

Corporate governance

Reporting review

June 2007

Grant Thornton 



Welcome to our inaugural review of corporate governance disclosure by the ASX 300. From review of the disclosures made in their 2006 annual reports*, two hundred and ninety two companies have been assessed against the terms of the ASX Corporate Governance Council's Principles of Good Corporate Governance and Best Practice Recommendations (the Principles) and associated guidance in order to profile disclosure practices and trends.

Shirley Liew
Head of Business Risk Services
Grant Thornton Sydney

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*Reports reviewed included those for financial year ending either 30 June 2006 or 31 December 2006 for the majority of companies.

Overview

Our review confirms a continuing improvement in governance disclosure but also throws out a challenge to all directors of Australian public listed companies to embrace the true spirit of the Principles (which form part of the ASX Listing Rules) by providing more disclosure details rather than the adopting boilerplate disclosures, and furthermore to the non-executive directors to champion compliance by challenging any proposed departures as to whether they are truly in the interests of their stakeholders.



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Review findings

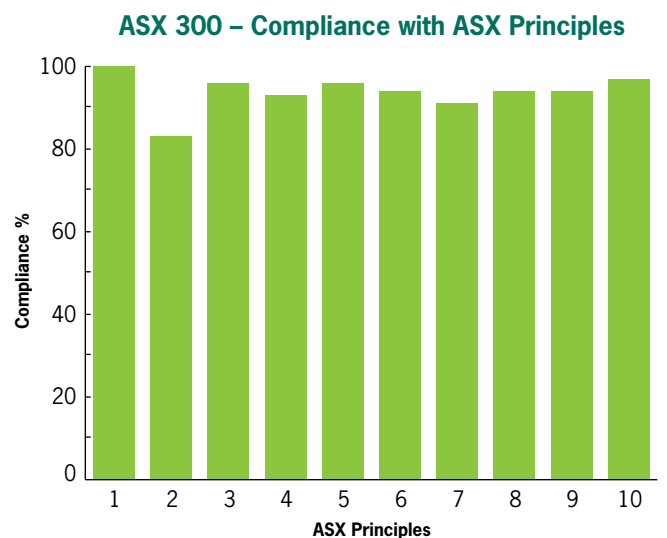
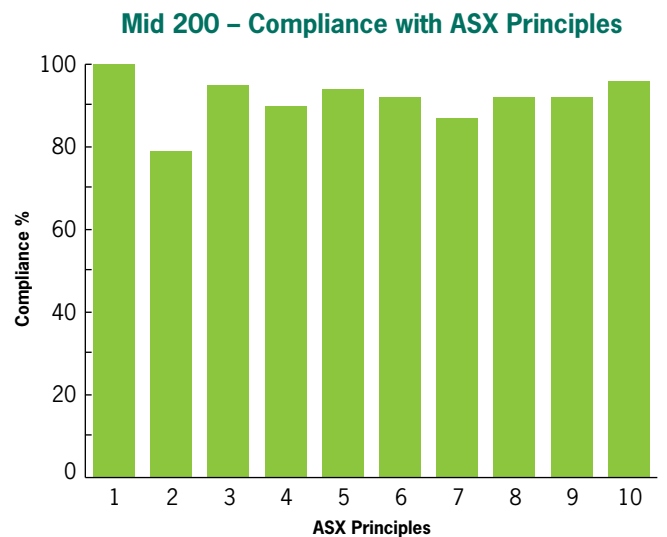
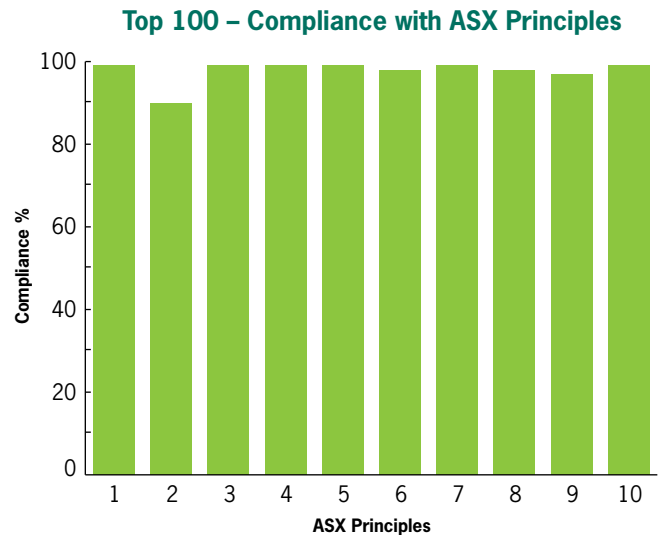
Our 2007 review, whilst confirming that Corporate Australia is in good shape, indicates there are still challenges ahead for Australia's larger public listed companies in complying with the Principles.

Looking more closely at the results, in particular, areas which allow for judgement and discretion, as opposed to a straight "yes" or "no" answer, we noted that not many companies voluntarily provide additional disclosure.

Survey results

We noted that overall, Australian publicly listed companies in the top 300 have disclosed that they are largely compliant with the ASX Principles of Good Corporate Governance and Best Practice Recommendations.

Principle	Topic
Principle 1	Lay solid foundations for management and oversight
Principle 2	Structure the board to add value
Principle 3	Promote ethical and responsible decision making
Principle 4	Safeguard integrity in financial reporting
Principle 5	Make timely and balanced disclosure
Principle 6	Respect the rights of shareholders
Principle 7	Recognise and manage risk
Principle 8	Encourage enhanced performance
Principle 9	Remunerate fairly and responsibly
Principle 10	Recognise the legitimate interest of stakeholders



Comparing the summary results against the 10 main principles we noted the following:

Principle 1 had the highest average score of 99% for the ASX top 100. Principle 2 had the lowest average score of 79% for the ASX 200 to 300 (Mid 200).

Our review identified that only 134 companies or 45% of the top 300 companies provided adequate disclosure to be considered fully compliant.

As expected, the ASX top 100 are the highest scoring overall. However, it is surprising to note that for Principles 4 and 7, the results were not 100% (as the establishment of an audit committee is a recommendation of the ASX Listing Principles), with the ASX top 100 scoring an average of 99% compliance on both principles.

It is also interesting to note especially for Principle 7.3 – Make public the information risk management policy and internal compliance control system – that based on disclosures, only 83 -88% of the mid 200 were compliant.

Disclosures provided by the companies indicated full marks or near full marks in the following:

- Recognising and publishing the respective roles and responsibilities of board and management (100%)
- Establishing a code of conduct for directors and key executives (97%)
- Establishing written policies and procedures to ensure compliance with ASX listing rule disclosure requirements (97%)
- Designing and disclosing a communications strategy with shareholders (97%)
- Providing disclosure in respect of the company’s remuneration policy (99%)
- Establishing a corporate code of conduct (97%).

Whilst this level of compliance is comforting, it is still surprising to note that full compliance has not been achieved in the establishment of audit committees with the composition, operation and responsibility as prescribed by Principles 4.2, 4.3 and 4.4 and ASX Listing Rule 12.7.

If not, why not – a matter of convenience or better for the stakeholder?

The Principles refer to “if not, why not” in regards to compliance with the Principles. This is referred to in the preamble to the Principles. While the emphasis is on complying, or complying most of the time and departing only if it can be justified with considered explanations, it is surprising to note that based on our review, 55% of companies chose to depart from the recommended Principles.

Pushing full compliance

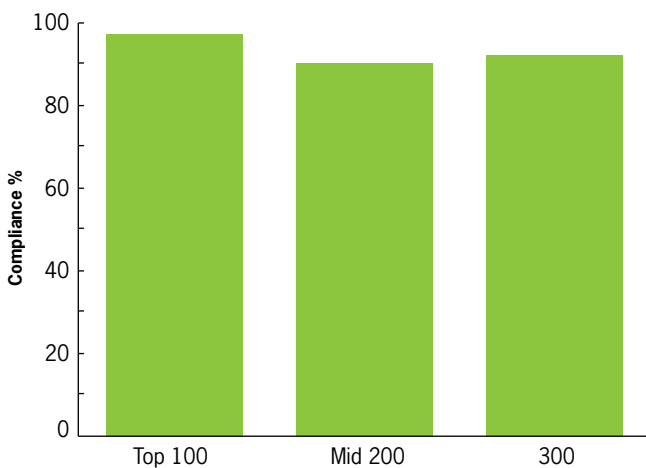
Looking more closely at those areas which allow for judgement and discretion as opposed to a straight forward yes or no, we noted that the number of companies providing additional informative voluntary disclosures, especially among the Mid 200, could be improved. This is particularly the case in the areas of risk and internal controls (Principle 7), where we noted few companies going the extra mile with detailed disclosures. While there is a high incidence of companies providing details of their non-compliance, it also raises the question of whether companies are hiding behind the “comply or explain” option. The risk is for Australian publicly listed companies to become complacent, choosing minimum disclosure rather than truly demonstrating commitment to the ASX Principles of Corporate Governance, as such an approach would potentially lead to a more prescriptive regime.

Overall there are three key principles scoring less than an average of 90% compliance, namely; Principles 2, 4 and 7. These three Principles and issues arising from them are discussed in detail on the following pages.

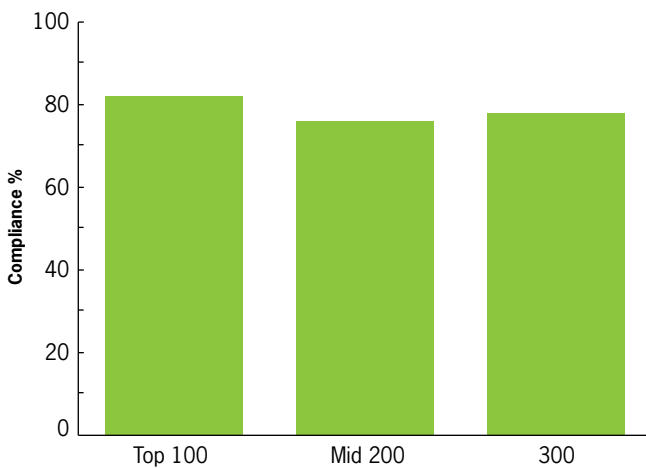
Principle 2: Structure the board to add value

The aim of Principle 2 is to ensure the effectiveness of the board via achieving independence and accountability.

Principle 2.3 – The roles of Chairperson and Chief Executive Officer should not be exercised by the same individual



Principle 2.1 – A majority of the board should be independent directors

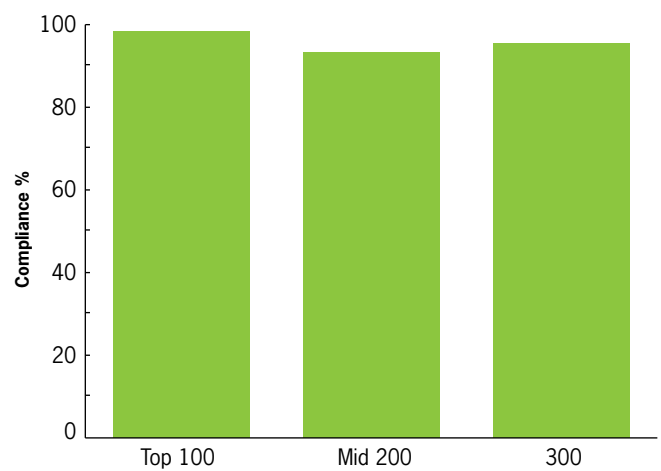


- Of all the companies reviewed, 7% or 20 companies indicated that the role of Chairman and CEO were exercised by the same individual (Principle 2.3)
- 22% of all companies surveyed have a non-compliant board structure, where the independent directors do not form a majority of the board (Principle 2.1)

Role of the committees

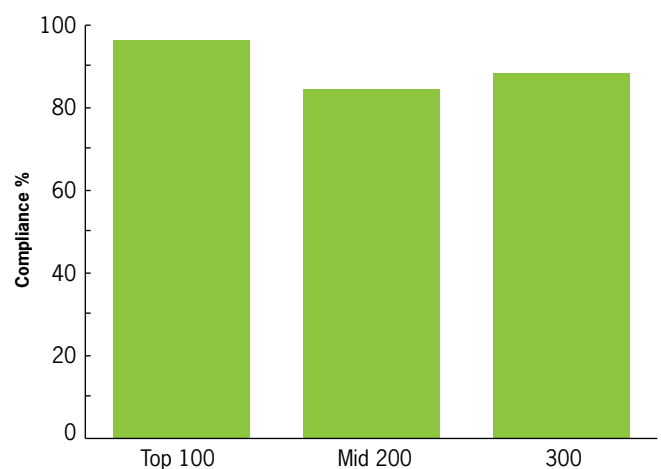
Also related to structuring the board to add value is the role of committees. This is dealt with by Principles 4.2, 4.3, 2.4 and 9.2.

Principle 4.2 – The board should establish an audit committee



Principle 4.3 – The structure of audit committee should consist of:

- Only non-executive directors
- A majority of independent directors
- An independent chairperson, who is not chairperson of the board
- At least three members

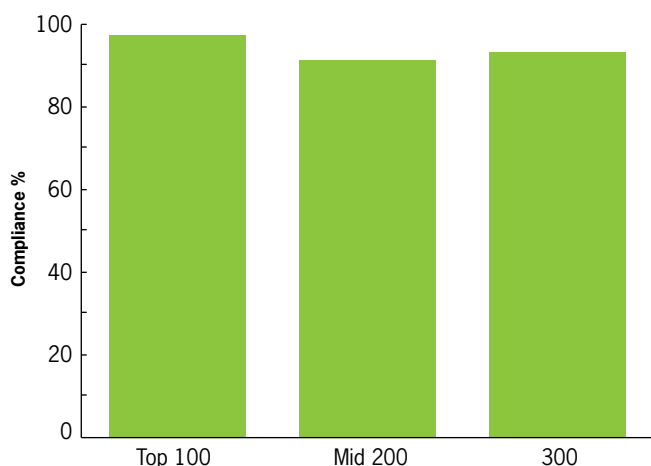


- Based on our results, 96% of companies claim establishment of an audit committee (Principle 4.2) and only 89% claim compliance with the prescribed composition (Principle 4.3).

Principle 2.4 – The board should establish a nomination committee



Principle 9.2 – The board should establish a remuneration committee



- Based on the disclosures in their annual reports, 83% of nomination committees (Principle 2.4) and 94% of remuneration committees (Principle 9.2), are in line with the Principles.

Some companies provide additional disclosure regarding the members of the audit committee who have financial experience.

Given the increasingly challenging environment of heightened regulatory and shareholder scrutiny as well as increasingly complex responsibilities within which audit committees have worked over the past several years, few have provided illuminating and enhanced disclosures around oversight practices and processes or allocation of audit committee resources around compliance focus versus strategic/risk management focus.

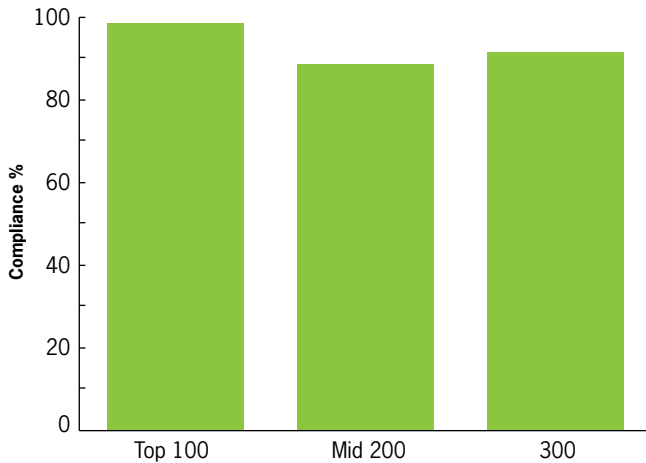
Where disclosures of independence of directors is required, good disclosure practices would have seen greater disclosures of how structure of the board, if not fully compliant, achieves effectiveness and attains capacity to exercise judgement independent of management. The relationships are initial indicators of matters that could affect independent decision making. Disclosure of “relationships affecting independent status” would be useful to assist boards when assessing a director’s independence as would disclosure of frameworks used for reasoning about a determination of independence. Other useful disclosures that might provide greater clarity on board experience, independence and capability include length of service on board where companies do not have a nomination committee, as well as description of how the company carries out the functions of a nomination committee.

In relation to board performance, we noted that a majority of the companies surveyed did not provide any illuminating details as to the criteria, the frequency of review nor the overall performance review during the reporting period and how it was conducted. However most common criteria cited included number of board meetings held, meetings attended, size of the board and experience of various board members.

Principle 4: Safeguard integrity of financial reporting

Principle 4 relates to ensuring the integrity of financial statements and internal control reporting.

Principle 4.1 – Require the Chief Executive Officer (or equivalent) and the Chief Financial Officer (or equivalent) to state in writing to the board that the company's financial reports present a true and fair view, in all material respects, of the company's financial condition and operation results and are in accordance with the relevant accounting standards.



While 92% of the companies reviewed provided disclosure against Principle 4.1, regarding the integrity of financial statements, only 89% indicated that the results were based on a sound system of risk management and internal compliance and control. A few companies provided additional disclosure regarding their internal audit functions, and where these services were outsourced, provided details of the internal audit provider.

Few noted that it is the board's responsibility for establishing the company policy on risk and developing the system of risk management and internal control. However, most companies did not provide details of the existence of an internal audit function, description of companies' policies on risk management and internal control.

Principle 7: Recognise and manage risk

We noted few companies make explicit statements of their risk management practices in their annual report. It is therefore difficult to gauge what framework is in place to guide processes or what measures are in place.

Few, if any, describe information on what systems are in place to enable effective reporting about risk management and internal control systems. Little information is available on what has been put in place to identify any material deficiencies in systems - in particular, how risks are identified, monitored, measured and managed. Nor is it clear how procedures are developed and implemented to ensure that risk management systems are working and to make decisions about how they are reported and whether these reports are audited or reviewed.

These risks can ultimately have a direct or indirect financial impact and must be included even in a financially-focused approach to risk management.

Financial reporting risks potentially create a false degree of security as it ignores the potential financial impact on non-financial reporting risks.

Disclosure provided little insight as to the framework adopted by various companies to determine what risks are "material" for companies of similar type and size and how they should be taken into account in the process of sign-off for risk oversight and for determining the company's risk profile.

Identification of "material business risks" extends beyond financial risks which in itself should extend beyond the risk of a material error in the financial statements.

Other risks include operational, environmental, sustainability, compliance, strategic or external, ethical conduct, reputation or brand, technological, product or service quality and human capital. All of these have the potential to impact on a company if not properly managed.

Principle 10: Recognise the legitimate interest of stakeholders

Matt Adam-Smith: National Service
Line Leader – Assurance Services

Principle 10.1 – Establish and disclose a code of conduct to guide compliance with legal and other obligations to legitimate shareholders.



Corporate responsibility

A large number of companies disclosed the existence of processes related to social responsibility reporting. Whilst these are not included in the Principles, it was interesting to note that many companies provided additional disclosures in this area. Independent verification of these results may become an increasing area of focus with corporate responsibility moving from a “nice to do”, to having a significant commercial impact.

Conclusion

Corporate governance continues to garner support from corporate champions around the world. Our review identified that Australia’s corporate governance practices are in line with or better than those in the UK and Hong Kong (compared due to their similar risk-based approach to Australia’s, which differs from the US with its rules-based regime – see “Review findings in context” section). This assessment is based on disclosed compliance with the ASX Principles of Good Corporate Governance and Better Practice. However, there are still a number of areas that require improvement and Australian directors would be wise to pay more attention to improving corporate governance practices within their companies.



Commentary on review findings

Departure from the Principles and associated disclosure

The ASX Principles apply the “if not, why not” approach. ASX Listing Rule 4.10 prescribes that companies are required to provide a statement in their annual report disclosing the extent to which they have followed these best practice recommendations in the reporting period. Where companies have not followed all the recommendations, they must identify the recommendations that have not been followed and give reasons for not following them. An exception regarding audit committees applies to companies comprising the S&P/ASX All Ordinaries Index – the ASX Listing Rules mandate the establishment of audit committees by those companies, and require that the composition, operation and responsibility of the audit committee comply with the Council’s best practice recommendation.

As they are guidelines rather than prescriptions, common perception is that the Principles do not have to be rigorously applied, that “comply or explain” are equal options and if a company considers that a recommendation is inappropriate to its particular circumstances, it has the flexibility not to adopt it. Whilst the Listing Rules do give the option, the emphasis of the Principles is very much on compliance. With a large majority of companies feeling they can justify departure from the Principles, perhaps choosing “departure” has become simply too easy. With nearly all companies surveyed providing disclosures regarding compliance (or not) with the Principles, while providing the bare minimum of disclosure information in their annual reports, the burning issue is the extent of disclosure: How much is enough?

Overall issues of convergence

This year’s review highlights the generally high standards of governance practised by Australian listed companies.

In applying the Principles, those charged with corporate governance should look at multi jurisdictional and a harmonised approach. The key is to understanding what stakeholders require and how the board of governance can apply a pragmatic approach to a principles-based approach.

Should directors be worried about the legislative creep, or is it inevitable that the market will, over time, seek to reach a harmonised global approach towards governance practices?

The key is to understand what stakeholders want, which should ultimately be no different from the direction given by the Principles. That is:

- a consistent, reliable, honest, comparable accounting and reporting, coupled with low investment costs and easy access to capital
- effective disclosures relates to the quality of information rather than quantity which takes into account the broad range of stakeholders, particularly in the context of risk management
- audit and risk management oversight function which effectively discharges areas of oversight in relation to accounting estimates and judgement
- risk management based on clearly defined risk management framework and which leverages breadth and depth of experience of board members
- system of board performance and review.

The underlying issue here is quality of disclosure rather than quantity. Effective corporate governance **disclosure needs to take a broad range of stakeholders** into account, particularly in the context of risk management. Accordingly, company size should not be used as an excuse. All companies, regardless of size or industry, that have made the decision to raise capital from the public, should provide investors with sufficient disclosure to enable them to assess the quality of the corporate governance policies and processes in place for companies in which they invest.

The challenge

The findings of this review and the issues identified throw down a challenge to those charged with governance to truly embrace the spirit of the Principles and so ensure the future of a principles based approach. Ultimately, it is the degree to which Australian listed companies choose to apply the Principles which will determine the future of our governance practices.

Review findings in context

The Australian corporate governance landscape

As Australian companies seek to compete globally, and maintain and promote investor confidence in Australia and overseas, demonstrated good corporate governance practices are becoming increasingly important. These are especially important in determining the cost of capital in a global market.

The Principles were published in 2003, and have been instrumental in sculpting and improving the corporate governance landscape in Australia.

Proposed changes

The ASX Corporate Governance Council announced a new timetable for the implementation of the revised Principles of Good Corporate Governance and Best Practice Recommendations (the ‘Principles’). The council has decided that the start date for the revised Principles will now be 1 January 2008. It is expected that the finalised Principles will be released to the market by the end of June 2007. This comes after two years of monitoring by the ASX of company disclosures of corporate governance practices in annual reports.

It is interesting to note that amongst the proposed changes, there is particular emphasis made to Principle 2: Structure the board to add value. Most notable changes proposed are as follows:

- Amending the definition of ‘independence’ (Principle 2) to list a series of ‘indicators of independence’
- Widening Principle 3 to cover all company codes of conduct and their content and disclosure
- Clarifying the nature of risk management and risk management processes (Principle 7)
- Removing areas of regulatory overlap in relation to sign-off on financial statements, disclosure of remuneration policies and attendance by an external auditor at Annual General Meetings



- Recommending that the hedging of unvested options be prohibited
- Replacing the term ‘best practice’ with ‘good practice’.

The proposal also formalises the need for companies to:

- issue written statement to the board from the CEO or equivalent and other responsible senior executives confirming the effectiveness in all material respects of the risk management and internal control system in relation to “material business risks” not covered by Recommendation 7.2
- issue a governance statement, to indicate whether or not they have complied with a code of governance
- disclose information about control and risk management systems and to appoint an audit committee.

Further, the proposal provides a recommendation for risk management sign-off in the form of a written statement to the board from the CEO or equivalent and other responsible senior executives confirming the effectiveness in all material respects of the risk management and internal control system in relation to “material business risks”.

On the issue of corporate responsibility/sustainability, there has also been recommendations for the disclosure of corporate responsibility/sustainability risks that are material business (non-financial) risks.

As per Eric Mayne, Chair of the Council and Chief Supervision Officer of ASX Markets Supervision, “Corporate governance is an evolving debate. The proposed changes to the Principles and Recommendations continue to emphasise providing a flexible, practical and non-prescriptive corporate governance framework for the Australian market. The ‘if not, why not?’ approach remains central to the Council’s philosophy and the Principles continue to be supported by the ASX Listing Rules.

“Market disclosure remains the cornerstone. The more transparent listed companies are about their corporate governance practices, the better placed investors will be to make informed investment decisions”.

Problems inherent with size of organisation

There is a wide variety of listed entities to which the Principles and recommendations apply, and they need to assist all listed entities. Companies have differing levels of resources available, are at different stages of development and need different levels of assistance. The inherent flexibility of the “if not, why not?” approach allows companies which consider the Principles and recommendations too detailed, not to follow them, provided they explain why. A detailed approach, as in the current and proposed Principles and recommendations allows smaller companies to understand the reasons for the recommendations so that they can better illustrate any alternative method of achieving good corporate governance. Recommendations encourage these companies to adopt alternative approaches to those detailed in the Principles and recommendations and to disclose the level of detail appropriate to their circumstances.

Review findings in context

Insights from overseas jurisdictions and the trend towards a risk-based approach to corporate governance

US

In the US, there has been a growing clamour to apply a more risk based approach to corporate governance and Sarbanes-Oxley (SOX) compliance partly driven by inflated implementation costs - particularly with regard to Section 404, but also due to growing concern at the flight of registrants away from the US exchanges. Conservative interpretations of the requirements of Section 404 and the available guidance have driven additional cost into compliance regimes of main companies. This has albeit somewhat belatedly, now been recognised by the regulators.

The US Securities and Exchange Commission (SEC) is currently looking to reduce the costs of assessing and auditing internal controls while still achieving the intended benefits. To that end, both the Public Company Oversight Board (PCAOB) and the SEC are devising revised guidelines to assist management and auditors in this regard. US Vice President Dick Cheney, speaking recently about SOX, hinted it is highly likely that Congress will have to intervene to implement some level of exemption from Section 404 at such a possibility.

UK and Europe

During the last 12 months, the corporate governance landscape has evolved in the UK, and throughout Europe.

In the UK, Douglas Flint's review focused on refreshing the Turnbull guidance on internal control, and there was some fine tuning of the Code as a result of a refresh exercise by the Financial Reporting Council (FRC). There were also a number of amendments to the Companies Act, notably the consideration around the Operating and Financial Review (OFR).

The ISS Global Institutional Investor Study found that 78% of European institutional investors surveyed believe corporate governance will become "significantly or somewhat more important over the next three years" in Europe.

Asia Pacific

China, Hong Kong and Singapore are the three Asian financial markets that have also made changes to corporate governance regulations.

Regulatory authorities in Hong Kong decided to adopt the "comply or explain" based approach (as used in the UK Combined Code and the ASX Principles) rather than a rules based approach (such as SOX in the US).

Singapore has also adopted a similar revised code with a "comply or explain" approach.

In mainland China, however, the format of rules is different. There are two main sources of documents that listed companies must read and follow. They are:

- Shanghai and Shenzhen Stock Exchanges Listing Rules – Guidelines on Internal Control Requirements. Effective 1 July 2006, companies are required to disclose the result of their internal control review in their annual report and this must also be audited
- The China Securities Law (2005) and China Companies Law (2005) sets out the statutory requirements for listed companies to comply with (i.e. board composition, appointment, roles and responsibilities and termination) effective from 1 January 2006.

Appendix

Summary table of review statistical findings

Principles	% of compliance													
	1.1	2.1	2.2	2.3	2.4	2.5	3.1	3.2	3.3	4.1	4.2	4.3	4.4	4.5
Top 100	99%	82%	86%	98%	92%	92%	99%	99%	99%	99%	99%	97%	99%	99%
Mid 200	100%	76%	75%	91%	78%	76%	96%	94%	94%	89%	94%	85%	93%	92%
300	100%	78%	78%	93%	83%	82%	97%	96%	96%	92%	96%	89%	95%	94%

Principles	5.1	5.2	6.1	6.2	7.1	7.2	7.3	8.1	9.1	9.2	9.3	9.4	9.5	10.1
	Top 100	99%	99%	98%	99%	99%	98%	99%	98%	99%	98%	99%	95%	95%
Mid 200	95%	92%	96%	87%	94%	85%	83%	92%	98%	92%	88%	91%	89%	96%
300	97%	95%	97%	91%	96%	89%	88%	94%	99%	94%	92%	92%	91%	97%

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