recent BRLF Chairman's letter to the Federal Government also asked it to bring company directors and investor groups together so that the Government can legislate an 'honest and reasonable' director defence for individual director liability; and to consider the need for a 'safe harbour' protection for companies using best endeavours to make forward-looking disclosures with adequate and approved cautionary wording[9].

7 The consultation comments of 358 largely supportive global responses were addressed. The April 2013 Consultation Draft did not explain how the experience of the IIRC pilot programme's 100 business, and the impact and feedback from the 35 large investor pilots in 2012 and 2013, were being built into the <IR> Framework. Since April 2013, that body of experience significantly expanded, and will continue to expand. All of these developments are reflected in the <IR> Framework released in December 2013.

8 Forecasts and projections need not be included in the <IR>. Also, there is no requirement to look out 8-10 years in an integrated report. Future-oriented information included in an integrated report can include strategic objectives and strategies to achieve them (including those in place and those intended to be implemented), descriptions of future risks and opportunities, challenges and uncertainties that the organisation is likely to encounter, estimates of the effects of known matters scheduled to occur in the future (e.g. enacted regulations that will be effective in a future period), targets and, although not required by the <IR> Framework, forecasts and projections.

9 Copy of the BRLF letter is available at www.ske.org.au/BRLF

Corporate reporting in Australia beyond 2014

Australia is ready to be a fast follower in adopting <IR>, emulating the positive experiences of South Africa and the IIRC's pilot businesses, and building on the OFR experience under RG247 of 2013 and 2014.

This can be achieved through a market-based (non-mandatory) solution modelled on South Africa's approach of an 'apply or explain' provision under a Johannesburg Stock Exchange (JSE) listing rule.

The JSE Rule embeds that country's King Code of Corporate Governance in its listing rules, and requires listed companies to explain whether they have prepared an integrated report, and if not, why not[10]. Three years in, South African listed companies almost universally prepare integrated reports. Most do so enthusiastically. South African listed companies have been joined in preparing integrated reports by many private and public sector entities.

The Australian corporate governance framework is structurally similar to South Africa's, and is ideally suited to the South African 'if not, why not?' approach.

There is growing demand for <IR> as evidence builds of its ability to provide better information (information that is strategic, balanced, forward-looking, concise and focused on material value drivers and risks) needed by investors to assess stewardship, as well as make more precise and forward-looking capital allocation decisions based on better analysis of estimated future risk-adjusted cash flows.

- Management and the boards of the IIRC's pilot businesses are driving <IR> because of the business performance improvements that adopting it brings. One of the most mentioned benefits of <IR> is the opportunity it provides to connect teams from across an organisation, breaking down silos and leading to more integrated thinking[11].
- Investors in the IIRC's investor network have reported that the reports they reviewed have communicated a more holistic view of performance than is otherwise found in traditional financial reports. These reports are providing greater insight into areas such as business model, strategy, risk, governance and the future outlook. Investors feel that the integrated reports provide a contextual foundation for interpretation and analysis[12].
- Investors in South Africa are requiring deeper and broader assurance of integrated reports given the usefulness of the content for their decision-making needs. They are asking for assurance so that they can be more confident about the integrity of the useful information contained in the integrated report.

10 The King Code of Corporate Governance in South Africa has evolved from its origins some 20 years ago to a code which is recognised as world's best practice. For the last 10 years, The King Code has focused on corporate reporting as a primary tool of good corporate governance. The King Code's founder, Professor Mervyn King, was the first chairman of both the Integrated Reporting Committee of South Africa and the International Integrated Reporting Council. Integrated reporting is now a primary tool of good corporate governance in South Africa, and the IIRC's integrated reporting pilots are having similar experiences.

11 Refer to the IIRC's *Understanding Transformation: Building the Business Case for Integrated Reporting*, which tracks the behavioural changes of businesses on their journey towards Integrated Reporting during the first year of the IIRC's Pilot Programme. http://www.theiirc.org/resources-2/other-publications/building-the-business-case-for-integrated-reporting/. Other benefits include improved internal processes; better understanding of organisational activities is enabling a more holistic business model and more streamlined communications; increased interest and engagement of senior management in long-term business sustainability issues and better measurement of value to stakeholders of managing and reporting on broader issues.

12 Refer to the IIRC's Pilot Programme Investor Critique 2013 - http://www.theiirc.org/wp-content/uploads/2013/10/IIRC-Pilot-Programme-Investor-Critique-2013.pdf

Incorporation of <IR> into ASX CGC Principles

While some momentum in investor demand for <IR> has begun to build, the level which would be required for the ASX Corporate Governance Council (ASX CGC) to adopt a more formal path to ‘if not, why not?’ adoption of <IR> has not yet been reached.

With the IIRC having a key strategic goal of building investor demand in 2014, this momentum could build quite quickly.

If director liability issues can be resolved, the overall quality of <IR> continues to improve, and investor demand gathers momentum, there may be the required public groundswell that the ASX CGC can use as the litmus test for change to the ASX CGC Principles for the 2016 financial year.

<IR> could then be explicitly positioned and endorsed in the ASX CGC Principles, demonstrating that the ASX CGC Principles can continue the shift away from a focus on financial reporting as the primary instrument of corporate reporting to one more focused on <IR> supported by detailed analysis provided on corporate websites.

The adoption of <IR> should not be mandatory or immediate. One possible pathway for adoption is for the ASX CGC Principles to introduce <IR> in two phases, with progress to phase two dependent on success of the first phase.

- Companies would consider establishing a plan to introduce the <IR> Framework from 1 July 2015 and report on whether such a plan had been established on an ‘if not, why not?’ basis in their annual reports for years ending on or after 30 June 2016.
- Companies would consider the <IR> Framework in preparing their corporate reports for years beginning on or after 1 July 2016, again reporting on an ‘if not, why not?’ basis in their annual reports for years ending on or after 30 June 2017.

Assurance of an integrated report

In South Africa and among the IIRC's pilot organisations, directors are asking for assurance on integrated reports to enhance the credibility of information being provided to investors for decision making. This is resulting in a 'best fit' assurance approach for integrated reports being developed using current standards and via market practice.

It is likely that some form of assurance on integrated reports, including both limited and reasonable assurance, will shortly be the norm in some jurisdictions. This will be achieved based on the work currently underway within the <IR> innovator and early adopter community, and the IIRC working with the International Auditing & Assurance Standards Board on how to bring <IR> assurance within the international auditing and assurance standards framework.

Given the 2014 change to Principle 4 of ASX CGC Principles to include all 'corporate reporting' within its coverage, guidance will be needed to help directors assess the level of assurance required over corporate reports that capital markets will trust. Meanwhile work continues at the international level on an integrated report assurance framework.

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