AUSTRALIAN INSTITUTE *of* COMPANY DIRECTORS

Essential Director Update:16

Your duties. Your update.

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Published in September 2016

Welcome message from John Brogden AM FAICD

The Essential Director Update is one of the Australian Institute of Company Directors' (AICD) most valued member services. Attended by more than 5,000 members across Australia each year, it is our largest event series, designed to provide our members with the latest updates in the Australian and international governance environment. The events are delivered in capital cities and regional centres around the country.

2016 marks our 10th year holding this event. To mark this milestone, we are delighted that the keynote address will be delivered by leading director Graham Bradley AM FAICD. If you are attending the Essential Director Update for the first time, you will discover a session that provides valuable insight into recent legal and regulatory developments, as well as other contemporary practice issues across the director and governance landscape.

The Essential Director Update Handbook builds on the topics covered in the live events and webinar. This year the document has a specialist approach, drawing on your peers to contribute individual articles from their areas of expertise.

I hope you enjoy the 2016 Essential Director Update and take away insights that can be practically applied to your role and governance practices.

John Brogden AM FAICD
Managing Director & Chief Executive Officer
Australian Institute of Company Directors

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1.0 THE BUSINESS ENVIRONMENT

1.1 Technology

1.1.1 Embracing exponential technologies

Technology has become indivisible from how people, enterprises and governments operate. The accelerating rate of change – also known as exponential technologies – has profound implications for every aspect of governance: products and services, employees and customers, business models, stakeholders and regulation. To govern effectively, it is critical for boards to understand these exponential changes.

Effective boards contribute in an informed way to discussions on business strategy and performance. Directors must educate themselves, but not just about inevitable technology-related discussions. Exponential changes and the disruption they can cause affect risk profiles, investment priorities and competitive analysis. It is not appropriate to rely solely on external expertise specialists or management, or even a fellow director who has technology expertise, any more than such reliance would be for financial matters.

Technology is changing exponentially and in an interconnected, complex way. It impacts the customer experience, supply chain, business model and competitive landscape and so directors need to be across these interactions that are at the core of any business.

“Effective boards contribute in an informed way to discussions on business strategy and performance.”

Some of the current technology trends and future business models that informed boards are discussing include:

- the explosion of sensor technology and the internet of things: for example, drones, satellites, home objects;
- big data and real-time data with mobile access quickly out-pacing privacy implications: for example, wearables[1] in health insurance, delivering contextual information for customers, online advice and rating of health providers[2];
- platform businesses that bring together producers and consumers transforming competition and the traditional legal framework of operation: for example, Uber and Airbnb;
- cognitive computing and artificial intelligence: for example, IBM Watson;
- automation and robotics: for example, autonomous cars changing insurance, public health and road infrastructure;
- cybersecurity and future crimes: for example, the shift

[1] Wearables like Fitbit are launching platforms based on the health data that is captured.

[2] See www.whitecoat.com.au

to adaptation not prevention in cyber risk as hacks become a daily occurrence for business;

- energy sustainability and the impact on both those who use power and those involved with traditional power generation: for example, the Tesla Powerwall battery for storage and distributed infrastructure for solar energy production.

Every industry is different and technology will likely have varying implications. Blockchain[3], peer-to-peer lending and new payment systems[4] are changing the banking industry. 3D printing is shifting manufacturing and health sectors.[5] Sensors and real time data are changing insurance.

Ongoing professional development in this arena is essential to inform strategy development, the assessment of business performance and the oversight of risk. Curiosity and an appetite to learn are critical, as are opportunities to understand the underlying trends, trajectories and implications of exponential technologies.

Some other practical approaches include:

- looking at other industries, markets and immersion opportunities: for example, the Australian Israel Chamber of Commerce trade missions, or the factory and site tours conducted by Tesla and Google in the US to demonstrate their use of robots and data;
- following local innovation hubs, accelerators and initiatives;[6]
- accessing technology focused education programs;
- tapping into expertise on cybercrime;[7]
- Australia's digital and data innovation groups: for example, CSIRO Data61;
- staying abreast of government sponsored initiatives and regulatory guidance.[8]

Given the increasingly all pervasive impact of technology, it is incumbent on all directors to be informed.

Christine McLoughlin FAICD, Non-Executive Director Suncorp Group Limited, nib holdings limited, Whitehaven Coal Limited, Spark Infrastructure Limited and ANZ Stadium.

1.1.2 Digital disruption and the 'fourth industrial revolution'

Taking a futurist perspective, today's rapid convergence of digital, biological and physical technologies heralds the beginning of an economic and social revolution, which will fundamentally alter the way we live, work, and relate to one another.

This transformation is just starting to emerge, and there is strong evidence that it will alter the way that we create, exchange and distribute value on a scale comparable to the previous three major industrial revolutions: the first factories, automated machinery, widespread use of fossil fuels between 1750-1950; the rise of electrical systems, the telephone, mass manufacturing, the automobile and much more between 1870-1914; and the advent of digital computing, mobile digital communications, space-based technologies and so on since 1960.

The emerging transformation is labelled the fourth industrial revolution, and it is being driven by technologies which treat digital connectivity and processing capabilities as an essential infrastructure, in the same way that the digital revolution relies on pre-existing electricity and telecommunication systems. Examples include neuro-technologies, additive manufacturing, artificial intelligence, cryptography, advanced materials, and biotechnologies.

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[3] The Australian Digital Currency and Commerce Association runs blockchain bootcamps.
[4] See www.australianpaymentscouncil.com.au
[5] See enablingthefuture.org
[6] See stoneandchalk.com.au, and ASIC's innovation hub and regulatory sandbox for Australian financial technology (fintech) startups.
[7] See http://www.marcgoodman.net/, and pwc's *Game of threats – A cyber threat simulation.*
[8] ASIC, *Cyber resilience: Health check,* Report 429, March 2015, http://asic.gov.au/regulatory-resources/find-a-document/reports/rep-429-cyber-resilience-health-check/

The revolutionary aspect of these technologies exceeds their new, powerful capabilities – such as the ability to interpret brain signals, create rapid prototypes or edit genomes. It is the expected speed, scale and influence of their diffusion across industries and social groups that will disrupt existing systems of transport, communication, agriculture, production, security and governance. This will impact our social and economic relationships and even our sense of what it means to be human.

Much of the discussion to date has been polarised around fears related to employment or promises that new technologies represent a panacea for current economic woes. We should be optimistic that new technologies will provide new opportunities, however this optimism must be matched with thoughtful action by directors – indeed by all stakeholders – to embed positive values in technological systems, support innovative regulatory systems and ensure both the benefits and costs of the fourth industrial revolution are shared fairly.

Nicholas Davis, Head of Society and Innovation, Member of the Executive Committee, World Economic Forum.

"The emerging transformation is…being driven by technologies which treat digital connectivity and processing capabilities as an essential infrastructure"

1.1.3 Virtual reality (VR) technologies

Virtual reality (VR) technologies use interactive computer graphics to create the perception that the user has been transported into a world entirely created from digital media. This year the release of high-end consumer VR headsets (such as the HTC Vive and the Oculus Rift) and Mobile VR techniques (like Google Cardboard of Samsung's Gear VR) means that millions of smartphone owners can now download VR apps.

A similar cost/fidelity spectrum exists within augmented reality (AR) technologies. A modern smartphone can be used as a 'magic window' through which to observe virtual data overlayed on the physical world and soon high-end AR headsets like the Microsoft HoloLens, Meta and Google-backed Magic Leap are expected to be released.

Deloitte's tech report has highlighted this as a significant technology trend for 2016 and the current surge of consumer VR and AR devices means that techniques and technologies previously only installed in specialist facilities can now benefit millions of people. In fact, over the past 20 years, VR and AR technologies have been used to help surgeons train apprentices, allow expert technicians to remotely guide maintenance workers through a repair task and even tele-operate mining robots. These technologies are now starting to explode into education, tourism, e-commerce, architecture, design, enterprise, entertainment, art and even journalism.

While VR represents the next step in the ability to share experiences, AR has the potential to be the next big shift in personal and mobile computing. To achieve that, AR will often require sensors like cameras and microphones to be 'always on', constantly gathering data and, like an attentive butler, responding to requests. The Pokémon Go phenomenon, for example, has clearly shown that AR and other gameplay incentives can bring a brand to the forefront of people's minds and entice them to give up personal location information as long as they do not feel like they are being exploited.

AR devices and displays will increasingly need to gather context information about the places, things and people that form part of daily life. Whether the processing of this information takes place in the cloud, or on the device, the systems will need to pay careful attention to the way this sensitive data is captured, presented, secured, shared or kept private.[9]

Consideration should also be given to the types of applications built using AR:

- The enhanced realism of virtual interactions can lead to heightened physiological and emotional states (which can be desirable or undesirable). For AR computing to be used in social settings, appropriate consents may be required.
- Within the enterprise, physical designs and documents may be captured and even sent to the cloud for optical recognition processing, without explicit action by the user.
- Apps (like CluckAR from CHOICE[10]) can provide consumers with a great deal more information about production or competitors that a business may have assumed.

Matt Adcock is a Senior Research Engineer in CSIRO Data61's quantitative imaging team.

Gavin Walker is a Principal Experimental Scientist at CSIRO Data61.

1.1.4 Advanced machine learning

Advanced machine learning (AML) gives computers the ability to discover patterns and insights from data using sophisticated algorithms. AML is now gaining significant market traction - for example in organisations such as Amazon - because of advances in data storage (more affordable disks) and improved algorithms (better insights).

Data, not big data:
Data does not have to be big and much can be done with small amounts of data that can fit on a $10 memory stick.

Hype:
AML is a powerful technology but it is not a panacea. Despite this, the hype means there is an intense war for talent in AML and organisations can expect to pay a premium for talent.

Opportunities:
Like any new technology, AML can change the rules of the game. Smart organisations should look for opportunities to be the lateral aggressor: for example, a business does not need to be traditionally working in the agriculture sector to disrupt agriculture.

Not a single thing:
AML is not a single technology but a portfolio. It is a 'general purpose technology' similar to railways, the steam engine or electricity, and will underpin future economic growth. Initially, AML was used commercially to detect email spam or credit card fraud, and to create recommendation engines. Now, every sector is expected to be impacted.

New business models:
New ownership and business models will be enabled by AML embedded technologies, with profound implications not only for strategy but also for the structures of companies and industries.

Challenges and risks:
An abundance of data does not make conclusions certain. Scientists have worked with large datasets for years, but can still err in the decision-making process. Many vendors offer enticing turnkey solutions, but a major challenge is the lock-in this can engender. Seeking solutions that are interoperable is a good risk mitigation strategy. Making an organisation more dependent on data implies it needs to put data onto its balance sheet and manage it like any other asset.

Chelle Nic Raghnaill and **Bob Williamson**, Data61

[9] L Hearn, When augmented reality bites, *The Sydney Morning Herald,* 15 September 2010, http://www.smh.com.au/digital-life/mobiles/when-augmented-reality-bites-20100915-15bu3.html

[10] CluckAR – *The Free Range Egg Detector App*, Choice, http://newthings.choice.com.au/cluckar

1.1.5 Industrial analytics

Industrial analytics (IA) is about harnessing value from data and increasing productivity. With the internet of things creating a ubiquitous sensor capability, future industrial processes will be more responsive (ensuring a better quality of services and products), more productive and more capable of taking into consideration data from within an organisation and beyond. Sooner or later IA will need to be embraced and an organisation's risk appetite will dictate when.

IA benefits from the fact that sensor data is actionable and is tied to a given business process, for example the supply chain. Sensors read parameters and processes, while the analytics inform decisions on change processes.

What organisational opportunities can be expected with IA?

- Substantial productivity gains and reduced waste by supporting informed decision-making processes in real-time;
- Facilitated audit processes and support for decision making in real-time by keeping efficient track of available data available and the rationale for decisions made in the production line or service provided;
- Working environments made safer for employees by providing relevant risk data across a logistics chain.

For non-executive directors there are some risks from developing an IA solution that need to be considered. Some examples of these risks include: How should data privacy be considered, and appropriate consents ensured, when deciding between a human or machine decision-making process for an autonomous system? Has the organisation attempted to minimise potential public backlash by informing its customer base on how IA is beneficial? And how will the organisation continue operations, report performance and delivery if a data blackout happens?

“ future industrial processes will be more responsive (ensuring a better quality of services and products).”

Boards may consider the following questions in managing risk appetite and strategic opportunities offered by IA:

- Does the management team understand the value proposition of IA for the organisation?
- Can the organisation demonstrate that the opportunities associated with IA have been considered for its business or technology strategy?
- How are data assets currently audited? What data is not being measured or utilised and how can its value be harnessed?
- What is the quality of the data, and how should data quality be assessed and controlled?
- How does data management impact the organisation's risk appetite?
- Are delegation frameworks in place regarding decision-making in data-driven processes?
- Does the board have access to technology expertise to help navigate this area?

Paulo de Souza MAICD is an Office of the Chief Executive Science Leader in micro-sensing technologies and systems at CSIRO Data61.

1.1.6 Blockchain

A blockchain is a distributed database technology, which was first used to record transfers of Bitcoin digital currency between anonymous parties worldwide without the involvement of trusted third parties such as banks. Today the idea is being explored for commercial application outside of the Bitcoin system. Rather than just financial transactions, blockchains could record transactions of any kind in any industry, without the involvement of traditional intermediaries or third parties. This has the potential to disrupt traditional market structures and to reshape trust relationships in society. Some examples of possibly impacted operations are the transfer of physical assets in a supply chains, digital rights management, securitised assets, business process execution, and payments processing or voting.

Blockchains are sometimes erroneously called 'trustless' networks. In reality, trust is merely shifted from traditional third parties to the technology underpinning the blockchain systems, the developers who create them and the market incentives supporting their operation. Nonetheless, this is a major change in how transactional relationships can operate in the economy.

There are significant implications for potential competitive disruption across all industries and serious implications for governance and risk management. Organisations that rely on blockchain-based systems internally, or through partners, will need evidence that these systems are trustworthy and that the evolution of those systems will continue to be aligned with their needs and risk profiles.

The early blockchain systems were public whereby any anonymous party could join the system as a processing node and participate in transactions. (The key technical advance of blockchain technology is enforcing data integrity and unmodifiable audit trails, despite this anonymous global participation.) However, some recent blockchain systems are instead private, or 'permissioned' systems (often called Distributed Ledger Technology).

"blockchains could record transactions of any kind in any industry, without the involvement of traditional intermediaries or third parties."

In private blockchains there are gatekeeper authorities who control access to participation and use of the system. These do not provide the same low barrier to participation as public blockchains, but they do provide more control and visibility on the operation of the system and so may be a better fit with existing regulatory requirements. Regardless, many uncertainties about feasibility, scalability, and security remain with this emerging technology. Many organisations are developing internal 'proof of concept' systems to better understand how it may impact their business. In addition, many boards may need to think differently about how they manage contractual issues and delegations in this new environment. This is not just technology research and development, it is a critical way to identify and evaluate risks and opportunities for effective organisational governance.

Mark Staples is a Principal Researcher and a Group Leader in the software and computational systems program at CSIRO Data61, and is a Conjoint Associate Professor in the School of Computer Science and Engineering at UNSW.

1.2 Government

1.2.1 Government response to FSI and Harper reviews

The Australian government has responded to two major enquiries that it commissioned in 2013, the Financial System Inquiry (FSI) and the Harper Competition Review, respectively. The FSI was conducted by an expert panel chaired by David Murray, reporting to government in December 2014. The competition review was conducted by Professor Ian Harper and reported in March 2015.

On the FSI, the government has accepted most of the recommendations, including significant changes to strengthen bank capital. Important reforms include new capability reviews of regulators (commencing with ASIC) and governance reforms for superannuation (yet to pass the Senate). The Productivity Commission will also be asked to review competition in the financial services industry in 2017.

> "The Harper review was the first major review of competition laws in more than 20 years, making 56 recommendations for reform."

The Harper review was the first major review of competition laws in more than 20 years, making 56 recommendations for reform. The most contested proposal was for a new 'effects test' to be added to the s 46 misuse of market power provisions in the *Competition and Consumer Act 2010*. This divided the business community: favoured by small business and opposed by others who argued it would stifle competition and create uncertainty.

In March the government announced its intention to proceed with a timetable for draft legislation by end 2016, but the measure does not have bipartisan support.

Stephen Walters, Chief Economist, AICD.

1.2.2 Governance of the nation: A blueprint for reform

As the voice of excellence in governance, the AICD brings a unique perspective to the challenges facing our nation. In March 2016 the AICD released an important document championing national reform priorities – *Governance of the nation: A blueprint for growth.*[11]

The publication reflects the AICD's concern at the short-term focus of political discourse and policy making. Directors understand that long-term planning is critical to sustainable growth and value, and that short-termism can be the enemy of good governance.

The policy prescriptions in the AICD's *Governance of the nation: A blueprint for growth* encourage a focus on long-term gains for the nation from different, and often difficult, reform opportunities. These include:

- reforming national governance - including fixed four-year terms for the federal government;
- fiscal sustainability – spending restraint (below 24% of GDP) and substantial tax reform (GST reform, personal tax cuts, CGT reform and incentives for removal of inefficient state taxes);
- innovation – encouraging a bipartisan agenda to lift Australia from 'lag' to 'lead' on global innovation measures, including shifting the dial of regulatory settings encouraging risk aversion;
- not-for-profit sector – five year funding cycles for funded NFPs as a best practice guide;

- human capital – boosting female participation in work and leadership, and simplifying the industrial relations framework and improving its governance;
- national infrastructure – a 15-year national investment plan for productive infrastructure.

These recommendations were informed by the insights of our diverse membership through the AICD's *Director Sentiment Index* and other channels. The *Governance of the nation: A blueprint for growth* reflects a broader focus for AICD advocacy work, as discussed by AICD Chairman Elizabeth Proust AO FAICD:

"The AICD has a diverse membership of nearly 38,000, collectively responsible for millions of jobs and billions of dollars across the economy. We can either run with a narrow agenda, which I think we've been guilty of in the past, or attempt to have a role in the broader debate about issues for the governance of the country in the medium-to-long term. We've chosen to do the latter."

Louise Petschler, General Manager Advocacy, AICD.

1.2.3 Retention of the Australian Charities and Not-for-profit Commission (ACNC)

Following the election of the Abbott Government, Kevin Andrews, the then Minister for Social Services, committed to abolish the Australian Charities and Not-for-profits Commission (ACNC). Andrews proposed a return to the Australian Taxation Office as de facto charity regulator with a 'Centre for Excellence' established in the ACNC's place. Following this announcement, many in the sector including the ACNC called for the ACNC to be retained.

In March of 2014, Minister Andrews introduced a Bill (ACNC No. 1 Repeal Bill) stating the government's intention to abolish the ACNC, but required additional legislation to take effect. A further Bill was never brought forward, and a subsequent reshuffle moved Andrews to the defence portfolio.

In March of 2015, the Turnbull Government's Minister for Social Services and the Assistant Treasurer jointly announced the retention of the ACNC. Their statement indicated that consultation showed "sufficient support" for the retention of the ACNC, noting that the government wanted to provide certainty to the sector. The announcement proposed a renewed focus for the ACNC on helping charities to become more effective and improve their governance.

Lucas Ryan, NFP Policy Adviser, AICD.

[11] See *Governance of the nation: A blueprint for growth*, AICD, 2016, http://www.companydirectors.com.au/director-resource-centre/policy-on-director-issues/policy-papers/2016/governance-of-the-nation-a-blueprint-for-growth

1.2.4 Changes to the definition of charity

In 2012, the Western Australian State Administrative Tribunal found that the Chamber of Commerce and Industry of Western Australia was charitable for the purposes of state payroll tax concessions. This made clear in the common law that such member advocacy bodies could be considered charitable, potentially opening the entitlement to other organisations.

The introduction of the *Charities Act 2013* (Cth) codified centuries of existing common law and legislation around the definition of charity into one Act for the purposes of determining charity status at the Commonwealth level. Among other things, the Act clarified the entitlement of organisations involved in advocacy work to charity status.

Subsequent to this, governments in the Australian Capital Territory (ACT) and Western Australia brought in legislation to exclude some peak bodies and professional groups from the definition of charity applied at the state level, ending their entitlements to the benefits received by charities in these jurisdictions.

The ACT government put forward the explanation that, as Australia's capital, their jurisdiction is home to a higher concentration of such organisations and is therefore subject to a disproportionate drain on revenue. The move has been criticised by many in the sector, noting that it is a departure from the general trend towards the harmonisation of state and territory requirements.

Lucas Ryan, NFP Policy Adviser, AICD.

"The ACT government put forward the explanation that their jurisdiction is home to a higher concentration of such organisations and is therefore subject to a disproportionate drain on revenue."

1.3 Politics

1.3.1 Election update - implications for policy

We know now that the Coalition government was returned at the federal election. The Coalition has secured the 76 seats needed to govern in its own right but, as insurance, three independents have committed to passing supply bills and supporting the government in confidence motions. In the upper house the crossbench numbers 20 senators, with the balance of power held by independents and senators from minor parties.

Some argue that the splintered election result proves the political system is broken and that Australia faces a crisis of politics and confidence, but the new configuration of the houses is the most common state for our Parliament. Governments have controlled both houses for only one quarter of the time since proportional representation was introduced for the upper house in 1949.

And, not all of the Coalition's legislative measures will be opposed. There is, for example, a decent chance the planned company tax cut will be passed by Parliament, although only for smaller companies. Similarly, the government's proposed changes to superannuation concessions probably have broad support, as does the increase in the tobacco excise and the crackdown on multi-national tax avoidance.

The prospects for other measures, though, have dimmed. The Parliament is unlikely to rubber stamp the government's planned changes to education funding, or the proposed increase in the pension age. Similarly, the government's planned changes to eligibility arrangements for the dole and savings measures in welfare probably are doomed.

The really bad news is that the tight election result, the fraught campaign that saw rank populism rewarded, and the highly-partisan nature of Parliamentary debate mean that much needed, longer term reform in areas like taxation, industrial relations and federalism most likely will be bequeathed to future Parliaments.

Stephen Walters, Chief Economist, AICD.

1.3.2 Social impact investing

Social impact investments have the purpose of achieving a social or environmental benefit alongside a financial return. The most common form of this model is the social impact bond (SIB). SIBs are financial instruments through which private investors provide capital to a third party to achieve agreed social or environmental outcomes, and a return is paid based on the cost savings made to government if the outcome is achieved. SIBs, and other forms of social impact investing, have been gaining increased attention in Australian markets and internationally.

The key benefit of this growing trend is the availability of capital which can be applied to solving social and environmental challenges with the market for impact investing expected to reach $32 billion in Australia over the next decade. Social impact investing also facilitates cross-sector cooperation and creates a positive incentive for businesses to collaborate with, support or indeed become socially-motivated organisations.

However, in order for impact investing to continue to grow, government must be an active participant. Government's role is to identify policy priorities, enter into contracts with investors and pay returns on successful schemes. However, while government approaches all new ideas with caution, entrepreneurs do not. Although social impact investing represents great opportunity for many organisations, for example The Benevolent Society is on track to pay a 5%+ return on their social impact bond, it is a complicated undertaking that requires sophisticated governance structures to support it. More work must be done to facilitate the involvement of all sectors to participate in this work with confidence.

Lucas Ryan, NFP Policy Adviser, AICD.

1.4 Tax risk management

1.4.1 Voluntary tax transparency code

On 3 May 2016 (budget night), the government released and endorsed the voluntary tax transparency code ('Code') as developed by the Board of Taxation. The government is encouraging all companies to adopt the Code, commencing with the 2016 financial year and onwards.

The Code is one of the most comprehensive tax transparency measures in the world and is intended to facilitate a more informed public debate on business taxes through enhanced public disclosures targeted at a reasonable user. Whereas a mandatory code is likely to be implemented as a compliance exercise, a voluntary code provides a greater opportunity for the company board to ensure the 'disclosure' is meaningful for stakeholders and consistent with other communication strategies of the company.

The Code constitutes a set of principles to guide disclosures and includes the following recommendations:

- Part A - entities with Australian turnover of $100 million or greater are encouraged to disclose:
  - a reconciliation of accounting profit to income tax paid each year; and
  - effective tax rates for Australian and global operations.
- Part B - entities with Australian turnover of $500 million or greater are encouraged to disclose additional information related to:
  - the company's approach to tax strategy and governance (including details of dealings with the Australian Tax Office (ATO));
  - details of all federal, state and local tax contributions; and
  - a qualitative (rather than quantitative) summary of international related party dealings.

Increased scrutiny by the media (especially social media) and politicians means there is an expectation that companies will respond to and meet increased demand for more public disclosures in relation to tax information.

"The Code is one of the most comprehensive tax transparency measures in the world and is intended to facilitate a more informed public debate on business taxes..."

In addition, the ATO publicly reports certain tax information on both public and foreign owned companies (whose total income is at least $100 million) and private companies (Australian private companies with total income of at least $200 million), including the taxpayers' name, total income (similar to gross accounting revenue), taxable income and tax paid.

Directors should also be aware that there is now a requirement for Australian taxpayers to provide the commissioner with general-purpose financial statements (GPFS) for income years commencing on or after 1 July 2016, even where such reports are not otherwise required by ASIC. This may be an additional compliance burden and add to the cost of compliance.

All of these developments increase the relevance of a board's communication strategy regarding the group's tax contribution to the economy.

Karen Payne, CEO and Board Member, Board of Taxation and **Deepti Paton**, Board of Taxation Secretariat.

1.4.2 New Australian Tax Office (ATO) guide signals increased scrutiny of tax risk governance

The assessment of the board governance controls concerning taxation risk by the Australian Taxation Office (ATO) is an important factor in any ATO engagement with a corporate taxpayer, including the tax risk rating, level of ATO review and scrutiny, and ultimately the tax audit.

The ATO guide *tax risk management and governance*, updated in August 2016, sets out the ATO views on the role of the board of directors and management in the control of tax risk. The guide fundamentally recommends that taxpayers evidence the operation of their controls through regular control testing.

Directors should be aware of the ATO views for several reasons, including:

- There is increased activity by the ATO on corporate tax governance risk reviews.
- The board should be aware if their governance protocols around tax risk will meet with approval by the ATO.
- The Board of Taxation recommendation for voluntary disclosure of the 'tax governance framework' for large groups increases the potential significance of such measures; this was endorsed by the government as part of the 2016/17 budget.

The following checklist reflects the key issues the ATO will review in any governance risk review:

- There is an established framework to identify and manage tax risk:
  - The board should endorse an overarching risk management framework which includes tax or alternatively a formal tax control framework.
  - There should be documented roles and responsibilities around tax risk management.
  - The board should be appropriately informed (regularly and materially) about the tax control framework and have sufficient information to ensure effective control.
- Policies and controls are regularly assessed:
  - There should be periodic internal control testing.

Although the standards in the guide reflect 'best practice' and are not mandated, they do provide a clear pathway for corporate taxpayers wishing to minimise compliance costs and minimise lost productivity as a result of 'avoidable' scrutiny by the tax regulator.

The guide can be of assistance to the board as follows:

- The board can reference and leverage this document in communicating its approach to tax risk governance.
- The board can commission internal risk reviews to self-assess the existing tax governance framework and documentation of same against the regulator's 'best practice' standards.
- The board can benchmark existing governance controls against the ATO standards – for example by testing on the basis of if not, why not – and compare existing governance controls for consistency across corporate taxpayers and identify any areas for improvement in the tax control framework.

Karen Payne, CEO and Board Member, Board of Taxation.

1.4.3 Multinational tax avoidance and the role of the director

Australian directors will be well aware that the domestic tax landscape is increasingly changing to respond to global tax developments and interactions. This requires a new level of international tax awareness and competency of management to ensure they are identifying when and how these new measures will impact the company and bring any material risks to the attention of their board. These risks include greater penalties, increased audit & scrutiny by the ATO and increased compliance obligations.

> " ...the domestic tax landscape is increasingly changing to respond to global tax developments and interactions. "

Directors of listed, large and private companies should expect to be made aware of some of the following new measures.

Changes to target multinational tax avoidance by corporate groups:

- Multinational anti-avoidance legislation (MAAL) now applies to significant global entities deemed to be avoiding a taxable presence in Australia. A significant global entity is broadly a global parent entity with annual global income of at least $1 billion, or any member of that global parent entity's consolidated accounting group. Penalty amounts have doubled for MAAL scheme tax liabilities.
- A proposed diverted profits tax (DPT) is to be introduced at the tax rate of 40%, on profits transferred out of Australia by a significant global entity – that is, under an offshore related party transaction that is deemed by the commissioner to lack sufficient economic substance and designed to secure the tax reduction. The DPT may apply when a transfer price (including on debt instruments) reduces the tax paid on the profits generated in Australia by more than 20%. Liability for a deemed DPT amount will be imposed up-front at the time an assessment is issued by the ATO and can only be adjusted following a successful review of the assessment or if the taxpayer amends their assessment during the review period.
- The combination of measures mirror the so-called 'Google tax' measures introduced in the UK and are directed at offshore entities making profits from the Australian market without returning the appropriate profit in Australia.
- The final report of the Senate Economics References Committee's inquiry into corporate tax avoidance in Australia is also yet to be delivered.

Increased transparency around taxes paid and collected:

- Refer to section 1.4.1 Voluntary tax transparency code.

The 15 action plans of the Organisation for Economic Co-Operation and Development (OECD) to address base erosion and profit shifting (BEPS):

- The introduction of new standards for transfer pricing documentation and country-by-country reporting require Australian taxpayers to produce additional documentation for the ATO on their group structure and related party transactions: a local file, master file and country-by-country report, as recommended by the OECD.

Directors should expect an update on these tax measures at least quarterly at their board meetings and more regularly through their audit risk committee meetings.

Karen Payne, CEO and Board Member, Board of Taxation and **Jarrod Thomas**, Board of Taxation Secretariat.

1.5 Asia

1.5.1 The rise and change of economies in Asia

Australia's future inevitably is hitched to developments in the economies to our north. Not only is Australia located in Asia, but two thirds of our exports are destined for customers there. China receives a whopping 30% of our merchandise exports, more than any other country. Japan receives 15%, Korea another 10%.

Australia rode modernisation in Asia by exporting commodities needed for rapid development – coal and natural gas for power generation, and iron ore for construction of infrastructure and housing. Booming demand for our commodities triggered a surge in prices, which prompted the investment boom in Australia and lifted prosperity.

Increasingly, though, Australia's future lies in exporting services into Asia, including tourism, education and healthcare, as well as 'hard' commodities. Consumers are becoming a larger share of the Asian economies. Living standards are rising, which brings with it higher demand for education and healthcare, and the desire to travel. There still will be demand for commodities but, over time, services will come to dominate our exports into Asia.

A good example is China, which already provides Australia's largest source of tourists, as well as having more tertiary students here than any other country. This reflects rapid development in China, which continues to evolve towards being a more modern, outward looking economy.

The World Bank estimates that, by 2030, two thirds of the world's middle class will be located in Asia, so Australian exporters cannot stand still as the Asian economies evolve. After all, increasingly wealthy Asian households won't be buying shiploads of iron ore!

Stephen Walters, Chief Economist, AICD.

"Increasingly, though, Australia's future lies in exporting services into Asia, including tourism, education and healthcare, as well as 'hard' commodities. Consumers are becoming a larger share of the Asian economies. Living standards are rising, which brings with it higher demand for education and healthcare, and the desire to travel."

1.6 Board Composition

1.6.1 A review of the academic literature examining independent board members and company performance

The Corporate Governance Council of the ASX released its *Corporate Governance Principles and Recommendations* 3e in 2014. Principle 2 in this documents states that "the board needs to have an appropriate number of independent directors".

The recent working paper *Board Composition and Company Performance: New Australian Evidence* (A Frino, Sydney Business School, University of Wollongong, 2016), examines the published academic literature which has examined the relationship between the proportion of board members who are outside or independent and company performance. The paper identifies that there have been at least 11 such studies published in peer-reviewed scholarly journals which have tested for the relationship in samples of Australian companies.

Six of these studies have examined the relationship between the proportion of independent board members and the return on assets or return on equity of companies. Of these, two[12 13] provide evidence of a positive and statistically significant relationship between board independence and the return on assets or the return on equity of companies while the rest could not find a statistically significant relationship.

Similarly, 10 of these studies have examined the relationship between the proportion of independent board members and Tobins Q or market-to-book ratios. Such ratios are not strictly performance measures, but may merely be measuring the investment in growth opportunities by companies. This literature provides mixed and contradictory findings. While two of these studies[14 15] provide some evidence of a statistically significant positive relationship between board independence and Tobins Q or market-to-book ratios, one[16] provides evidence of a negative relationship and the remainder could not find any statistically significant relationship.

On the balance, the published academic literature provides evidence of a positive relationship between board independence and company performance.

Alex Frino, Professor of Economics, Sydney Business School, University of Wollongong.

1.6.2 Independence of super fund trustee boards

The federal government has had a long-term aim of requiring that superannuation funds have at least one third independent trustees. The focus of public debate is primarily on the not-for-profit (NFP) sector because the retail superannuation funds, primarily operated by the banks and insurers, have already agreed that they will have a majority of independent trustees.

The industry bodies that represent the NFP sector have successfully frustrated the government's ambitions and have gained agreement for a review of best practice governance standards for the NFP sector. It is understood that the review has been completed and has been held over till after the federal election.

[12] Bonn, 'Board structure and firm performance: Evidence from Australia', *Journal of Management & Organization*, vol 10, no 01, 2004, pp 14-24.

[13] M Hutchinson, 'An analysis of the association between firms' investment opportunities, board composition and firm performance', *Asia-Pacific Journal of Accounting & Economics*, vol 9, no 1, 2002, pp 17-38.

[14] D Henry, 'Corporate governance structure and the valuation of Australian firms: Is there value in ticking the boxes?', *Journal of Business Finance & Accounting*, vol 35, nos 7-8, 2008, pp 912-942.

[15] P K Pham, J A Suchard and J Zein, 'Corporate governance and alternative performance measures: evidence from Australian firms', *Australian Journal of Management*, vol 36, no 3, 2011, pp 371-386

[16] G C Kiel and G J Nicholson, 'Board composition and corporate performance: How the Australian experience informs contrasting theories of corporate governance', *Corporate Governance: An International Review*, vol 11, no 3, 2003, pp 189-205, http://scholar.google.com.au/citations?view_op=view_citation&hl=en&user=EYutXVYAAAAJ&citation_for_view=EYutXVYAAAAJ:u5HHmVD_uO8C and

The NFP sector claims that their current representative model has led to improved performance compared to the for-profit sector. Commentators including the Australian Prudential Regulation Authority (APRA), the regulator of the superannuation funds, challenge these claims. APRA believes that:

"…independent directors broaden the skills and capabilities that can be brought to the board table, and improve decision-making by bringing an objective perspective to issues the board considers".

The existing equal employer and employee representational rules were established in 1993 when the coverage of superannuation funds extended to include all employees. Contributions for most of these employees were effectively a salary offset. The funds were either specialized industry funds or employer funds. The landscape is now very different. Most of the large employer funds have now closed and the large industry funds are now primarily public offer funds.

The AICD supports the government and APRA's stand on independent trustees. Superannuation funds are now some of Australia's largest financial institutions. They are investing for our future. APRA should be allowed to move to a governance model that they already successfully apply to the banks and insurers. Whilst there is still a legitimate debate to be had on exactly what makes a trustee 'independent' we believe that new rules can be implemented over a period of three years.

Barry Rafe FAICD, Principal, Rafe Consulting.

"The existing equal employer and employee representational rules were established in 1993 when the coverage of superannuation funds extended to include all employees. Contributions for most of these employees were effectively a salary offset."

1.7 Strategy

1.7.1 The role of boards in strategy

The role of the board in strategy is a key corporate governance issue. Though it is widely understood that strategy is an important board function, there is less clarity around how involved boards should be.

Historically, the board's role in strategy was often confined to an annual review of the strategy proposed by executive management, and its approval or rejection. Today, boards will typically oversee two key strategic functions:

1) strategy development; and

2) strategy execution.

More effective and value-adding boards tend to assume a role that is broader than pure oversight.[17]

The role of boards in strategy development varies significantly from one organisation to the next. In addition to an oversight role, the board may provide support to management, shape or co-create strategy. Typically, this role evolves over time within an organisation in response to changing circumstances.

In terms of strategy execution, the board's primary responsibility is to ensure there is an effective executive management team in place. In particular, it needs to choose the 'right' CEO. While it is not the board's role to manage the execution and operational activity itself, more effective boards tend to actively monitor strategy execution.

Deloitte[18] argues that boards should focus their attention equally on strategy development and execution, since much of the effectiveness of a strategy lies in its execution.

There has been a growing push for deeper and more active board involvement in strategy. This has been fueled by, for example, high profile corporate collapses and scandals, as well as growing shareholder activism. Recent research supports a greater role for boards in strategy: for example, McKinsey (2014) found that high impact boards spend triple the time on strategy than low or moderate impact boards.

For optimal board and organisational performance, the board needs to clearly understand and articulate its role in relation to strategy within the organisation. Importantly, the board should ensure that the exercise of its strategic function is not confined to an annual event; it is a critical and ongoing board responsibility.

Louise Pocock, Deputy Executive Director of the AICD Governance Leadership Centre.

"While it is not the board's role to manage the execution and operational activity itself, more effective boards tend to actively monitor strategy execution."

[17] C Bhagat and C Kehoe, 'High-performing boards: What's on their agenda?', *McKinsey Quarterly*, April 2014, http://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/high-performing-boards-whats-on-their-agenda

[18] Deloitte LLP, 'Hot Topics: Improving Board Effectiveness: Oversight of Strategy', *Corporate Governance Monthly*, November 2012, http://www2.deloitte.com/content/dam/Deloitte/dk/Documents/governance-risk-compliance/Improving-Board-Effectiveness-Oversight-of-Strategy-Hot-Topics.pdf

2.0 | THE GOVERNANCE ENVIRONMENT

2.1 Corporate culture

2.1.1 Corporate culture

Since the global financial crisis (GFC), regulators around the world have increasingly focussed on the role of culture in corporate misconduct, particularly in the financial services sector. In Australia, the Financial System Inquiry recognised the impact of poor corporate cultures on consumer confidence in the financial system in making its recommendations. Additionally, both the prudential and market regulators – the Australian Prudential Regulatory Authority (APRA) and Australian Securities and Investments Commission (ASIC) – have intensified their scrutiny of cultural issues and the role of boards in shaping organisational cultures.

With effect from 2015, APRA's expectations of banks and insurers' management of their risk cultures have been set out in prudential standards CPS/SPS 220 *Risk Management*. These instruments require the board of directors to oversee the establishment of a sound risk management culture, including forming a view as to the existing risk culture, identifying any desirable changes to that culture and overseeing the implementation of those changes.

While ASIC is yet to issue any formal guidance on culture, the regulator has repeatedly emphasised its interest in culture as an indicator of conduct in speeches and reports, and at its 2016 annual forum *Culture Shock*. ASIC is incorporating considerations of culture into its risk-based surveillances and other work involving the assessment of risk. The regulator is also raising awareness of the importance of culture through discussions with stakeholders and public messages. Although ASIC has acknowledged that 'culture is not something that can be regulated with black letter law', it has made plain its view that 'values and culture leadership must come from the top' and that 'the board plays an important role in setting the tone, influencing and overseeing culture'.[19]

Importantly, culture is an issue for all boards, regardless of sector, industry or size. And as research has repeatedly shown, organisational culture not only presents risks and challenges for companies and their boards, but also competitive advantages as culture can powerfully drive performance.

Lysarne Pelling, Senior Policy Adviser Advocacy, AICD

"...regulators around the world have increasingly focussed on the role of culture in corporate misconduct..."

[19] G Medcraft, 'Tone from the top: Influencing conduct and culture', ASIC chairman's speech at the Thomson Reuters 4th Annual Australian Regulatory Summit, 21 June 2016, http://download.asic.gov.au/media/3901451/greg-medcraft-speech-thomson-reuters-4th-annual-australian-regulatory-summit-21-june-2016.pdf.

2.2 Short-termism

2.2.1 Short-termism

An effective board manages and balances short-term, medium-term and long-term horizons. It attends to the company's long-term interests and financial health, as well as short-to-medium-term risks and opportunities.

Yet there is arguably an imbalance in corporate decision making in favour of short-term perspectives and objectives. This arises from various pressures on companies and their leadership, including stakeholder demands, reporting practices and requirements, and reward structures.

Public companies, for example, seek to manage market expectations. Many investors today are holding onto their stock for less time and focusing on short-term investment performance. Even where investments have a longer-term focus (for example, retirement benefits), investment managers are often rewarded for their performance over the short-term. Further, notwithstanding modest earnings growth, dividends paid by Australian listed companies have grown substantially since the global financial crisis[20], thereby reducing capital reinvestment for long-term growth.

The concern is that excessive short-termism can impede long-term value creation and the sustainability of corporations. Beyond this, it presents broad social and economic challenges, including in relation to the need to address climate change, invest in infrastructure to accommodate future needs, and promote innovation for societal benefit.

There are various practices that boards can adopt to help their organisations limit excessive short-termism. For example, working with management, the board can:

- set long-term, forward-looking strategy, and ensure it is clearly communicated to investors and other key stakeholders;
- allocate resources for ongoing investment in long-term, value-creating opportunities such as research and development;
- monitor external communications, and the form and content of financial statements, to ensure they clearly communicate the company's long-term, value-creating prospects;
- build and reinforce a positive, long-term corporate culture, including through mission, vision and values statements that emphasise innovation and responsibility (for example, customer retention and safety); and
- tie a meaningful proportion of executive remuneration to incentive measures that look beyond short-to-medium term market or operational performance and align with the company's long-term strategy.

Given the accountability of the board to their organisation's shareholders and other key stakeholders, and the board's vantage point above day-to-day operational and management activity, the board is uniquely placed to be the custodian of long-term value.

Louise Pocock, Deputy Executive Director of the AICD Governance Leadership Centre

> "The concern is that excessive short-termism can impede long-term value creation and the sustainability of corporations."

[20] M Bergmann, 'The rise in dividend payments', *RBA Bulletin*, March 2016, http://www.rba.gov.au/publications/bulletin/2016/mar/pdf/bu-0316-6.pdf

2.3 Risk

2.3.1 Corporate social responsibility (CSR) activism

Attempts to bring about corporate change through environmentally focussed shareholder activism has been part of the Australian landscape for some time. More recently, the Australasian Centre for Corporate Responsibility (ACCR) requisitioned shareholder resolutions at the 2015 AGMs of ANZ, AGL and Origin Energy on climate change issues.[21] The resolutions were not endorsed by the boards of those companies and not passed by the members.

A test case run by the ACCR has now effectively ended shareholder requisitioned resolutions which are 'advisory' or on matters relating to the management of a company.[22] In this case, the ACCR challenged the approach of the Commonwealth Bank of Australia (CBA) to shareholder resolutions requested for its 2014 AGM.

The court's decision in 2016 confirms that directors:

- need not put up for vote resolutions that purport to direct management or to express shareholder opinion; and
- can comment on, and recommend against, shareholder requisitioned resolutions.

Despite this decision, the level of environmentally focussed shareholder activism is unlikely to decline. The ACCR (and others) have had some success in raising awareness of their campaign by requisitioning special resolutions to amend the constitutions of large Australian banks, energy and mining companies. While it is not surprising that none of these resolutions have been successful in Australia, considering the 75% voting threshold required, they have brought attention to the issues raised. For example, AGL and Origin Energy have committed to the "We Mean Business" initiatives.[23]

It is therefore likely that shareholder activists will continue to make use of all available corporate governance tools, including seeking constitutional amendments and commenting at AGMs.

Mary Boittier, Executive Counsel, Herbert Smith Freehills

"...the level of environmentally focussed shareholder activism is unlikely to decline."

[21] See http://www.accr.org.au/
[22] Australasian Centre for Corporate Responsibility v Commonwealth Bank of Australia [2016] FCAFC 80
[23] See http://www.accr.org.au/power; https://www.originenergy.com.au/about/investors-media/media-centre/origin-becomes-worlds-first-energy-company-to-adopt-seven-initiatives-climate-change.html; https://www.agl.com.au/about-agl/media-centre/article-list/2015/september/agl-adopts-we-mean-business-commitments

2.4 Diversity

2.4.1 Progress towards 30% by 2018

The number of female directors on ASX 200 boards is now at 23.4 per cent (30 June 2016). This number has increased from 20.4 per cent in April 2015 when the AICD called for all boards, with particular emphasis on ASX 200 boards, to achieve at least 30 per cent female directors on their boards by 2018. Female appointments to ASX 200 boards have tracked above 40 per cent so far in 2016, the highest rate since the AICD began monitoring figures in 2009. This solid performance in the first five months of the year indicates that the target may be reached by 2018.

The AICD is working with chairs and non-executive directors of the ASX 200, executive search consultants, investors and other individuals that have a key role in influencing and advocating for change to ensure a holistic and comprehensive approach to increasing the number of women on boards.[24]

Rhian Richardson, Board Diversity Manager, AICD

2.4.2 Cognitive diversity

Bringing together a diverse range of skills and experience on a board is an essential part of good governance. Research also proves that it contributes to better financial performance. Increasing board diversity with the intention of improving board performance is not as simple as adding female directors or directors from cultural or linguistically diverse backgrounds, although that can be a good start. Directors ultimately should consider cognitive diversity and understand how diversity of thinking works. Cognitive diversity relates to the different mental processes, perceptions and judgements individuals possess and the influence these have on decision-making.

In *Which Two Heads Are Better Than One?*[25], Juliet Bourke demonstrates that senior leaders are more likely to draw on one or two default approaches to thinking when making decisions. Juliet cites research which indicates that relying on only one ‘thinking approach’ produces a 70 per cent rate of accuracy. By contrast, when six different thinking perspectives are applied to the discussion, these accuracy rates can be elevated to between 90-100 per cent. In this book she identifies what those six thinking ‘attributes’ or approaches are, so as to provide a framework for enhanced decision making.

Juliet also recognises the confluence of diversity elements, mental models and bias and how these all contribute to team dynamics. For boards to benefit from demographic and cognitive diversity, individual directors should engage in both self-reflection and analysis of their peers, providing deeper awareness of the factors that contribute to board decisions. Harnessing the unique approaches of fellow directors enables individuals and teams to be more deliberate and effective in making better decisions.

Rhian Richardson, Board Diversity Manager, AICD

“Bringing together a diverse range of skills and experience on a board is an essential part of good governance.”

[24] See http://30percentclub.org/about/chapters/australia.

[25] J Bourke, *Which two heads are better than one? How diverse teams create breakthrough ideas and make smarter decisions*, AICD, 2016, http://www.companydirectors.com.au/director-resource-centre/publications/book-store/which-two-heads-are-better-than-one

2.5 Meetings

2.5.1 Review of the 2015 annual general meeting (AGM) season

The tectonic post-millennium shifts in international politics, global financial markets and the falls in oil and commodity prices pose serious implications for directors, management and shareholders. Boards must satisfy shareholders that they understand and are capable of managing uncertainties and risks in the current climate. Separation of governance and management are fundamental at this time.

Board and senior executive remuneration and commitment to board diversity should be anticipated as matters concerning shareholders.

Corporate and not-for-profit boards will have to be better equipped and more prescient about future events and decisions affecting both short and medium term plans.

Chairs and boards will have to be far more rigorous in satisfying shareholders about:

- medium and long term forecasting;
- testing risk profiles influencing the business;
- monitoring and reviewing board performance, and credibly substantiating directors and CEO's remuneration; and
- remuneration being adjusted accordingly to reflect unsatisfactory results, if performance has been below forecast; in some cases shareholders will ask why senior management and non-executive directors should not be removed or demoted.

Far more intelligent assessments must be made about handling critical data and communicating results. Reliance cannot be placed on current media such as Facebook and Twitter. They may remain part of the social milieu but will never be a core source of reliable information which a non-executive director or shareholders can rely upon.

Forecasters, analysts and the management who directors will expect to be 'ahead of the pack', will all need highly evolved prospective intellectual skills and the greatest challenge will be the faster evolution of industry to supply increasingly knowledgeable buyers in world markets with what they want, how they want it delivered, how much they are prepared to pay for it.

Ken Baxter, Commissioner of the Productivity Commission and Chair of XRF Scientific Ltd

"Corporate and not-for-profit boards will have to be better equipped and more prescient about future events and decisions affecting both short and medium term plans."

2.6 Environmental, social and governance (ESG) reporting

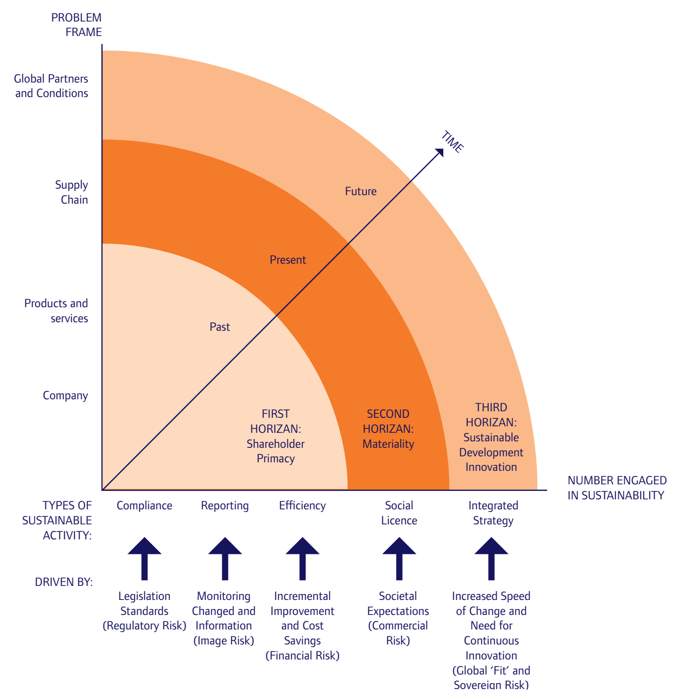
2.6.1 ESG reporting

In its report *Corporate Reporting in Australia*,[26] the Australian Council for Superannuation Investors says that reporting is not the equivalent to managing or mitigating the risks. With 90% of the ASX200 companies now providing some level of reporting on sustainability in 2015, the next horizon of competition is demonstration that they can more effectively deal with reducing financial risk and commercial risk through their sustainability agenda.

The concept of sustainable reporting was borne in the early 1990s as a way for organisations to transparently communicate their risks to build trust that they were progressing to resolve their issues.

Today, the issues of a company aren't simply contained to its own company and product/services boundaries. The risks they need to manage include the risks of the supply chain that they are within. When Australian fisheries company Austral moved to produce the world's first carbon neutral fish product they offset the carbon in its entire supply chain. Taking responsibility in this way to build its social licence also paid off commercially for the company with the entire investment returning an outcome within 2 months. It's a dream run for return on investment and highlights the importance of assessing materiality in the supply chain.

The third horizon for sustainable development (see diagram[27]) is already emerging now with the greatest number of consumers expecting sustainability than ever before. The requirement is for multi-stakeholder initiatives to solve significant sustainable development problems through partnerships. The value of the integrated strategy moves companies to solve problems in ways that drive results and as such will create the types of innovation that can manage and mitigate problems that not one organisation "owns".



Companies that move towards these types of solutions will find integrated strategy that improves their ability to deliver on the UN's sustainable development goals and targets as well as protect their commercial interests in the long-term. Examples of this are currently occurring in the deforestation arena where competing concepts are being resolved by companies such as Unilever and BASF who are forming partnerships with smallholders, aid agencies and NGOs to protect forests and secure the long-term supply of palm oil.

Katherine Teh-White, Founder, Futureye

[26] Australian Council for Superannuation Investors, *Corporate reporting in Australia: Progress in disclosure of sustainability risk among S&P/ASX200 companies,* June 2016, https://acsi.org.au/images/2016SustainabilityReportFINALweb.pdf

[27] Futureye, *The age of the curve hugger: Why society expects sustainable innovation from your business now*, 2015, p 27, http://futureye.com/publications/

2.7 Directors' liability

2.7.1 Insolvent trading reforms

On 7 December 2015, the government announced insolvency law reforms aimed at encouraging entrepreneurship and innovation.[28] The reforms broadly reflected Recommendations 12.1, 14.2 and 14.5 made by the Productivity Commission in its *Business Set-Up, Transfer and Closure* inquiry report.[29] The government has recognised that

"[o]ur current insolvency laws put too much focus on penalising and stigmatising the failures",

to the detriment of startups and corporate recoveries.

The risks of inadvertent insolvent trading are often cited as a reason early stage investors and professional directors are reluctant to become involved in startups.[30] And fear of personal liability arising from restructuring a financially distressed company can lead to unnecessary or premature invocation of insolvency processes, with the negative consequences of job loss, contract terminations, goodwill destruction and overall value diminution.

In responding to the government's consultation[31] on the reforms, the AICD supported the introduction of an insolvent trading safe harbour that would:

- protect directors who take reasonable steps to rehabilitate ailing businesses outside of formal insolvency processes while taking into account the interests of creditors;
- place the onus of proof on the person alleging that directors have breached the duty to prevent insolvent trading; and
- be sufficiently flexible to apply to all directors irrespective of a company's size, industry, sector and circumstances.[32]

Additionally, the AICD welcomed the government's proposal to prohibit the operation of ipso facto clauses which terminate or amend agreements during formal insolvency processes (subject to certain exceptions and appeal rights). This reform would allow companies in voluntary administration to preserve key contracts and so trade on, without affecting creditors' rights should the company breach any contractual obligations.

The AICD will continue to engage on these important reforms as they are formalised. Legislation is expected in mid-2017.

Lysarne Pelling, Senior Policy Adviser Advocacy, AICD

"The risks of inadvertent insolvent trading are often cited as a reason early stage investors and professional directors are reluctant to become involved in startups."

[28] See *National Innovation and Science Agenda - Report*, www.innovation.gov.au.
[29] Australian Government Productivity Commission, *Business Set-up, Transfer and Closure,* Productivity Commission Inquiry Report, No. 75, 30 September 2015, http://www.pc.gov.au/inquiries/completed/business/report
[30] See *National Innovation and Science Agenda - Report*, www.innovation.gov.au.
[31] Australian Government National Innovation and Science Agenda, *Improving bankruptcy and insolvency laws,* proposals paper, April 2016, http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2016/Improving-bankruptcy-and-insolvency-laws
[32] AICD policy submission, *Improving bankruptcy and insolvency laws*, 27 May 2016, http://www.companydirectors.com.au/director-resource-centre/policy-on-director-issues/policy-submissions/2016/improving-bankruptcy-and-insolvency-laws

2.8 Enhanced auditor reporting

2.8.1 Enhanced auditor reporting

The Australian Auditing and Assurance Standards Board (AUASB) has amended the Australian Auditing Standards to provide an enhanced audit report. The enhanced audit report will increase the public's confidence in both the audit process and the company financial statements by providing investors with:

- greater transparency about auditor responsibilities; and
- insights into key audit matters (KAMs) and how the auditor deals with those areas.

KAMs are defined in ASA 701 *Communicating Key Audit Matters in the Independent Auditor's Report* to be:

> *"...those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial report in the current period. Key audit matters are selected from matters communicated with those charged with governance."*

Whilst the enhanced audit report applies to all entities, KAMs are only required for listed entities. Audit committee members of listed entities will likely be interacting with the auditor more, discussing the expanded audit report prior to its release. A key concern for the audit committee is whether the auditor provides original information about the company in the audit report. This concern can be addressed by engaging in open and early communication with the auditor and considering whether additional disclosures are required within the financial report of these matters.

- Other changes that apply to non-listed entities, including private entities, include:
- more prominent placement of the audit opinion towards the front of the report;
- new descriptions of responsibilities relating to going concern in both the management responsibilities area and the auditor's responsibilities area;
- enhanced reporting where a material uncertainty relates to going concern exists;
- identification of those charged with governance within the management responsibilities area of the report who is responsible for the oversight of the financial reporting process;
- revised auditor reporting for other information issued in conjunction with the financial report (such as the annual report), including the identification of such other information; and
- an expanded description of auditor's responsibilities including key features of the audit.

These changes are applicable to financial reports for periods ending on or after 15 December 2016.

Kerry Hicks, Senior Policy Adviser Advocacy, AICD

> "A key concern for the audit committee is whether the auditor provides original information about the company in the audit report."

3.0 THE REGULATORY ENVIRONMENT

3.1 Australian Securities and Investments Commission (ASIC) update

3.1.1 ASIC's Innovation Hub – recent progress

Whilst innovation is not new, the current speed and magnitude of change underpinned by technology is unprecedented. Across the financial sector, there has been an explosion in the number of financial technology (fintech) startup businesses seeking to disrupt the status quo by providing new products and services to consumers, or finding new ways to deliver existing ones.

ASIC's Innovation Hub[33] was established in April 2015 to engage with and help fintech businesses to navigate the regulatory framework, reduce red tape and work more closely with industry. Since then it has worked with over 100 entities and granted 16 new licences to businesses within the Australian fintech sector.

ASIC has established relationships with international regulators in the Europe, Asia, and North America, to discuss innovation developments and policy proposals. They have signed world-first co-operation agreements with both the UK's Financial Conduct Authority (FCA) and Singapore's Monetary Authority of Singapore (MAS), and continue looking to enter more agreements of this nature with other regulators in the near future.

These agreements create a referral process for innovative fintech businesses looking to scale abroad to the FCA and MAS. Referred businesses will have access to a dedicated team to help them understand how the regulatory framework of each respective jurisdiction applies to their business, in addition to support throughout any prospective authorisation processes. This is invaluable support to any fintech business looking to expand into new markets with unique regulatory frameworks.

ASIC is also looking at establishing a 'regulatory sandbox' for fintechs. This is an environment where financial products can be tested before normal compliance obligations apply. In June 2016, a consultation paper was issued that proposes options for a regulatory sandbox. The final report is due to be issued by the end of 2016.

John Price, ASIC Commissioner

"ASIC is also looking at establishing a 'regulatory sandbox' for fintechs. This is an environment where financial products can be tested before normal compliance obligations apply."

[33] See http://www.asic.gov.au/for-business/your-business/innovation-hub/

3.2 Australian Competition and Consumer Commission (ACCC) update

3.2.1 ACCC Update

Mergers:

The Australian Competition and Consumer Commission (ACCC) has dealt with several complex merger assessments in the last year, with only very few mergers opposed and some significant mergers approved.

Its timetable for clearance of complex mergers appears to practitioners to have become a little less flexible than in the past. ACCC coordination with overseas counterparts as part of its assessment of any international merger has become routine.

Cartels:

The ACCC continues to actively investigate and prosecute cartels. For example, in June 2016 the ACCC commenced proceedings alleging a cartel among wholesalers of polycarbonate roof sheeting commonly used in commercial and home building projects. On 18 July 2016, global shipping company Nippon Yusen Kabushiki Kaisha (NYK) pleaded guilty to the first criminal charge laid against a corporation under the cartel provisions of the *Competition and Consumer Act 2010* (Cth). As yet there have been no contested criminal cartel prosecutions.

The Federal Court dismissed the ACCC's case against the Australian egg industry association in February 2016. The Court found that while the ACCC had established that the respondents intended that egg producers should take action to address and 'correct' an oversupply of eggs, it did not establish that this was intended to be pursuant to an agreement or understanding involving reciprocal obligations by competing producers. The ACCC has appealed this decision.

Important questions remain to be resolved by the High Court about the application of cartel laws to dealings between principals and their distribution agents. An initial Federal Court decision regarding an alleged attempted cartel involving Flight Centre and various airlines caused a lot of confusion among businesses involved in the sale and distribution of a range of products such as travel, accommodation and financial services. That decision cast doubt on the demands a supplier could lawfully make of its distributors and vice versa. The Full Federal Court on appeal removed the confusion, finding that Flight Centre acted as agent for the airlines and was not relevantly a competitor. That decision was granted special leave to appeal to the High Court and a final decision is expected in late 2016.

Misuse of market power:

In 2015, the Federal Court dismissed the ACCC's proceedings against Pfizer Australia Pty Ltd for alleged misuse of market power and exclusive dealing in the supply of a generic cholesterol-lowering pharmaceutical to pharmacies. The case is the first time that the ACCC has challenged in court a distribution strategy embarked on by a pharmaceutical patent holder immediately prior to expiry of its exclusive rights. The Court found that Pfizer did not have the requisite substantial market power at the relevant time and at no time engaged in conduct for a prescribed prohibited purpose. The appeal is likely to be decided in 2016.

Paul Schoff, Head of MinterEllison's Australasian Competition and Regulatory Group and Head of MinterEllison's Cartels Unit.

Unfair Contract Terms:

Many small firms entering into agreements with larger businesses have no option but to accept all the terms of standard form contracts. New laws coming into force on 12 November 2016 will allow the courts to strike out unfair contract terms.

The protections apply where at least one party to the contract employs less than 20 people, and the price payable under the contract is no more than $300,000, or $1 million if the contract is for more than 12 months. (The law doesn't apply to terms setting the price payable under a contract). A term may be unfair if it causes significant imbalance, is not necessary to protect the legitimate interests of the party advantaged by the term, and would cause harm to the other party if it were relied on.

An example of an unfair term might be an agreement for telecommunication or advertising services where one party, but not the other, is allowed to unilaterally change or cancel the contract.

If the court finds a term unfair, that particular term will be void and treated as if it never existed. The rest of the contract will remain in effect to the extent it is capable of operating without the unfair term.[34]

ACCC Deputy Chair Dr Michael Schaper said:

"For every business that deals with small businesses, now is the time to check that your contracts are compliant…the new protections will help address significant imbalances or disadvantages to small businesses in their dealings with other businesses by allowing the courts to declare void unfair terms within standard form contracts."

Review of the Australian Consumer Law:

The first review of the Australian Consumer Law is under way and there are many issues on table of interest to company directors.

The law provides businesses with both rights and obligations and covers what you can and can't say in your advertising, how you deal with customers as well as things like product safety.

The review will test whether the law suits the modern marketplace and whether the tools and sanctions are delivering compliance. For example, one of the burning questions for the review is whether the maximum available penalty of $1.1 million is enough to deter larger firms from breaking the law.

Dealing with 'phoenix' companies is another live issue. A company shuts down, often harming consumers and suppliers in the process, only to start-up again under a different business name while avoiding the liabilities of the old company. The review is seeking views on whether the law can better deal with these types of situations.

At present, unconscionable conduct protections (s 21) don't apply to public companies.

Unconscionable conduct is the term for particularly harsh or oppressive behaviour that goes against conscience as judged against business and social norms and standards. The fact a company is publicly-listed is not always a good reflection of its size, level of resourcing or its ability to withstand unconscionable conduct. The review is asking whether the ACL needs to be extended to cover publicly-listed companies.

ACCC Chair Rod Sims said:

"The ACL review gives us a chance both to reaffirm the benefits of what we have, and to make the law even better."

Consumer Affairs Australia and New Zealand are conducting the review with a final report expected in March 2017.[35]

Dr Michael Schaper, ACCC Deputy Chair and Member of the ACT AICD Council.

[34] See http://www.accc.gov.au/business/business-rights-protections/unfair-contract-terms, and https://www.youtube.com/watch?v=0b9vZIgn7ow

[35] See http://consumerlaw.gov.au/review-of-the-australian-consumer-law/about-the-review/

3.3 Australian Prudential Regulation Authority (APRA) update

3.3.1 Bank and insurer risk management

CPS 220 has entered the lexicon of the directors of our banks and insurers. Mention the code in a board room and there will be knowing nods. That is extraordinary. Codes for prudential standards are not normally top of mind for directors.

Risk management is important for any business but it is particularly important for banks and insurance companies because they make financial promises to the community, and a sound and stable economy depends on those promises being met. This is the fundamental rationale for why these institutions, in Australia, are regulated by the Australian Prudential Regulation Authority (APRA).

Prudential regulators pay particular attention to capital levels (a buffer when things go wrong), risk management (helps avoid things going wrong) and governance (to make sure capital and risk are managed well).

In 2015, APRA introduced a prudential standard on risk management – CPS 220. Much of this was not new, but in banking's case it was the first standard dedicated to risk management. It also introduced some new requirements.

Of particular note is that the board must 'form a view' on the risk culture and how well it supports the risk appetite, identify areas for change, and ensure something is done to effect that change. Boards are grappling with how best to tackle this, and both thinking and good practice are evolving. At the very least the board should address this issue systematically, and ensure it does indeed form and record its view of risk culture, and not just assume directors have a consistent collective view.

CPS 220 has a number of concepts intended to give structure to risk management. Directors may find it helpful to approach it systematically, for example:

- Understand the main requirements and how they work together, in particular those covering the risk management framework, the risk management strategy, risk appetite and risk culture.
- Understand the specific responsibilities of the board.
- Be satisfied that there is a systematic approach in place to properly address all of the requirements, with competent people and good processes supporting the board.
- Do not look on this as a compliance exercise, and instead use CPS 220 as a framework for good risk management practice that will add real value to the business.

Ian Laughlin, Chairman of OnePath life, OnePath general and ANZ lenders mortgage insurance companies, and chair of the advisory board of Blackhall and Pearl.

> "Risk management is important for any business but it is particularly important for banks and insurance companies because they make financial promises to the community..."

3.4 Financial reporting update

3.4.1 Financial reporting update

Australian Securities and Investments Commission:

The Australian Securities and Investments Commission (ASIC) has issued its focus areas for 30 June 2016 financial reports (16/174MR) as follows:

- accounting policy choices;
- key disclosures;
- accounting estimates (impairment testing and asset values).

Whilst ASIC targets listed and other public interest entities, they also review proprietary and unlisted public companies on a reactive basis from complaints and other intelligence.

In the update, ASIC acknowledges that directors are not required to be accounting experts. However, they remind directors to seek explanations, involve experts where appropriate and to challenge asset values in the financial report.

"...they remind directors to seek explanations, involve experts where appropriate and to challenge asset values in the financial report."

In addition, on July 25 2016, ASIC released a consultation paper about it directly communicating specific financial reporting and audit findings identified from ASIC reviews of external audit files to directors, audit committees or senior managers of companies, responsible entities or disclosing entities.

Australian Accounting Standards Board:

The Australian Accounting Standards Board (AASB) has issued a number of accounting standard updates, the most significant being:

- AASB 15 *Revenue from Contracts with Customers,* applicable for financial years commencing on or after 1 January 2018;
- AASB 9 *Financial Instruments*, applicable for financial years commencing on or after 1 January 2018;
- AASB 16 *Leases*, applicable for financial years commencing on or after 1 January 2019.

AASB 15 *Revenue from Contracts with Customers* provides a new framework for recognising, measuring and disclosing revenue following a five step approach.

The revised standard is expected to have varying impacts across organisations and industries. Some organisations, mainly telecommunications, will require substantial changes to financial systems and processes, whereas many others will benefit from simpler implementation. These impacts could extend to systems outside of finance such as bonus schemes, commissions, etc.

As some revenue contracts can extend over multiple years and the comparative period for the standard commences in 2017, it is timely now for directors to consider questioning management on their implementation plan for this standard.

AASB 9 *Financial Instruments* introduces a new hedge accounting model, an expected loss impairment model and changes to classifying and measuring financial assets.

The impact of the standard will differ, depending on the industry and the degree to which it has adopted and/or intends to adopt hedge accounting practices. Some entities may have early adopted various part of this standard, to take advantages of some of the changes the standards bring.

An understanding of the full impact of this standard should be undertaken by management, and directors should consider the impact as well as risks and opportunities that may be presented.

AASB 16 *Leases* will significantly impact lessees and have minimal impact for lessors. It results in the recognition of almost all leases on the balance sheet, removing the distinction between operating and finance leases. Therefore, it will impact financial ratios and debt covenants. In addition, the timing of expense recognition will be impacted, with expenses typically higher in the earlier years of the lease.

Any current lease negotiations should consider the impact of this standard, and directors should consider questioning management about the impact on existing lease arrangements, given that leases usually span a number of years.

Australian Tax Office (ATO):

For financial years commencing on or after 1 July 2016, global entities, with annual global revenue over $1 billion (or with a parent with revenues of this magnitude) will be required to lodge to the ATO, who will forward them to ASIC, general purpose financial reports with their annual tax assessments. This amendment was passed by Parliament in 2015 and the details are contained in the *Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015*.

This will have a significant impact on entities that previously lodged special purpose financial reports, as more accounting standards need to be adopted when preparing general purpose financial reports. However, for most taxpayers the ATO does not anticipate that lodgement of these financial reports will be required until early 2018. Prior to this, the administration arrangements need to be determined and these will be consulted on in due course.

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