AUSTRALIAN INSTITUTE *of* COMPANY DIRECTORS

Essential Director Update:17

Your duties. Your update.

AUSTRALIAN INSTITUTE
of COMPANY DIRECTORS

Level 30, 20 Bond Street
Sydney NSW 2000
t: 61 2 8248 6600
f: 61 2 8248 6633
e: publications@companydirectors.com.au
w: www.companydirectors.com.au

The Australian Institute of Company Directors is committed to excellence in governance. We make a positive impact on society and the economy through governance education, director development and advocacy. Our membership of more than 40,000 includes directors and senior leaders from business, government and the not-for-profit sectors.

Disclaimer The material in this publication does not constitute legal, accounting or other professional advice. While reasonable care has been taken in its preparation, the Australian Institute of Company Directors does not make any express or implied representations or warranties as to the completeness, reliability or accuracy of the material in this publication. This publication should not be used or relied upon as a substitute for professional advice or as a basis for formulating business decisions. To the extent permitted by law, the Australian Institute of Company Directors excludes all liability for any loss or damage arising out of the use of the material in the publication.
Any links to third party websites are provided for convenience only and do not represent endorsement, sponsorship or approval of those third parties, any products and services offered by third parties, or as to the accuracy or currency of the information included in third party websites. The opinions of those quoted do not necessarily represent the view of the Australian Institute of Company Directors.

Copyright Copyright strictly reserved. The text, graphics and layout of this guide are protected by Australian copyright law and the comparable law of other countries. The copyright of this material is vested in the Australian Institute of Company Directors. No part of this material can be reproduced or transmitted in any form, or by any means electronic or mechanical, including photocopying, recording or by any information storage and retrieval systems without the written permission of the Australian Institute of Company Directors.

© Australian Institute of Company Directors 2017

Published in October 2017

Welcome

Good governance relies on being up to date, and for 11 years the Essential Director Update has provided members of the Australian Institute of Company Directors (AICD) with information about the critical changes to the governance, business and regulatory landscapes that impact director duties and responsibilities.

A core benefit of your membership with us, it is our largest complimentary event for members and this year we are traveling to more places than ever before across Australian capital cities and regional centres.

For our members based in capital cities, we are pleased to welcome back Graham Bradley AM FAICD as keynote speaker. This year Graham will be joined by the AICD's chief economist Stephen Walters MAICD for a look ahead into what is in store for Australian directors and business leaders.

For members in other metropolitan and regional areas of NSW, Queensland and Victoria, Essential Director Update events will be facilitated by experienced directors and popular past contributors Sarah-Jane Christensen MAICD, Lucas Ryan GAICD and David Shortland FAICD.

In response to feedback from last year, this year's events provide more opportunities for engaging discussion and expert insights, with facilitators offering their personal views on topical issues as well as answers to your questions in the Q&A session.

More than 5,000 of your fellow members are expected to attend Essential Director Update events around the country in 2017. We hope that it provides the need-to-know information that will assist you on your director journey, as well as a valuable opportunity for you to meet with peers.

Contents

1.0 THE BUSINESS ENVIRONMENT 8

1.1 Changing business environment 8

1.1.1 AICD Director Sentiment Index 8

1.1.2 Trust and business legitimacy 8

1.2 Government 10

1.2.1 Governance of the Nation: A Blueprint for Growth 2017 10

1.3 International business environment 11

1.3.1 China relations 11

1.3.2 Foreign bribery 12

1.4 Technology 13

1.4.1 Key technology trends 13

2.0 THE GOVERNANCE ENVIRONMENT 15

2.1 Corporate culture 15

2.1.1 Sustained focus 15

2.2 Whistleblowing reform 16

2.2.1 Whistleblowing reform 16

2.3 Shareholder activism 17

2.3.1 Shareholder activism 17

2.3.2 Proxy advisers 17

2.4 Annual general meeting season 19

2.4.1 Executive remuneration 19

2.4.2 Hybrid and electronic annual general meetings 20

2.5 Reporting and disclosure 21

2.5.1 Environmental, social and governance reporting trends 21

2.5.2 Integrated reporting 22

2.5.3 Underlying profit 22

2.5.4 Company tax transparency: justified trust and a fair share of tax 23

2.6 Director liability 25

2.6.1 Insolvent trading safe harbour reform 25

2.6.2 Illegal phoenix activity, director identification numbers and the Fair Entitlements Guarantee scheme 26

2.6.3 Increasing regulatory powers and director penalties 27

2.6.4 Climate change director liability 27

2.7 Superannuation 29

2.7.1 Director independence 29

2.7.2 Member outcomes and engagement 29

2.8 Cybersecurity 30

2.8.1 Mandatory data breach disclosure 30

2.8.2 ASX100 Cyber Health Check Report 31

2.8.3 Cyber insurance 32

2.9 Diversity 32

2.9.1 Progress towards 30% by 2018 32

3.0 THE REGULATORY ENVIRONMENT 33

3.1 Australian Securities and Investments Commission 33

3.1.1 Regulatory priorities 33

3.1.2 Enforcement priorities 34

3.1.3 New crowdfunding legislation 35

3.2 Australian Competition and Consumer Commission 36

3.2.1 Unfair contract terms 36

3.2.2 Franchising Code of Conduct 37

3.3 Australian Taxation Office 38

3.3.1 Justified trust: the Top 1,000 Tax Performance Program 38

3.4 Australian Prudential Regulatory Authority 39

3.4.1 Regulatory priorities 39

3.5 Financial reporting 40

3.5.1 New for 2017 40

3.5.2 Enhanced auditor reporting 41

3.6 Australian Charities and Not-for-profits Commission 42

3.6.1 Regulatory priorities 42

3.6.2 Fundraising reform 42

3.6.3 Australian Charities and Not-for-profits Commission statutory review 43

1.0 | THE BUSINESS ENVIRONMENT

1.1 Changing business environment

1.1.1 AICD Director Sentiment Index

In May 2017, the AICD released the latest results from the Director Sentiment Index – Australia's only indicator measuring the opinions and future intentions of directors on a range of issues including the economy, government policy and governance regulations.

The results showed that director sentiment was at its highest point since 2011. This increase in sentiment was primarily driven by increasing confidence around domestic and international economic conditions. Directors' confidence in the outlook for the Australian economy rose significantly, as did expectations around the health of the US and Asian economies. Concerns around global economic uncertainty and a China slowdown also dropped substantially.

Sentiment on investment levels and staff hires were at their highest points since 2011 and directors' confidence about the growth of their primary business was at record levels, with 57 per cent of directors expecting their business to grow over the next 12 months.

However, directors remain concerned about the ability of the government and parliament to drive reform and growth, with 86 per cent rating the current quality of public policy debate in Australia as poor. Directors also ranked less focus on short-termism as the number one measure to boost productivity.

Directors also remained pessimistic about the state of the current annual general meeting system with only 25 per cent of directors of the opinion that the current annual general meeting system is working well.

Directors nominated sustainability and long-term growth prospects, changing business models and legal and regulatory compliance as the issues most likely to keep them up at night.

Matt Pritchard, Head of Government Relations and Media, AICD

1.1.2 Trust and business legitimacy

Globally, trust in institutions – business, government, media and NGOs – is in crisis.

This is driving a wave of populist sentiment being felt in many democracies, including our own.

According to the 2017 Edelman Trust Barometer[1] a global 'implosion of trust' has seen the general population's trust in key institutions decline. Worldwide, over half of the 30,000+ respondents to the survey feel that the current system has failed them and is unfair.

[1] Edelman Intelligence, 2017, *2017 Edelman Trust Barometer: Global Annual Study*, January, https://www.edelman.com/trust2017/, (accessed 23 August 2017).

The survey also found that the credibility of leaders was at its lowest level in the seventeen years of the study – CEO credibility fell to an all-time low of 37 per cent globally but was far lower in Australia at 26 per cent.

In this environment, business faces continuing calls to invest in meeting their 'social licence to operate' linked to changing community values and expectations.

The focus by regulators and legislators on corporate culture – including the role of the board in setting and monitoring culture – is partly a response to this trust deficit. This regulatory focus shows no signs of dissipating with 2017 bringing new layers of regulation for banking organisations aiming to boost corporate accountability and focus on culture.

"The focus by regulators and legislators on corporate culture – including the role of the board in setting and monitoring culture – is partly a response to this trust deficit."

ASIC's Chairman Greg Medcraft returned to this theme in a recent appearance before the Parliamentary Joint Committee on Corporations and Financial Services.

"At this time of massive technological and digital change, culture—or cultural failure—is enormously critical because that often goes to trust," said Mr Medcraft.

"Creating a sustainable business today is not only about delivering a quality, product or service it's also about the quality of a firm's conduct, both internally and externally."[2]

> "To rebuild trust and restore faith in the system, institutions must step outside of their traditional roles and work toward a new, more integrated operating model that puts people – and the addressing of their fears – at the centre of everything they do".
>
> 2017 Edelman Trust Barometer[3]

While trust is in crisis, it can be rebuilt. Along with the focus on culture being encouraged by regulators, boards can take note of trends from the global study.

Firstly, avoiding trust-destroying behaviour is vital: paying bribes, avoiding tax, excessive executive remuneration, overcharging for essential services amongst them.

Secondly, 'get real' by putting people at the centre of engagement: do things with the general population, rather than for them, and engage with the general population not just a target audience, suggests Edelman.

Louise Petschler MAICD, General Manager Advocacy, AICD

[2] Proof Committee Hansard, 2017, *Parliamentary Joint Committee on Corporations and Financial Services: Oversight of the Australian Securities and Investments Commission and the Takeovers Panel*, 11 August, p 2.
[3] Edelman intelligence, 2017, "2017 Edelman Trust Barometer", [website], https://www.edelman.com/trust2017/, (accessed 23 August 2017).

1.2 Government

1.2.1 Governance of the Nation: A Blueprint for Growth 2017

Urgent national reform is needed to drive Australia's growth, income and prosperity. The aim is to lift productivity, which can be defined as the level of output extracted from a given set of inputs. Improvement here is the result of combining the factors of production, particularly labour and capital, in the best way possible.

Unfortunately, productivity in Australia has lagged for some years, as it has in many other countries, but is a key driver of long term national living standards. The AICD aims to engage in the debate on productivity and to help prosecute the case for lasting reform.

To support this, earlier this year, the AICD launched the 2017 edition of *Governance of the Nation: A Blueprint for Growth*. The blueprint recommends national policy reforms to deliver tangible benefits and a longer-term focus for national policy making. This year's document builds on the 2016 edition but includes a much broader range of recommendations, particularly in regard to fiscal sustainability.

Boosting productivity is not a job for government alone; for too long the private sector has left the heavy lifting to government. The regrettably partisan nature of modern politics, however, has made achievement of crucial national goals all but impossible. The blueprint recognises the vital role that the private sector – and directors and boards, in particular – must play to drive reform and boost productivity.

"Boosting productivity is not a job for government alone; for too long the private sector has left the heavy lifting to government."

The 2017 edition of the blueprint makes recommendations in six main areas: reforming national governance, fiscal sustainability, innovation and entrepreneurialism, partnership with not-for-profits, human capital and national infrastructure. Some progress has been made in key areas, particularly in infrastructure, but much less in others. Disappointingly, reform of the tax system has been piecemeal at best.

We recognise that the prospects for achieving meaningful reform in the current contested state of politics is a greater challenge than ever before. The AICD believes, however, that a time like this calls for informed advocates of change to progress well-considered arguments for reform, and not shrink into the background and remain silent.

Stephen Walters MAICD, Chief Economist, AICD

1.3 International business environment

1.3.1 China relations

Extradition Treaty

The Australian Government still intends to ratify a controversial extradition treaty with China signed on 6 September 2007, which would see the range of extraditable offences expanded to include all offences considered to be serious by both countries, such as murder.

This is despite the government having to withdraw the treaty after it was tabled in parliament in March of this year, after strong indications from the Senate that it would block the treaty due to human rights concerns.

Concerns have been expressed by some bodies, including the Law Council of Australia, about the human rights safeguards contained in the treaty. These concerns include the right to a fair trial, the independence of the judiciary, and the use of the death penalty within the Chinese legal system. Labor has also called for a review of the *Extradition Act 1988* (Cth) itself.

The government maintains that these concerns are addressed through a number of safeguards built in the new treaty which resemble those in the *Extradition Act 1988* (Cth).

These safeguards include an extensive number of "mandatory grounds for refusal", such as where the extradition is requested is regarded as a political offence, where there are "substantial grounds" for believing the person has been or will be subject to torture or other cruel, inhumane, or humiliating treatment or punishment.

Crown Resorts

All 16 current and former employees of Crown Resorts who were detained in China, including three Australians, have now been released, following their conviction and imprisonment for crimes related to the promotion of gambling. Three junior employees were initially detained, but were not fined or imprisoned.

Crown Resorts had been operating in China in an effort to promote gambling business for the group. The operation did carry significant risks, given that Chinese law more-or-less prohibits the marketing or promotion of gambling. Australian Jason O'Connor, Crown's head of international operations, was given a 10-month prison sentence, while executives Jerry Xuan and Pan Dan were given 9-month sentences. In addition, individuals were fined a total of approximately AU$1.67 million.

The episode highlights the importance of effectively monitoring and managing legal risk in foreign jurisdictions (including China), and having an effective crisis management plan in place, should things go wrong.

In particular, when conducting business overseas, directors should ensure that management has set up appropriate staff briefings with relevant experts who are familiar with the risks associated with the business and ensure that foreign legal counsel is briefed in advance so that legal assistance can be called upon quickly. To the extent possible, directors should also conduct their own due diligence on the laws and customs of a foreign jurisdiction.

Foreign Investment Review Board Update

The Foreign Investment Review Board (FIRB) has a new chair, David Irvine AO, replacing outgoing chair Brian Wilson. Mr Irvine was a former Australian Ambassador to China and Director General of ASIO and ASIS. He has been appointed for a five year term, which commenced on 16 April 2017.

Recent and notable recommendations of the FIRB include the following:

- In a late and unexpected decision, FIRB recommended against approval for the acquisition of a 99-year lease of a 50.4 per cent share of state-owned Ausgrid (the NSW electricity provider), citing "national security" concerns. The State of NSW had hoped to net AU$10 billion from the deal.
- FIRB recommended approval of the AU$7.48 billion takeover of energy company DUET Group by a consortium of companies based in Hong Kong, including Cheung Kong Infrastructure, Cheung Kong Property, and Power Asset Holdings.

- FIRB recommended approval of the AU$386.5 million sale of S. Kidman & Co Limited to the Williams Family, along with Australian Outback Beef Pty Ltd, which is owned in turn by Hancock Beef Pty Ltd and Shanghai CRED Real Estate Stock Co Ltd.
- FIRB recommended approval of the foreign investment application of Moon Lake Investments to acquire the land and assets of the Tasmanian Land Company from the New Plymouth District Council.

The controversial recommendation of the FIRB on the Ausgrid decision gave rise to concerns about the potential unpredictability of the FIRB's recommendations, particularly where "national security" issues could emerge from a transaction. It was clear that more guidance and clarity was required for investors about these issues.

To ameliorate these concerns, on 23 January 2017 the government announced the introduction of a new Critical Infrastructure Centre, which will pre-emptively assess national security risks for critical infrastructure and advise FIRB. However feedback has indicated that more guidance and clarity was still required.

Going forward, when assessing acquisitions of significant infrastructure, directors should engage with FIRB at the earliest opportunity to ensure that any national security issues can be addressed.

Matthew McGirr, Policy Adviser, AICD

1.3.2 Foreign bribery

Australia's foreign bribery laws are currently under scrutiny and are likely to change soon, if the proposals found within a consultation paper released earlier this year are any indication.

The consultation paper, released in May 2017, follows in the wake of several public allegations of foreign bribery involving Australian companies, including mining giant Rio Tinto and an iron ore mine development in West Africa.

In 2011, a set of confidential emails were leaked revealing that senior Rio Tinto executives had arranged for a AU$10.5 million payment by Rio Tinto to a French banker named François de Combret, who had close ties with the Guinean president, Alpha Condé.

The payment concerns Rio's attempt to secure the Simandou iron ore project, valued at AU$700 million. The email leak sparked an internal investigation and the suspension or removal of several executives involved.

Bribery of a foreign public official is currently an offence under s 70.2 of the *Criminal Code Act 1995* (the Criminal Code), which carries significant penalties for individuals and companies. However, since its introduction, there have been no successful prosecutions.

Australia's lack of enforcement outcomes has previously drawn criticism of the OECD, which noted in its most recent Phase 3 report on implementing the OECD Anti-bribery Convention that out of the 28 foreign bribery referrals that have been received by the Australian Federal Police, 21 have been concluded without charge.

Key changes proposed by the government's consultation paper are as follows:

- A new corporate offence of failing to prevent foreign bribery. The new offence would cause a company to be automatically liable for the offence if one of the company's employees, contractors, or agents commits a foreign bribery offence, unless the company can show they had a proper system of internal controls and compliance in place to prevent foreign bribery from occurring. The offence reverses the onus of proof, so a company would have to prove they had a proper system of internal controls and compliance in place to escape liability.
- A new foreign bribery offence based on a fault element of "recklessness" in an effort to enable greater scope for authorities to achieve a successful prosecution, and serve as a greater deterrent for foreign bribery activity.

- A new legal test for foreign bribery offences. At present, the prosecutor must show that a payment was "not legitimately due" to succeed. The government proposes to replace this test with either a test based on whether a payment was made to "improperly influence" a public official, or whether the payment was "dishonest".

The AICD provided a submission to the government in response to these proposals, and has subsequently appeared at a public Senate Committee inquiry hearing. In that submission and Senate hearing, the AICD opposed the introduction of a fault element of "recklessness", arguing that it would create too much uncertainty for directors in practice.

In response to a question on notice arising from the Senate Committee hearing, the AICD indicated that it was supportive of the introduction of a "failure to prevent" offence, but that it did not support the reversal of the onus of proof.

The AICD will continue to advocate for measured changes to the law to improve enforcement outcomes.

Matthew McGirr, Policy Adviser, AICD

1.4 Technology

1.4.1 Key technology trends

Augmented human work
The impacts of artificial intelligence and machine learning on human work are now very real and rapidly impacting governance matters. Questions directors are asking themselves include: Is it sound to sign off on multi-year year financial statements without a real view on where the organisation could be enabling machine learning? What will a competitor do with automation that could impact an organisation's cash flows or future value creation? What new organisational skills are needed to leverage a future labour force? How should stakeholder expectations regarding automation be managed for community support and acceptance?

Division of labour has always been about where and who should perform each task. The dimension of where labour can be outsourced to machines is nothing new. With augmented machine intelligence, however, it's not just labour that can be outsourced. It now also includes higher level order work like customer insights, financial analysis, customer interactions, customer behaviour prediction and a growing list of other use cases from staff planning to capital allocation. The driverless car is a case in point in terms of reach, as just three years ago it was not seen as a near term possibility. Today there are a common sites in Europe and the US and car manufacturers, insurance companies, infrastructure specialists, government legislators and engineers are scrambling to adjust to this new reality.

While human capacity is constrained by evolution and biology, the capacity of machine learning is growing exponentially and this is increasing the amount of opportunity from augmented human work.

Directors making capital allocations and long term plans will need to have a clear line of thought on where the impact of artificial intelligence and machine learning will influence their organisation's ability to serve and understand their customer needs. This is at the heart of where augmented human work is being deployed at scale today.

Technology giants now teach customer-driven retail
No matter what industry an organisation is in, employees, customers and shareholders now know what good customer service and retail experience can look and feel like thanks to technology giants such as Amazon, Google, Facebook, Apple and Netflix. Collectively, they are redefining retail experience benchmarks.

Amazon is taking proactive customer-oriented action to ensure that what their customers experience is acceptable in terms of speed, accuracy and response: from patenting seamless e-commerce through one-touch buy buttons, to predictive personalisation engines, to the sort of customer sensitivity that allows automatic rebates for customers who stream a movie and experience buffering and slow load times.

Similarly, Netflix's customer-centricity is redefining how products get to market. It doesn't rely on surveying customers to understand them – a staggering 75 per cent of all Netflix viewing is off its recommendation engine to customers.

These examples show the breadth and speed at which technology is changing the face of retail (and competition and privacy), and directors of companies not founded in new technologies face a significant challenge: how to create a culture and operating environment where customer signals can be found, analysed and integrated into well-considered workflows and processes. In this sense, retro fitting this sort of data-centric customer capability into a traditional business is one of the key governance challenges of our times.

The impact of automated advice

Automation in the work force is no longer constrained to areas like robo advice for financial services. As stock pickers and brokers were outpaced with machines that could spot arbitrage opportunities at the speed of light, the way was opened for this sort of automated anticipatory machine learning to scale not only across sectors but also within organisational layers.

This sort of change in how advice is developed and utilised – raising the quality of human advice rather than replacing it – is creating complexity for board's considering future organisational development. It is no longer enough to acknowledge that constant human learning is required at all levels of the organisation including the board. There is a growing pressure on directors to also have a view on where automation, artificial intelligence and machine learning will impact the organisation.

Although not expected to be experts themselves, directors are expected to know when their organisation has a need for advice or new external capability. Failure to seek advice, or install a new capability when needed, is a governance challenge and it follows that not being aware of how to use relevant automated advice from data and machines is a new exposure.

Boards need to carefully assess how their organisations are structured and resourced to:

- find and mine data signals relating to current and future customers, competitors and operating markets;
- find and harness the best systems for understanding data relating to the relevant environmental landscape;
- find and keep, or outsource, talent that supports the creation of data, artificial intelligence and augmented decision making;
- integrate the above three points into the connective tissue of the whole organisation so it can function off the most relevant customer signals for sustainable change and real customer-centricity;
- have a robust understanding of the regulatory frameworks and stakeholder expectations around data privacy and protection; and
- prepare for cyber threats and mitigate the knock-on impacts to reputation and financial impacts of a cyber breach.

Tim Trumper MAICD, Advisor to Quantium and Director NRMA and PHRN

2.0 THE GOVERNANCE ENVIRONMENT

2.1 Corporate culture

2.1.1 Sustained focus

The Australian Securities and Investments Commission (ASIC) continues to focus on corporate culture because, in the words of Commissioner John Price, "we see the very real impact of poor culture through misconduct, scandals and poor outcomes for investors and consumers".

Commissioner Price recently confirmed that while not seeking to regulate culture with black letter law, ASIC expects boards to "play a role in setting the tone, influencing and overseeing culture, and ensuring the right governance framework and controls are in place."[4]

To gain insights into a company's culture and to encourage positive conduct, ASIC suggests that boards consider the following questions:

- Has the culture of the organisation been independently assessed? Do the firm's stated values match the actual experiences of customers, employees, suppliers, etc.?
- Is culture a regular feature on the board and audit committee agendas?
- Do directors have broader interaction across the organisation (for example, not limiting themselves to the chief executive officer and executive management)?
- Do directors have relationships with key employees (for example, line managers) to gather insights about the company's culture and issues?
- Does the board engage with external stakeholders such as customers, suppliers, and regulators?
- Is data captured on key indicators (for example, employee feedback and surveys, customer complaints, progress on employee training on culture issues)? Is this data monitored to see how the various indicators change or move together?
- Is the information in internal and external audits being fully used?[5]

As part of the 2017 Federal Budget, the government announced new statutory measures – the Banking Executive Accountability Regime (BEAR) – to hold banks and senior bankers accountable for conduct failures. The BEAR proposals, as set out in a consultation paper in July, will apply to authorised deposit-taking institutions (ADIs) and their subsidiaries. The proposals include: new civil penalties for ADIs; additional conduct expectations for certain senior executives and directors; and greater powers for the prudential regulator, APRA, including to compel changes to remuneration policies, and to remove and disqualify senior executives and directors.

Lysarne Pelling GAICD, Senior Policy Adviser, AICD

[4] J Price, 2017, "Outline of ASIC's approach to corporate culture", AICD Directors' Forum: Regulators' Insights on Risk Culture, AICD, Sydney, 19 July.
[5] ibid.

2.2 Whistleblowing reform

2.2.1 Whistleblowing reform

Australia's corporate whistleblower protections are considered among the weakest of OECD nations and reform to this framework has emerged as a priority issue for the Australian Government in 2017.

The government announced a review of corporate and tax whistleblowing laws late in 2016 and has undertaken public consultation on proposed reforms throughout 2017. The scope of the review is expansive and is likely to result in significant reform to the regime with a focus on providing better protections for corporate whistleblowers.

> "The scope of the review is expansive and is likely to result in significant reform to the regime with a focus on providing better protections for corporate whistleblowers."

Some reforms are straightforward and likely to receive broad support. For example, extending whistleblower protections to former officers (including former directors), staff and contractors, as well as unpaid workers, accountants and auditors. Consideration has also been given to whether disclosures should be protected if they are made anonymously, or through a lawyer.

The reforms are likely also to include a much more expansive definition of what it means to victimise a whistleblower and a more comprehensive framework for compensation.

Other aspects of the consultation are likely to be more controversial, such as removing the requirement that protected disclosures must be made in good faith, extending protection to disclosures made to third parties and consideration of a US-style system of financial reward for whistleblowers whose disclosures result in the successful application of a penalty.

Legislation is scheduled to be presented to the parliament before the end of 2017. The AICD has been active in the reform process and will continue to advocate for stronger protections for whistleblowers, recognising that robust whistleblower protections support good governance.

Lucas Ryan GAICD, Senior Policy Adviser, AICD

2.3 Shareholder activism

2.3.1 Shareholder activism

The public campaign launched by US activist investor Elliott Management in April 2017 to 'unlock value' in BHP Billiton, one of Australia's largest and oldest companies, has raised the profile of shareholder activism in this country.

Shareholder activism is not new to corporate Australia, however it is increasing. The number of campaigns grew from 28 in 2011 to 74 last year. The vast majority of these have been waged against small-cap, natural resources companies.[6]

Historically, activists have been domestic investors, intent on changing board composition in a bid to address perceived underperformance. Since 2013, activists have reportedly won 113 seats on Australian boards.[7] More recently, activists (including foreign hedge funds) have targeted larger Australian companies with specific economic value creation proposals in addition to pursuing board representation (for example, Sandon Capital/ BlueScope Steel and Elliott/ BHP).

Opinions on the effects of economic activism vary, often strongly. Proponents claim that it leads to more engaged boards and management, resulting in improvements in business operations and share value. Critics argue that shareholder activism leads to short-term decision making that benefits the activist, but undermines long-term shareholder value. Research on this issue is mixed.

Another emerging trend in corporate Australia that is broadly in line with overseas developments, is the rise of shareholder activism on environmental, social and governance (ESG) issues, such as climate change (for example, ACCR-led shareholder groups/ CBA, AGL and Origin Energy).

In terms of ESG activism, a lack of board gender diversity will be in the cross-hairs this annual general meeting (AGM) season with the Australian Council of Superannuation Investors (ACSI) announcing it will recommend that its members oppose the re-election of directors to ASX200 boards that do not have a plan to achieve 30 per cent women by year end.[8]

Directors should also expect to see greater collaboration among activists, particularly as foreign hedge funds look to local investors (including long-term shareholders) for assistance in navigating our market and regulations.

Lysarne Pelling GAICD, Senior Policy Adviser, AICD

2.3.2 Proxy advisers

Proxy advisers play an increasingly influential role in the Australia's listed market. Negative voting recommendations can have a significant impact on listed companies, particularly given the potential for our 'two strikes' rule to lead to board spills.

The AICD recognises that proxy advisers fulfil an important function by facilitating the informed voting of holdings in listed entities.

Given this impact and influence, the AICD and others have argued that standards should be set to ensure the recommendations of proxy advisers are well-researched, accurate, considered and objective. Meaningful engagement between proxy advisers, issuers and institutional investors must be an essential part of this process.

Some other jurisdictions have, or are proposing, such standards in regulations, codes or guidelines.

[6] JPMorgan, 2017, *Shareholder Activism in Australia: Navigating the evolving landscape*, JPMorgan Chase & Co, p 4.
[7] Activist Insight and Arnold Bloch Leibler, *Shareholder activism in Australia: A review of trends in activist investing*, p 4.
[8] Australian Council of Superannuation Investors, 2016, *Time running out for all-male boards*, media release, ACSI, Melbourne, 19 October.

The 2016 AGM season, which saw several of Australia's largest companies receive a 'strike' against their remuneration reports, prompted questions about some proxy adviser practices.

Inadequate engagement with boards prior to making negative recommendations, questions over the quality of analysis, a lack of transparent conflicts management and an inflexible 'tick-the-box' approach to governance issues were among the concerns raised.

Responding to these and other issues, ASIC hosted a roundtable in May 2017 for proxy advisory firms, investor representatives and relevant industry groups, including the AICD. While no consensus for industry action emerged, ASIC has stated that it will monitor the engagement issues raised at the roundtable during the 2017 annual general meeting season.[9]

The AICD will continue to advocate for improvements in voting governance.

Lysarne Pelling GAICD, Senior Policy Adviser, AICD

"The 2016 AGM season, which saw several of Australia's largest companies receive a 'strike' against their remuneration reports, prompted questions about some proxy adviser practices."

[9] ASIC, 2017, *REPORT 539 ASIC regulation of corporate finance: January to June 2017*, ASIC, August, paragraphs 216-230.

2.4 Annual general meeting season

2.4.1 Executive remuneration

Over a number of years, director and executive remuneration continues to be a dominant corporate governance issue globally. In Australia, while the number of remuneration report strikes have come down somewhat since 2011 (a high of 23 in the ASX 300), last year saw 18 companies in the ASX 300 being given a remuneration strike. Of these 18, one company (Liquefied Natural Gas) has had its first second strike and two companies (Mortgage Choice and UGL) have now been given three strikes.

As observed in the March 2017 AMP Capital *Corporate Governance Report*, the spotlight on executive pay seems to be on bonuses and long term incentives, as fixed pay is seen to be down to pre global financial crisis levels. The size and frequency of bonuses for chief executives remains an issue, as well as the performance hurdles attached to these and whether they reward stretch performance.

As reported in the AMP Capital report, investors are placing more importance on recognising the drivers of company value, and how these are linked to performance of executives and hence remuneration. These drivers include significant intangible components – such as people, culture, employee engagement, safety, customer satisfaction, etc. Having targets built around these components is becoming more prevalent and acceptable to investors as long as these targets are clearly articulated, linked to strategy and can be reported on appropriately. Over the long term these intangible targets (or non-financial targets, or 'soft' targets) will have financial impacts but the timing is uncertain.

" ...investors are placing more importance on recognising the drivers of company value, and how these are linked to performance of executives and hence remuneration."

In August 2017 the UK Government issued its response to the government's green paper consultation published in November 2016, with the benefit of the House of Commons Business, Energy and Industrial Strategy (BEIS) Committee's report on corporate governance published on 5 April 2017. With regards to executive remuneration, the government intends to improve the UK Corporate Governance Code through changes to remuneration committee responsibilities, and by extending the recommended minimum vesting and post-vesting holding period for executive share awards. The main legislation reform proposed is to require listed companies to report annually the ratio of CEO pay to the average pay of their UK workforce, along with a narrative explaining changes to that ratio from year to year. Furthermore, there is a proposal to maintain a public register of listed companies encountering shareholder opposition of pay awards of 20 per cent or more.

Kerry Hicks GAICD, Senior Policy Adviser, AICD

2.4.2 Hybrid and electronic annual general meetings

In the wake of the 2016 annual general meeting (AGM) season, the continued decline in AGM attendance has renewed calls for the embracement of greater use of hybrid and virtual AGMs. Virtual-only AGMs are meetings which are held without a physical location for members to attend, whereas hybrid AGMs involve both a virtual method of participation and a physical location for shareholders to attend in person.

Less than one per cent of company members now attend listed company AMGs in person, despite significant costs and time associated with their preparation. Given this, the use of virtual or hybrid AGMs does make sense for companies looking to improve their engagement with shareholders, while defraying costs associated with traditional AGM structures. This is particular so considering the developments of streaming technology and the widespread use of smartphone technology.

That said, not all believe that virtual AGMs are a net-positive development for shareholder engagement. Over the past year, a number of prominent media articles have aired the concerns of investors relating to virtual AGMs. Concerns expressed by investors include that virtual meetings enable companies and directors to control an AGM by filtering questions, censoring debate, and limiting genuine engagement with shareholders.

In particular, shareholders have expressed concerns about the lack of an opportunity within a virtual-only AGM for any 'back-and-forth' with management, and the scope for management to filter out follow up questions and even uncomfortable questions through their control of the technology platform.

Despite these concerns, the AICD recognises that the march towards a greater use of technology in AGMs is inevitable. Indeed in the United States several large companies have already adopted virtual AGMs, including HP Inc, GoPro, Inc, PayPal Holdings and others. Others have adopted hybrid AGMs, including Microsoft Corporation, Berkshire Hathaway and Johnson & Johnson.

In Australia, there continue to be unresolved issues of law reform which hold back companies from embracing technology. The AICD has long advocated for changes to the law to enable companies to embrace technology more readily in all aspects of their activities, including the adoption of technology neutrality within the *Corporations Act 2001*. We will continue to do so leading up to the 2017 AGM season and beyond.

> "The AICD has long advocated for changes to the law to enable companies to embrace technology more readily in all aspects of their activities, including the adoption of technology neutrality within the *Corporations Act 2001*."

Matthew McGirr, Policy Adviser, AICD

2.5 Reporting and disclosure

2.5.1 Environmental, social and governance reporting trends

Investors consider a variety of information when they are assessing the long-term value of a company. Environmental, social and governance (ESG) factors are one such type of information that has been gaining prominence globally and within Australia.

According to Blackrock[10], companies do not talk typically in terms of ESG but rather use their own terminology like sustainability or corporate social responsibility. This report identifies a growing number of organisations trying to facilitate consistent disclosure and integration of material ESG factors through major ESG standards initiatives. These include the United Nations' Principles for Responsible Investment, Global Reporting Initiative, International Integrated Reporting Committee, CDP, Financial Stability Board, Global Impact Investing Rating System, Sustainability Accounting Standards Board, Ceres and Sustainable Stock Exchanges.

The Australian Council of Superannuation Investors (ACSI) annually releases a report that analyses disclosures of the ASX 200. The latest report[11] was issued in July 2017, noting the following improvements in sustainability or ESG reporting:

- The number of ASX200 companies reporting to a "Leading" or "Detailed" level has increased from 39 in 2008 to 101 in 2016.
- The number of ASX200 companies that did not provide any sustainability reporting has almost halved from 31 in 2008 to 16 in 2016.

This report also noted that the best reporters (those that were reporting to a "Leading" or "Detailed" level) use internationally recognised external standards and/or verification, as follows:

- 30 per cent used Integrated Reporting or the Global Reporting Initiative as a framework.
- 17.5 per cent undertook external verification of their reporting.

As an emerging trend amongst ASX200 companies, 9.5 per cent referred to the United Nations' Sustainable Development Goals in their reports.

The growing importance of ESG factors to investment decisions has been highlighted by Blackrock's Chairman and CEO, Larry Fink, in both his 2016[12] and 2017[13] annual letters to CEOs. His view is that ESG factors relevant to a company's business can provide essential insights into management effectiveness and thus a company's long-term prospects.

Kerry Hicks GAICD, Senior Policy Adviser, AICD

[10] Blackrock, 2016, *Exploring ESG: A practitioner's perspective*, June, https://www.blackrock.com/corporate/en-gb/literature/whitepaper/viewpoint-exploring-esg-a-practitioners-perspective-june-2016.pdf, (accessed 23 August 2017).

[11] Australian Council of Superannuation Investors, 2017, *Corporate Sustainability Reporting in Australia: An analysis of ASX200 disclosure Featuring climate related risk, ACSI*, Melbourne, July, https://www.acsi.org.au/images/stories/ACSIDocuments/generalresearchpublic/2017-Sustainability-Report-FINAL.pdf, (accessed 23 August 2017).

[12] L Fink, 2016, *Corporate Governance Letter to CEOs*, Blackrock, 1 February, https://www.blackrock.com/corporate/en-us/literature/press-release/2016-larry-fink-ceo-letter.pdf, (accessed 23 August 2017).

[13] L Fink, 2017, *Annual Letter to CEOs*, Blackrock, https://www.blackrock.com/corporate/en-us/investor-relations/larry-fink-ceo-letter, (accessed 23 August 2017).

2.5.2 Integrated reporting

More and more organisations are changing their reporting to stakeholders – producing reports that incorporate reporting on a company's strategy, business model, governance, risks, performance and outlook.

While some of these requirements are outlined for listed companies in ASIC's *Regulatory Guide 247: Effective disclosure in an operating and financial review*, a more fulsome framework is outlined in The International Integrated Reporting Council's (IIRC's) *International <IR> Framework* (IRF)[14]. This framework seeks to improve investor disclosure by including both financial and non-financial data in an integrated way within the annual report.

In 2017, the IIRC reported that over 1,500 companies used some form of integrated reporting globally, with mainstream adoption occurring in both South Africa and Japan. Further, Stephen Haddrill, CEO of the Financial Reporting Council UK, stated that "the principles in a UK strategic report are consistent with an integrated report".

In Australia, the latest Australian Council of Superannuation Investors (ACSI) report, *Corporate Sustainability Reporting in Australia*[15], noted that the IRF was formally used or referred to by four ASX200 companies in 2016. Notably, last year Lendlease Group prepared its operating and financial review (OFR) with reference to the IRF and reduced their reporting portfolio by two reports at year end.

Further, academic research highlights marked benefits for those organisations that move away from being centred on regulatory 'tick-a-box' reporting and move towards a better explanation of how they create and preserve long-term sustainable value. For example, Zhou, Simnett and Green[16] found that small-cap companies in South Africa that prepared integrated reports achieved a lower cost of capital.

The lack of an effective business judgement rule combined with the directors' liability provisions make the IRF difficult to fully implement in Australia, particularly with regards to the need for forward looking information. These concerns are being managed by Australian companies by not adopting the IRF in full and adapting their reporting by using some of the content elements of the IRF without mention of the IRF or stating the IRF has been referenced or similar.

What we are observing in some Australian organisations is a flexible, voluntary adoption of integrated reporting principles within the OFR, in order to improve the quality and usefulness of information reported to stakeholders, without increasing the reporting burden.

Kerry Hicks GAICD, Senior Policy Adviser, AICD

2.5.3 Underlying profit

Listed companies frequently report alternative earnings numbers (commonly described as underlying profit) in their presentations to the market. This information, along with the statutory profit information, can provide valuable information to shareholders and the wider investment community about the performance of a company.

Calculating underlying profit (or similar) often involves the removal of one-off or unusual items. Removal of such items from the statutory operating profit can enable investors to focus on future cash flows as part of an assessment of ongoing operations. However, such presentation of information must be done appropriately and in accordance with ASIC guidance in *Regulatory Guide 230: Disclosing non-IFRS financial information*, and the general duty of companies and their officers not to provide information that is false or misleading.

[14] The International Integrated Reporting Council, 2013, *The International <IR> Framework*, IIRC, December, http://integratedreporting.org/resource/international-ir-framework/, (accessed 23 August 2017).

[15] Australian Council of Superannuation Investors, 2017, *Corporate Sustainability Reporting in Australia: An analysis of ASX200 disclosure Featuring climate related risk*, ACSI, Melbourne, July, https://www.acsi.org.au/images/stories/ACSIDocuments/generalresearchpublic/2017-Sustainability-Report-FINAL.pdf, (accessed 23 August 2017).

[16] S Zhou, R Simnett and W Green, 2017, "Does Integrated Reporting Matter in the Capital Market?", *Abacus*, 53(1), 3 March, pp 94-132, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2600364, (accessed 23 August 2017).

Last year Ownership Matters analysed 253 companies in the ASX300 and found the following results:

- 62.5 per cent adjusted profits higher than statutory earnings in their unaudited earnings disclosures (usually in company presentations);
- 22.5 per cent also showed their audited profits when presenting this information;
- 15 per cent adjusted profits lower than the statutory earnings; and
- the median restatement was to adjust earnings seven per cent higher.[17]

Ownership Matters consider the use of restated, adjusted or underlying profit measures too commonplace, with the market becoming more accepting of management's version of profits and ignoring the audited accounts. They believe that the upwards bias shown in restatement practices should be a warning bell for any investor seeking to conduct due diligence on their investments. They highlight that often the items excluded (such as impairment) represents 'spent cash' or money spent in the past that was wasted. They indicate they are particularly concerned where these adjusted earnings numbers are used for the purposes of assessing management remuneration incentives and highlight the need for disclosure and sensible justification for each adjustment to earnings.

This area is also a global issue, with many regulators around the world issuing their own guidance. It is also on the agenda of the International Accounting Standards Board. They are in the process of developing a consultation document in order to ensure some international consistency in the way alternative earnings measures are determined.

In the meantime, directors should query management on their use of the ASIC guidelines in respect of alternative earnings disclosures, since research from KPMG on the ASX200 revealed that many companies were not complying fully with these guidelines.

Kerry Hicks GAICD, Senior Policy Adviser, AICD

2.5.4 Company tax transparency: justified trust and a fair share of tax

Justified trust is an expression that recently and increasingly has been incorporated into the public tax debate and narrative. Another expression – fair share of tax – is also often cited. There is often congruence between these terms but what are the implications for directors when they are perceived to be in conflict?

What does justified trust mean?
Justified trust is a concept applied by the Organisation for Economic Co-operation and Development (OECD). Accordingly, the expression is not purely a domestic label but has global sponsorship. The Australian Taxation Office (ATO) applies the principle, especially in its engagement with large business taxpayers. The ATO sums up its view of justified trust as follows:

> "If we told the community how we assured the tax paid by a taxpayer, would they be satisfied we did enough?"

Essentially, does the ATO have a level of assurance - justified trust - that the right amount of tax according to law is reported and paid? This has informed the ATO's Top 1,000 Tax Performance Program.[18]

This also clearly has implications for public perceptions around whether companies are paying their fair share of tax, since the community will have confidence that large businesses are paying the right amount of tax. However, a potentially problematic disclosure and reputational risk issue arises for boards in the circumstances of a dispute with the ATO.

[17] J Samson, 2016, "Beware management spin on earnings – particularly when incentives are involved", [website], 8 September, https://www.linkedin.com/pulse/beware-management-spin-earnings-particularly-when-james-samson-cfa, (accessed 23 August 2017)
[18] This program is part of the Tax Avoidance Taskforce announced by the Australian Government as part of the 2016–17 Federal Budget.

What are the implications for directors?
Perspective is important in characterising the nature of a tax dispute. It is easy to see how justified trust and fair share of tax may be perceived to be in conflict in these circumstances. For the ATO, a dispute can represent the pursuit of justified trust. For the company taxpayer, it can represent a genuine dispute about what is the appropriate fair share of tax. How the message is managed and the relevant disclosures (both mandatory and voluntary) in the meantime is a concern for the board in managing brand and reputational risk. The importance of the Voluntary Tax Transparency Report is also apparent.

New guidance from the IFRS Interpretations Committee (IFRIC) clarifies the accounting for income tax treatments that are yet to be accepted by a tax authority. The Australian Accounting Standards Board (AASB) issued Interpretation 23 *Uncertainty over Income Tax Treatments* in July 2017 – which is effective from 1 January 2019. Although the interpretation does not apply until 1 January 2019, as this is an interpretation of existing accounting standards, good practice would suggest that directors ask questions of management regarding its immediate applicability.

In addition, the AASB have been asked by the Minister for Revenue and Financial Services to consider proposals to amend the Australian Accounting Standards to require entities to disclose details of taxation disputes in their financial reports. The AASB is currently assessing this proposal – which includes consultation with relevant stakeholders.

The ATO currently issues public guidance on what it is likely to dispute, either in the form of Taxpayer Alerts, Practical Compliance Guidelines or Public Rulings. Directors need to be made aware when a position taken is material and is likely to be disputed and that appropriate disclosures are made in relation to such disputes.

There is no doubt that the level of community and public interest in the tax contribution made by company taxpayers has significantly increased. Company boards should consider the disclosures that will assist demonstrate that there should be justified trust in the company tax system and that the company is paying its fair share of tax - through their Voluntary Tax Transparency Reports.

> “ Company boards should consider the disclosures that will assist demonstrate that there should be justified trust in the company tax system and that the company is paying its fair share of tax...”

There are now more than one hundred companies signed up to the Voluntary Tax Transparency Code including foreign companies or their subsidiaries[19] and government business enterprises[20]. Companies intending to adopt the Voluntary Tax Transparency Code should register their interest with the Board of Taxation.

Karen Payne GAICD, CEO and Member of the Board of Taxation

[19] This includes Aldi Foods Pty Limited, BP Australia, Citibank NA, Sandvik Australia Holdings Pty Ltd, Shell Australia and WSP Australia Holdings Pty Ltd.
[20] This includes Australian Postal Corporation, Moorebank Intermodal Company Limited, ASC Pty Ltd and Australian Rail Track Corporation Ltd.

2.6 Director liability

2.6.1 Insolvent trading safe harbour reform

On 12 September 2017, the Federal Parliament passed landmark legislation amending Australia's insolvency laws. Those laws had long been recognised as among the 'strictest' in the world.[21] They had the perverse and unintended consequence of forcing directors down the path of formal insolvency prematurely in circumstances where reasonable prospects of recovery existed, destroying value and jobs.

In part fulfilment of the Turnbull Government's 2015 commitment to align Australia's 'business laws with a culture of entrepreneurship and innovation',[22] the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017 (Cth) was introduced to parliament. Since its passage, the Bill has amended the *Corporations Act 2001* (Cth) by introducing:

- a 'safe harbour' for company directors from personal civil liability for insolvent in certain circumstances; and
- a stay on the operation of ipso facto clauses during formal restructuring procedures (for example, an administration or scheme of arrangement).

The safe harbour provisions took effect on 19 September 2017. Under these provisions, a director of a financially distressed company may rely on the safe harbour protection if they start developing one or more courses of action that are reasonably likely to lead to a better outcome for the company than the immediate appointment of an administrator or liquidator. Significantly, the safe harbour is conditional on the company meeting its employee entitlements and tax reporting obligations, and the director fulfilling existing statutory obligations to assist in the event of an administration or liquidation.

The new provisions identify a number of factors that a court may wish to consider should it be required to determine whether or not a director had been operating under the protection of the safe harbour. These factors include (but are not limited to):

- whether the director remained informed about the company's financial position;
- whether appropriate advice had been obtained from an appropriately qualified adviser;
- whether the director had taken steps to ensure the company maintained appropriate financial records; and
- whether the director had taken steps to prevent misconduct by officers and employees of the company.

The AICD welcomes the safe harbour reforms as a critical step to fostering a culture of corporate recovery and innovation in Australia.

The AICD also supports the introduction of a stay on the operation of ipso facto clauses during formal restructures as these clauses can reduce their scope for success. Ipso facto clauses permit a counterparty to vary or terminate an agreement solely due the occurrence of an insolvency event. Provided all other contractual terms are being met, the stay will prevent the variation or termination of an agreement during a formal restructure proceeding. The stay provisions are set to commence on 1 July 2018 (or earlier by proclamation).

Lysarne Pelling GAICD, Senior Policy Adviser, AICD

[21] W Martin, 2009, "Official Opening Address", *Insolvency Practitioners' Association of Australia 16th National Conference*, Perth, 28 May, http://www.supremecourt.wa.gov.au/_files/Insolvency_Practitioners_Assoc_National_Conference_28May09.pdf, (accessed 23 August 2017).
[22] National Innovation and Science Agenda, *National Innovation and Science Agenda Report*, 2015, Commonwealth of Australia, 7 December, http://www.innovation.gov.au/page/national-innovation-and-science-agenda-report, (accessed 23 August 2017).

2.6.2 Illegal phoenix activity, director identification numbers and the Fair Entitlements Guarantee scheme

The annual economic cost to Australia of fraudulent phoenix activity has been estimated in the billions of dollars.[23] Illegal phoenix activity occurs when the controllers of a business fraudulently shed debts and other obligations by transferring assets from one company before it is wound up or abandoned to another company that proceeds to carry on the business.

In a bid to combat this destructive practice, a taskforce comprised of over 20 Federal, State and Territory Government agencies has been working to identify, manage, monitor and prosecute illegal phoenix operators.

The work of the taskforce is to be supplemented by a comprehensive package of reforms announced by the Turnbull Government on 12 September 2017. Chief among the proposed reforms is the introduction of a unique director identification number (DIN) for every Australian company director.

DINs will allow regulators to map the relationships between individuals and entities. The AICD strongly supports this measure.[24] DINs have also been endorsed by the Productivity Commission (in 2015), the joint Melbourne Law School and Monash Business School 'Phoenix Project' (earlier this year), and the Federal Opposition (May 2017).

Other measures proposed in the government's reform package include:

- specific phoenixing offences;
- extending the director penalty regime to make directors personally liable for a company's GST liabilities;
- a dedicated phoenix hotline to provide the public with a single point of contact for reporting illegal phoenix activity;
- penalties for advisers who promote tax avoidance schemes to phoenix operators;
- powers for the ATO to obtain a security deposit from suspected phoenix operators;
- preventing directors from backdating their resignations to avoid personal liability or from resigning and leaving a company with no directors; and
- prohibiting entities related to a phoenix operator from appointing a liquidator.

In a related development, the Federal Government is proposing reforms to address corporate misuse of the Fair Entitlements Guarantee (FEG) scheme. The scheme is a legislative safety net which provides financial assistance for unpaid entitlements to eligible employees who have lost their jobs due to the liquidation or bankruptcy of their employers. The government contends that the costs of the FEG scheme have been increasing due to the adoption by some employers (and their associates) of practices that seek to avoid or reduce obligations of the company to pay its creditors (including employees).

In responding to the FEG scheme consultation, the AICD endorsed a number of measures, including strengthening the existing criminal offence provision and introducing a new civil penalty provision. However, the AICD did not support the government's proposal for corporate groups to be compelled to provide a contribution equivalent to any unpaid employee entitlements.

The AICD will engage with government and other stakeholders in relation to these proposals to ensure they are effective, appropriate and proportionate. Members will be informed of developments.

Lysarne Pelling GAICD, Senior Policy Adviser, AICD

[23] H Anderson et al., 2017, *Phoenix Activity: Recommendations on detection, disruption and enforcement*, Melbourne Law School and Monash Business School, February, https://law.unimelb.edu.au/__data/assets/pdf_file/0020/2274131/Phoenix-Activity-Recommendations-on-Detection-Disruption-and-Enforcement.pdf, (accessed 23 August 2017).

[24] AICD, 2017, *AICD Signals Support for Anti-Phoenix Measures*, media release, AICD, 24 May, http://aicd.companydirectors.com.au/media/media-releases/aicd-signals-support-for-anti-phoenix-measures, (accessed 23 August 2017).

2.6.3 Increasing regulatory powers and director penalties

Directors should expect to see further regulatory development in the area of director penalties, including an increase in penalties for directors who are found to contravene the *Corporations Act 2001*.

White collar crime report
On 23 March 2017, the Senate Economics References Committee handed down its report on white-collar crime and corporate and financial misconduct in Australia. The report recommended increases for civil penalties for contraventions of the *Corporations Act 2001*, and the introduction of disgorgement and multiplier penalties. A disgorgement penalty is set by the quantum of the benefit or profit acquired. A multiplier penalty is set as a multiple of the benefit gained or loss avoided.

The Committee also recommend that the government consider making infringement notices available to the Australian Securities and Investments Commission to respond to breaches of the financial services and managed investments provisions of the *Corporations Act 2001*.

The AICD is opposed to the use of infringement notices and will be engaging with the government to ensure our views are heard. The AICD has previously argued that infringement notices are problematic from a policy perspective, as they impose a penalty without requiring a regulator to establish any form of liability, and are therefore a form of 'lazy' regulation and contrary to the rule of law. However directors should expect further legislative change in the medium term in relation to the adequacy of current civil penalties.

ASIC Enforcement Review
In addition to this, a Treasury taskforce is currently undertaking a review of the enforcement regime of ASIC. This taskforce is chaired by Treasury, and is expected to report to the government in 2017 after a public inquiry on proposed policy responses.

The Taskforce is now well underway, with several discussion papers being released. Proposed changes that are being examined by the Taskforce include:

- harmonisation and enhancement of ASIC's search warrant powers and information gathering powers;
- an increase in the use of ASIC-endorsed industry codes in the financial sector; and
- an increase in ASIC's ability to obtain telecommunications intercept material when investigating "serious contraventions" of the *Corporations Act 2001*.

The AICD will continue to keep a watching brief on the Taskforce, and engage were necessary to ensure policy recommendations are appropriate.

Matthew McGirr, Policy Adviser, AICD

2.6.4 Climate change director liability

The Australian Government officially ratified the Paris Agreement in November 2016, committing to effective global action on climate change. The target set by the Australian Government is to reduce emissions by 26 per cent, to 28 per cent below 2005 levels, by 2030. However, some commentators have indicated that Australia will need to reduce emissions much further than this to meet the Paris target to limit global warming to 1.5 to 2 degrees.

In October 2016 a new legal opinion was released by the Centre for Policy Development and the Future Business Council entitled *Climate Change and Directors' Duties*[25]. The opinion makes the case that boards of Australian companies would be well-advised to engage with the risks of climate change, including financial and legal risks.

[25] N Hutley and S Hartford-Davis, 2016, *Climate Change and Directors' Duties*, Centre for Policy Development and the Future Business Council, Melbourne, 7 October, http://cpd.org.au/wp-content/uploads/2016/10/Legal-Opinion-on-Climate-Change-and-Directors-Duties.pdf, (accessed 23 August 2017).

The opinion defines climate change risks as:

- physical risks associated with rising global temperatures, such as severe weather events and rising sea levels damaging property and disrupting trade; and
- transition risks, being indirect financial risks that might arise from a transition to a lower carbon economy, including changes in policy, technology or investor preferences that could impact the value of assets and elements of business strategy.

The authors argue that:

- directors' duties oblige directors to obtain knowledge about factors affecting their business, and accordingly directors should consider and take steps to inform themselves about climate-related risks to their business, including obtaining expert advice if appropriate;
- in some cases – such as insurance businesses – the duty of care will likely require a director to go further than merely considering risks; and
- directors who are pro-active in turning their minds to climate change risks for their business, even if they decide on a properly informed and advised basis not to act, may have the protection of the business judgement rule against claims of breach of duty.

Subsequent to this opinion, in February 2017 APRA signalled a significant shift in its position on the relevance of climate change risk to the financial sector. APRA Board member, Geoff Summerhayes, made clear that all APRA-regulated entities must recognise that climate change has evolved from a non-financial issue to one that presents foreseeable and material financial risks.[26] Further he emphasised that failure to do so may expose directors of asset owners, asset managers, banks and insurers to a claim they have breached their duties.

Further developments have included the release of a report by the Australian Senate Economics References Committee, *Carbon risk: a burning issue*.[27] This report recommends the government commit to implementing the recommendations of the Task Force on Climate-related Financial Disclosures (Task Force) where appropriate, and undertake the necessary law reform to give them effect. At the date of this publication, the government response to this report has not yet been issued.

Further, the Task Force's final report was released on 29 June 2017[28] which sets out recommendations for helping businesses disclose climate-related financial disclosures.

Australia awaits further policy reform from government in the area of climate change in order to meet the targets agreed to in Paris. In the meantime, it is observed, by the authors of the legal opinion referred to above, asset managers (like Blackrock) and the Task Force, that current reporting on this issue by boards is variable. All the developments above point to the need for boards to consider disclosure of their businesses exposure to climate change risks sooner rather than later.

Kerry Hicks GAICD, Senior Policy Adviser, AICD

[26] Centre for Policy Development, 2017, *APRA lays down a marker on climate change risks in the financial sector*, [website], 17 February, https://cpd.org.au/2017/02/apraclimaterisk/, (accessed 23 August 2017).
[27] Economics References Committee, 2017, *Carbon risk: a burning issue*, The Senate, April, http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Carbonriskdisclosure45/Report, (accessed 23 August 2017).
[28] Task Force on Climate-related Financial Disclosures, 2017, *Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures*, June, https://www.fsb-tcfd.org/publications/final-recommendations-report/, (accessed 23 August 2017).

2.7 Superannuation

2.7.1 Director independence

It is now nearly two years since the government introduced the Superannuation Legislation Amendment (Governance) Bill 2015 into the House of Representatives (which has subsequently lapsed).

The bill, which would have mandated that all superannuation funds have a minimum of one-third independent directors and an independent chair, was successfully frustrated by industry bodies. In order to delay the bill, industry bodies gained agreement for a review of "best practice governance standards" for the super sector (particularly the non-for-profit super sector).

While the AICD understands that the Fraser review was completed some time ago, its release was delayed on the basis that the bill had lapsed. However, Fraser's report was finally released around two months after the Financial Services Minister Kelly O'Dwyer indicated in late 2016 that the government intended to reintroduce a bill into Parliament to mandate a minimum of independent directors on super boards.

The 39-page Fraser Report concluded that, in essence, no significant change was necessary within the not-for-profit (NFP) sector in relation to superannuation governance because, in the opinion of Mr Fraser, evidence showed that the NFP superannuation sector is better governance that its retail counterpart. In doing so, it failed to address the central question posed, which was whether independence could improve governance within NFP funds.

The AICD and others were publicly critical of the shortcomings of the Fraser Report. The AICD is now engaging with the government to improve superannuation governance and develop new legislation which will ensure that excellence in governance is achieved within this sector.

Matthew McGirr, Policy Adviser, AICD

2.7.2 Member outcomes and engagement

The government has released a set of proposed reforms which would see (amongst other things) the introduction of annual member meetings (AAM) for superannuation funds.

The objects of the proposed legislation, titled Treasury Legislation Amendment (Improving Accountability and Member Outcomes in Superannuation) Bill 2017, is to improve accountability and member outcomes within the superannuation sector. The bill would also introduce (amongst other things), a new civil penalty regime for directors of superannuation trustees, and an expanded directions power for APRA.

The AICD has provided a submission to the government in response to the bill, supporting the intent of the bill, but laying out significant concerns with the model of the AAM proposed by the government, and concerns relating to the scope of the APRA directions power. The AICD will continue to engage with the government on this issue.

Matthew McGirr, Policy Adviser, AICD

2.8 Cybersecurity

2.8.1 Mandatory data breach disclosure

The February 2017 passage of the Privacy Amendment (Notifiable Data Breaches) Bill 2016, establishes a mandatory data breach notification scheme in Australia. Commencing in February 2018, the amendment will require government agencies and businesses which are covered by the *Privacy Act 1988* (Cth) to notify any individuals affected by a data breach that is likely to result in serious harm.[29]

The Notifiable Data Breach scheme generally applies to businesses (also known as entities) with a turnover of $3 million or more where an "eligible data breach" is likely to result in serious harm to any of the individuals to whom the information relates. The entity must notify the Privacy Commissioner and the affected customers regarding the description of the data breach, the kind of information involved, and how customers should respond to the security incident.

If an entity suspects an "eligible data breach", they are required to carry out a "reasonable and expeditious" assessment within 30 days of whether there are reasonable grounds to believe a breach has occurred. This threshold occurs where:

- there is unauthorised access to or disclosure of the relevant information, which a "reasonable person" would conclude is "likely to result in serious harm" to any of the individuals to whom the information relates; or
- the relevant information is lost in circumstances where unauthorised access to or disclosure of personal information is likely to occur, and if it were to occur a "reasonable person" would conclude that it is "likely to result in serious harm" to any of the individuals to whom the information relates.[30]

Entities will need to comply with the new law, including implementing processes to meet the various assessment and notification requirements. Importantly, those who fail to notify face penalties including fines of $360,000 for individuals and $1.8 million for organisations. Company directors can use this as an opportunity to identify and manage the key data assets of the organisation, ensuring appropriate controls are in place. Further, it provides organisations with the opportunity can engage with customers and espouse their online trust credentials.

A data breach occurs when personal information held by an organisation is lost or subjected to unauthorised access or disclosure. This may include when:

- a device containing customers' personal information is lost or stolen;
- a database containing personal information is hacked;
- personal information is mistakenly provided to the wrong person.[31]

Where an organisation becomes aware that there are reasonable grounds to believe an eligible data breach has occurred, they are obligated to notify individuals at risk of serious harm and the OAIC as soon as practicable. This notification must set out:

[29] T Pilgrim, 2017, "Mandatory data breach notification", [statement], Office of the Australian Information Commissioner, 13 February, https://www.oaic.gov.au/media-and-speeches/statements/mandatory-data-breach-notification#mandatory-data-breach-notification, (accessed 23 August 2017).
[30] PricewaterhouseCoopers, 2017, *Australia introduces mandatory data breach notification regime*, 14 February, http://www.pwc.com.au/legal/assets/legaltalk/privacy-amendment-notifiable-data-breaches-bill-2016.pdf, (accessed 23 August 2017).
[31] Office of the Australian Information Commissioner, "Notifiable Data Breaches", [webpage], https://www.oaic.gov.au/engage-with-us/consultations/notifiable-data-breaches/, (accessed 23 August 2017).

- the identity and contact details of the organisation;
- a description of the data breach;
- the kinds of information concerned; and
- recommendations about the steps individuals should take in response to the data breach.[32]

Nigel Phair GAICD, Adjunct Professor, University of Canberra Centre for Internet Safety

2.8.2 ASX100 Cyber Health Check Report

In April 2016, the Australian Government released its national cyber security strategy. Among the many projects of the strategy was the ASX100 Cyber Health Check, designed to increase the cyber resilience of Australia's largest companies and enabling the executives and boards in the ASX100 to better understand cyber security strengths and opportunities for their business.[33]

The ASX 100 Cyber Health Check was the first attempt to gauge how the boards of Australia's largest publicly listed companies view and manage their exposure with respect to information security. An industry led initiative, it encourages government, regulators and businesses to work together to tackle cyber risk.[34]

Almost two-thirds (62 per cent) of directors said the level of attempted malicious cyber activity against their company has gone up over the past year, yet only 43 per cent of boards are confident their company is properly secured against cyber attacks. Interestingly, only 11 per cent of companies proactively reassure customers and investors about their approach to information security.[35]

Organisations of all shapes and sizes are operating in the online economy. Whilst this survey was focused on the ASX100 – arguably the subset of Australian business that should be the most prepared with the greatest ability to quantify, measure and appropriately control cyber risks – the findings can be applied across all sectors and all business types.

Many organisations focus purely on technical controls to guard against cyber attacks, yet there is much more for directors to think about when determining risk tolerances. This includes the human element, regularly the target of phishing attacks and the role third parties play. Three-quarters of ASX100 companies (75 per cent) have implemented ongoing staff training programs in cyber awareness, whilst almost a third of companies (30 per cent) haven't yet evaluated the cyber resilience of suppliers, customers and other key external parties that connect to them.[36]

Practising good information security is a journey not a destination. Company directors need to improve their individual skills and ensure there is a culture which defines and analyses organisational exposure.

Nigel Phair GAICD, Adjunct Professor, University of Canberra Centre for Internet Safety

---

[32] ibid.

[33] Australian Government, 2016, *Australia's Cyber Security Strategy: Enabling innovation, growth and prosperity*, Commonwealth of Australia, https://cybersecuritystrategy.pmc.gov.au/assets/img/PMC-Cyber-Strategy.pdf, (accessed 23 August 2017).

[34] ASX, 2017, *ASX100 Cyber Health Check Report: Capturing the opportunities while managing the threats*, April, http://www.asx.com.au/documents/investor-relations/ASX-100-Cyber-Health-Check-Report.pdf, (accessed 23 August 2017).

[35] ibid.

[36] ibid.

2.8.3 Cyber insurance

As dependency on complex internet connectivity continues to grow, cyber insurance can provide coverage for liability and expenses arising from exposures such as network outages, unauthorised data usage, the spreading of a virus or malicious code, computer theft or extortion. This type of insurance can also provide cover for business interruption and the cost of notifying customers, regulatory investigations or actions in case of a breach, without the requirement for physical damage that is a standard trigger under property policies.

A comprehensive cyber insurance policy should also cover immediate expenses such as crisis management, hiring a public relations firm to manage a data breach incident, forensic analysis, repairing and restoring computer systems and the loss of business income resulting from the incident.

Organisations should ensure that their cyber insurance policy includes explicit wording which covers first party and third party claims. First party claims include cost of data recovery, notification of affected customers, credit monitoring and legal expenses. Third party claims include financial penalties, customer compensation and reputational damage.

Cyber insurance should not be seen as an elixir to cyber risk management. With growing insurer scrutiny of security postures, real care needs to be taken in developing an organisation's risk profile (including target profile, perceived market value and level of breach responsiveness), and accompanying controls, to tailor a cyber insurance policy. The number of future successful claims will instruct the success of this type of insurance.[37]

Nigel Phair GAICD, Adjunct Professor, University of Canberra Centre for Internet Safety

2.9 Diversity

2.9.1 Progress towards 30% by 2018

The percentage of female directors on ASX 200 boards now stands at 25.4 per cent (31 August 2017). 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.

However so far in 2017 female appointments to ASX 200 boards have tracked below 30 per cent, a decrease from the 44 per cent average monthly new appointment rate for female directors in 2016. If the appointment rate does not increase to above 40 per cent for the remainder of 2017, and throughout 2018, then the 30 per cent female representation target for ASX 200 boards will not be reached until 2019.

The AICD is increasing its engagement with ASX 200 chairs and non-executive directors, particularly those who are on boards with only one female director. The Australian Chapter of the 30% Club is also working with the members of the Investors Working Group to engage with these companies as well as those with no female directors on their boards. Pleasingly 15 investment companies have signed up to the 30% Club's Statement of Intent, pledging their support to board diversity.

The AICD will continue to argue strongly for the benefits of greater board diversity and will ensure all stakeholders are engaged and working together to increase the number of women on boards.

Rhian Richardson, Board Diversity Manager, AICD

[37] N Phair, *Cyber Insurance Research Paper*, Centre for Internet Safety, University of Canberra.

3.0 | THE REGULATORY ENVIRONMENT

3.0 Australian Securities and Investments Commission

3.1.1 Regulatory priorities

The Australian Securities and Investments Commission's (ASIC) regulatory priorities are designed to tackle risks as they emerge. It is important that company directors and boards are aware of these priorities so they can act to promote the future of their company and the health of Australia's business environment.

At ASIC, we undertake a risk identification process to determine our main long-term challenges. These challenges help us plan for the short and medium term. Our four-year Corporate Plan, released in August 2017, identifies the following challenges as priorities for ASIC:

- Culture and conduct – aligning conduct in a market-based system with investor and consumer trust and confidence
- Building financial capability
- Digital disruption and cyber resilience in financial services and markets
- Globalisation of financial markets, products and services
- Structural and demographic change in our financial system enhancing the role of market-based financing.

We encourage all entities to consider these issues in their own planning, use the ASIC resources available to assist them, and review their business to ensure that compliance, best practice and positive cultures are embedded.

ASIC has developed guidelines that reflect our thinking on best practice, or 'what good looks like' in the sectors we regulate. We believe Australian public companies should:

- treat investors fairly, including when raising money or making change of control transactions;
- be accountable to investors by ensuring disclosure is accurate, complete and timely;
- adopt sound corporate governance practices that support market integrity and good investor outcomes.

In order to support our regulatory priorities, ASIC is participating in a consultation process that will boost the powers available to us, including new law reforms around product governance obligations, product intervention powers and a review of ASIC's enforcement tools.

In short, these initiatives will help ASIC achieve its regulatory vision of allowing markets to fund the economy and, in turn, economic growth – and in doing so, contributing to the wellbeing of all Australians.

John Price, ASIC Commissioner

3.1.2 Enforcement priorities

As the corporate regulator, ASIC is committed to ensuring that Australia's financial system is safe and fair for all who participate in it.

A key part of that role is ensuring that the gatekeepers of the system – company directors and officers, auditors, insolvency practitioners and business advisers – adhere to the standards required by law. Where necessary, we will take action against those who fail to meet these standards.

"A key part of that role is ensuring that the gatekeepers of the system – company directors and officers, auditors, insolvency practitioners and business advisers – adhere to the standards required by law."

While all forms of misconduct may be subject to enforcement action, ASIC is particularly focused on breaches that indicate deeper underlying concerns, such as:

- poor corporate culture;
- poor governance/management systems that results in the market not being properly informed;
- poor adherence to listing standards, including from emerging markets issuers;
- misuse of cross-border services and transactions;
- failure by corporations to respond appropriately to the threat of malicious cyber activity;
- rogue insolvency practitioners and others who facilitate serious illegal 'phoenix' behaviour and improper transactions in the face of insolvency.

When ASIC does take legal action as a result of a serious breach, we are committed to seeing that action through to an appropriate outcome. One recent example is the case against four officers and the fund manager of MFS Investment Management. Despite a drawn-out court process and many delays, ASIC pursued this action until penalties and compensation had been determined by the Courts. On May 26, 2017, the Queensland Supreme Court imposed penalties totalling $2 million and ordered the payment of more than $200 million in compensation. The defendants were disqualified from managing corporations for periods ranging from five years to a life ban.

The consequences are severe when gatekeepers of our financial system do not adhere to the law and carry out their responsibilities. ASIC will continue to take strong enforcement action to ensure investors and consumers can maintain their confidence in Australia's financial system.

John Price, ASIC Commissioner

3.1.3 New crowdfunding legislation

As of 29 September 2017, the Australian Government's crowd source equity funding (CSEF) model takes effect, enabling public companies to be eligible to engage intermediary organisations to obtain crowd-source equity funding.

On 9 January 2017, the AICD responded to a parliamentary inquiry on CSEF, supporting the prompt passage of the legislation, subject to certain concerns relating to audit requirements. Key provisions of the CSEF framework include:

- CSEF of up to $5 million per year per company;
- turnover and assets of companies must be less than $25 million;
- investor limit of $10,000 per issuer per 12-month period for retail investors;
- lower disclosures to access capital than currently required for public companies;
- the need for an intermediary that holds an Australian Financial Services Licence.

In an effort to be ready for CSEF, ASIC is currently in the process of developing appropriate guidance for intermediaries seeking to provide CSEF services, and for companies seeking to raise funds on a platform of a CSEF intermediary.

On 9 May 2017, the government released further draft legislation as part of a consultation proposing to extend CSEF to proprietary companies. The AICD put in a submission in response to the government, supporting the extension of CSEF to proprietary companies.

That said, the AICD also took the opportunity to express concerns relating to the proposed exemption from any audit or annual review requirement for proprietary companies until they raise more than $1 million from CSEF offers. That would mean that investors would need to reply on the financial reports and directors' reports, which would not be prepared independently.

Submissions closed on 6 June 2017. The AICD will continue to follow any developments in relation to this matter, and engage with the government where necessary.

Matthew McGirr, Policy Adviser, AICD

3.2 Australian Competition and Consumer Commission

3.2.1 Unfair contract terms

Since November 2016, the Australian Consumer Law has included a provision to outlaw unfair contract terms (UCT) in business-to-business standard form contracts.

This provision aims to protect small businesses from unfair contract terms where they have little or no opportunity to negotiate with a larger corporation. That is, the contract is given on a 'take it or leave it' basis.

Typically, UCT include:

- terms that enable one party (but not another) to avoid or limit their obligations under the contract;
- terms that enable one party (but not another) to terminate the contract;
- terms that penalise one party (but not another) for breaching or terminating the contract;
- terms that enable one party (but not another) to vary the terms of the contract.

> "This provision aims to protect small businesses from unfair contract terms where they have little or no opportunity to negotiate with a larger corporation."

These terms are common among telco, advertising, franchising, retail lease, waste management, independent contracting and agriculture contracts. Since the introduction of the business-to-business UCT law in November 2016, the Australian Competition and Consumer Commission (ACCC) has initiated a number of investigations against companies to ascertain whether their contracts contain potentially unfair terms, including Uber, Fairfax Media, Jetts Fitness, Lendlease Property Management and Sensis. These businesses have now amended their standard form contracts to address ACCC concerns. Some examples of the changes that have been made include:

- removing terms that allow a trader broad discretion to terminate a small business contract "without cause";
- making automatic contract renewal terms more transparent and including a contractual obligation to remind customers about the pending automatic renewal of their contracts;
- amending wide-ranging unilateral variation clauses to limit variations to circumstances where it is reasonably necessary to protect the trader's legitimate interests; and
- amending wide-ranging cost recovery terms so that the trader can only recover costs which are properly and reasonably incurred.

If a court or tribunal finds that a term is 'unfair', that term will be void while the rest of the contract continues to bind the parties to the extent it is capable of operating without the unfair term.

Directors should ensure management is familiar with the new UCT terms and that their businesses' contracts are compliant.

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

3.2.2 Franchising Code of Conduct

In the past year, action has been taken against a number of companies and directors for breaches of the Franchising Code of Conduct. This is a mandatory code of practice which governs franchising arrangements in Australia. The Code is overseen by the ACCC under the *Competition and Consumer Act 2010*. It is essential that company directors understand their responsibilities under the Code, as the ACCC is actively pursuing non-compliance.

In May 2017, Domino's Pizza Enterprises was the first company to pay penalties for non-compliance with the Franchising Code of Conduct. The ACCC issued the infringement notices because it believed that Domino's had failed to comply with the requirement in the Franchising Code of Conduct to provide franchisees with both an annual marketing fund financial statement and an auditor's report within the time limits prescribed under the Code.

Domino's paid penalties totalling $18,000. (It should be noted that the payment of a penalty specified in an infringement notice is not an admission of a contravention of the Code.)

In May 2017 the ACCC alleged carwash franchise Geowash made false or misleading representations and engaged in unconscionable conduct in breach of the Australian Consumer Law, and also failed to comply with the good faith obligation which is contained in the Franchising Code of Conduct. The representations related to potential earnings and profit statements which had no reasonable grounds, and representations of affiliations of commercial relationships with potential clients which may not be accurate. This action was ongoing at time of publication.

In another action, the ACCC is seeking penalties in the Federal Court against a current and former director of fast food franchise Pastacup. The ACCC has alleged the directors failed to disclose previous, relevant business experience in the franchise documents which may have affected the decision of potential franchisees. This action was ongoing at time of publication.

Directors of franchising firms should seek legal advice to ensure their company is compliant with the Franchising Code of Conduct.

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

3.3 Australian Taxation Office

3.3.1 Justified trust: the Top 1,000 Tax Performance Program

You have no doubt read about the recent changes to tackle multinational tax avoidance and introduce a 40 per cent diverted profits tax. Consistent with the theme of measures designed to safeguard the confidence in the tax system, the Australian Taxation Office (ATO) is seeking to obtain a level of assurance – 'justified trust' – that the right amount of tax is reported and paid. What are the implications for directors?

The ATO Top 1,000 Tax Performance Program aims to obtain additional evidence and greater assurance that the largest one thousand multinational and public companies are paying the right amount of income tax - mainly taxpayers with turnover above $250 million.[38]

For these purposes, the ATO is concerned about a company group's tax risk governance and disclosures.[39] Directors of the Top 1,000 should anticipate greater scrutiny of their organisations and, in their oversight role in key areas, should assess whether the board is:

- aware if the corporate group is part of the ATO Top 1,000 Tax Performance Program;
- aware of any material and potential disputes with the ATO;
- satisfied with the documented tax risk governance framework, that it has been designed effectively and its operation is regularly tested (the ATO suggests annually);
- receiving regular communications or assurances in relation to tax risks flagged by the ATO to the market;[40]
- satisfied that there has been appropriate disclosure of any disputes and uncertainties with the ATO;
- satisfied that the tax governance process is applied to significant or new transactions to ensure that the tax outcomes are reported appropriately and accord with the law; and
- satisfied that there is an explanation of why the accounting and tax results vary.

The checklist above is intended as a guide, based on the ATO's areas of interest.

Karen Payne GAICD, CEO and Member of the Board of Taxation

[38] This program is part of the Tax Avoidance Taskforce announced by the Australian Government as part of the 2016–17 Federal Budget.
[39] Australian Taxation Office, "Director's summary", Tax risk management and governance review guide, [webpage], https://www.ato.gov.au/Business/Large-business/In-detail/Key-products-and-resources/Tax-risk-management-and-governance-review-guide/?page=2#Director_s_summary, (accessed 23 August 2017).
[40] This includes: stapled securities, cross border related party debt funding and self-assessment of the relevant risk zone, related party foreign currency denominated finance with related party cross currency interest rate swaps and transfer pricing for offshore marketing hubs.

3.4 Australian Prudential Regulatory Authority

3.4.1 Regulatory priorities

Even though the Australian economy has clocked up a record twenty-six years of continuous economic growth, the Australian Prudential Regulatory Authority (APRA), with its aspiration to be a world class prudential supervisor, has continued to be very busy impacting directors in a large number of enterprises.

Health insurers
APRA will require its prudential standard for banks and insurers on risk management (the famous CPS 220), introduced in 2015, to be implemented by health insurers in 2018. This follows the successful absorption of the Private Health Insurance Administration Council into APRA in 2015. Directors of health funds can learn from the experience of their banking and insurance colleagues.

Life insurers
APRA's prudential framework is stable and mature and well regarded internationally but APRA has become more active in other areas of supervision. APRA and the Australian Securities and Investments Commission (ASIC) are working together to deliver enhanced public information on life insurance claims outcomes arising from growing community concern about the handling and payment of claims across the life insurance industry. This requires insurers to supply more data to APRA and the intention is to publish entity level information that will allow more meaningful comparisons of insurer performances.

Superannuation funds
The number of Registrable Superannuation Entities (RSEs) with more than four members has reduced from 683 in 2005 to 225 in 2016 yet APRA has expressed concern that a number of RSEs appear to be providing relatively poor member outcomes and others face sustainability challenges with ageing members, potential reductions in membership and negative cash flows as benefit payments increase. APRA is putting increasing pressure on the directors of RSEs to develop sound business plans and consider the longer-term implications of current and future likely trends. APRA expects directors to have triggers in place that would prompt review and action that could include winding up or merger with another fund.

> "Trustees must implement sufficiently robust strategic and business planning processes with a view to ensuring that their fund or funds will deliver high quality, value for money outcomes for members over the medium and longer term."

Helen Rowell, Deputy Chairman, APRA
Speech to the Conference of Major Superannuation Funds, Sydney 24 March 2017

Banks
APRA has continued to be active in macro prudential regulation with the imposition of a 30 per cent limit on interest only residential mortgages and a stringent limit to the growth in loans to investors of 10 per cent per annum. Directors must make sure their organisations can monitor and live within these and similar limits. APRA also responded to one of the main recommendations of David Murray's Financial Systems Inquiry that our banks should be "unquestionably strong" by announcing that the major banks' Common Equity Tier 1 capital ratios must be at least 10.5 per cent by 1 January 2020.

Banks continue to be in the spotlight with the Australian Treasury's consultation on the new Banking Executive Accountability Regime announced in the 2017-2018 Budget. This draws on elements of the recently introduced Senior Managers Regime in the UK and the Manager-in-Charge Measures in Hong Kong. The aim is to improve culture and increase accountability in the financial sector. Depending on its final form this will have significant impacts on directors of banking institutions.

Trevor Matthews, Chairman AMP Life, Non-Executive Director Bupa Australia and New Zealand

3.5 Financial reporting

3.5.1 New for 2017

ASIC guidance
ASIC has released a number of resources to assist directors improve the quality of financial reports for the FY17 reporting season. These include:

- Regulatory Guide 260 Communicating Findings from Audit Files to Directors, Audit Committees or Senior Management [RG 260]
- Result of ASIC Review of 31 December 2016 Financial Reports[MR 17 -219]
- Audit inspection report for 2015-2016 [Report 534]
- ASIC calling on preparers to focus on the quality of financial information [MR 17-162].

The ASIC focus areas included in MR 17-162 above are very similar to prior years with once again impairment testing and asset values being a key focus. Other areas include revenue recognition, expense deferral, tax accounting, off-balance sheet arrangements, disclosures of estimates and accounting policy judgements in addition to the focus on new accounting standards outlined below.

Changes to accounting standards
The introduction of some major new accounting standards will have the greatest impact on financial reporting since the adoption of International Financial Reporting Standards in 2005.

ASIC have indicated that it is important the directors and management plan for these new standards and inform investors and other financial report users of the impact on reported results. This includes making the required disclosures on the impact of the standards in the notes to the financial statements, which are required prior to the accounting standard implementation date.

The major new standards include:

- AASB 15 Revenue from Contracts with Customers (applicable from years commencing 1 January 2018, or from 1 January 2019 if you are a not-for-profit)
- AASB 1058 Income of Not-for-Profit Entities (applicable from 1 January 2019)
- AASB 9 Financial Instruments (applicable from years commencing 1 January 2018)
- AASB 16 Leases (applicable from years commencing 1 January 2019)
- AASB 17 Insurance Contracts (applicable from years commencing 1 January 2021).

The impact of the standards above will differ, depending on the industry and the degree to which it enters into the type of transactions covered in each standard. Depending on the transitional arrangements for some of these standards, the relevant comparative period will be as early as 2017. More details on those standards is included in the *Company Director* magazine article “The triple whammy”.[41]

Implementation plans should be in place already for these particular standards and should include identification of required system, process or internal control changes, assessment of business and compliance impacts, disclosures in current financial reports, possible continuous disclosure obligations, assessment of impacts on funding, debt covenant agreements or regulatory capital requirements and potentially the impact on links to employee incentive schemes.

Directors should be questioning management on the state of implementation plans for the major standard changes that impact their business, and satisfying themselves of the appropriate disclosures in the current financial report.

Kerry Hicks GAICD, Senior Policy Adviser, AICD

[41] W Basford, 2017, “The triple whammy”, *Company Director*, February, http://aicd.companydirectors.com.au/membership/company-director-magazine/2017-back-editions/february/the-triple-whammy, (accessed 23 August 2017).

3.5.2 Enhanced auditor reporting

From 15 December 2016, auditor's reports of all listed entities in Australia are required to provide information about key audit matters (KAM). This represents one of the biggest changes in auditor reporting for decades.

KAM are defined as "those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements of the current period". The matter will be a subset of the matters communicated to the audit committee, and may include:

- areas of higher assessed risks of material misstatements or significant risks;
- significant auditor judgements relating to areas of significant management judgement;
- the effect of significant events or transactions on the audit.

According to the Chartered Accountants Australia and New Zealand publication *Enhanced Auditor Reporting – One Year On*, the nature of the KAM reported to date are diverse and specific to each entity and its industry. It noted that common KAM observed to date covers the areas of revenue recognition, goodwill impairment, provisions and asset valuation. Although common KAM topics are emerging in practice, the description is unique to the entity.

There is no requirement for any specific number of KAM and it will vary between entities, even those in the same industry and even for the same entity year on year. Since the concept of KAM is relative it is envisaged that there will always be at least one for each audit, except in rare circumstances. The publication above, noted that from listed company audit reports observed to date 2-3 KAM are usually included.

Directors are involved in communicating with the auditor about the KAM at various stages throughout the audit. Usually at the planning stage of the audit a preliminary view of the matters likely to be KAM is developed and communicated to the audit committee. The auditors may even provide a draft KAM for review and feedback from the audit committee. Because the final KAM is based on the results of the full audit, it may change during the audit process. As a result, there will likely be a further need to have final discussions about KAM with the auditor at the conclusion of the audit.

Whilst the introduction of KAM is focused on listed companies, it is possible to include KAM in non-listed audit reports if desired.

Kerry Hicks GAICD, Senior Policy Adviser, AICD

3.6 Australian Charities and Not-for-profits Commission

3.6.1 Regulatory priorities

Since its establishment in 2013, the Australian Charities and Not-for-profits Commission (ACNC) has been gradually increasing its compliance activity as it moves out of its 'establishment phase' and into maturity as a regulator.

In its *Charity Compliance Report 2015 and 2016* (compliance report) the ACNC reported investigation activity (69 finalised), a growing number of revocations for compliance reasons (28) and expanded use of other regulatory powers (10 voluntary undertakings, two enforceable undertakings, one statutory warning and 40 penalty notices).

In 2016/17, there were a number of high-profile revocations including:

- Melbourne evangelical church 'Catch the Fire' ministries for soliciting donations for the political party Rise Up Australia; and
- Anzac centenary event Camp Gallipoli for failing to operate as a not-for-profit (private benefit).

Further information about revocations is limited owing to secrecy provisions in the ACNC's enabling legislation.

According to its compliance report, the leading cause of complaints about charities regard duties of charity board members (27 per cent). The next most common complaints were in relation to charities pursuing their charitable purpose and operating on a not-for-profit basis (24 per cent), entitlement to registration (14 per cent) and reporting non-compliance (13 per cent).

The ACNC has announced that its regulatory priorities for 2017-19 will be:

1. Fraud and financial mismanagement – including money laundering, tax avoidance and private benefit
2. Terrorism – using a charity for terrorist purposes or to foster terrorism (including providing financial support and association with listed entities of concern)
3. Harm to beneficiaries – particularly children and vulnerable adults
4. Political activities – where a charity is involved in promoting a particular political party or candidate for political office
5. Lodgement and accuracy of Annual Information Statements.

Lucas Ryan GAICD, Senior Policy Adviser, AICD

3.6.2 Fundraising reform

Fundraising has been elevated as a reform priority for the not-for-profit (NFP) sector since a report prepared by Deloitte Access Economics estimated that fundraising was the single greatest source of regulatory burden for charities.

Australia has seven different fundraising regimes which are out of date, inconsistent and result in compliance costs of approximately $15.08 million annually for charities alone (which represent only 10 per cent of the broader NFP sector).

A proposal for reform has been developed by a coalition of sector bodies which would significantly improve the regulation of fundraising. The proposal was released in the form of a joint statement issued in September 2016.

The statement sets out a simple proposal for the regulation of fundraising: clarify the Australian Consumer Law (ACL) to ensure its application to fundraising is clear and broad, and repeal existing state and territory regimes. This would, in effect, create a nationally-consistent regulatory regime, dramatically reducing red tape for NFPs around Australia and providing better protection for donors.

A formal review of the ACL is currently underway considering various aspects of its enforcement and administration. Advocacy from the NFP sector, including

the AICD, resulted in the inclusion of fundraising as a key consultation issue for the reforms. The review's final report recommended that regulators "clarify through regulator guidance the current application of the ACL to the activities of charities, not-for-profit entities and fundraisers."

While regulatory guidance is welcomed, it will not go far enough to provide certainty to the sector (and to state and territory governments) of the broad and effective application of the ACL to fundraising activities.

A determination by consumer affairs ministers about the recommendations of the final report is imminent.

Lucas Ryan GAICD, Senior Policy Adviser, AICD

3.6.3 Australian Charities and Not-for-profits Commission statutory review

The Australian Charities and Not-for-profits Commission (ACNC) was established on 3 December 2013 following over two decades of consultation on the establishment of a new regulatory regime for charities.

Embedded in its enabling legislation is a statutory requirement that a review be undertaken into its operations five years after its establishment. The review must be focused on the first five years of operation of the ACNC and must be completed within six months of the end of the five year period. The responsible minister must table the report with the parliament within 15 sitting days of its receipt.

The legislation does not stipulate how thorough the review must be or what aspects of the regime will be in focus. The form of the review may be a simple desktop activity undertaken by the Treasury or another government agency, or a more comprehensive review undertaken by an external expert, panel or appointed firm.

It is likely that the review will consider the:

- 'secrecy provisions' which prevent the ACNC from informing the public about regulatory activity and complaints against charities unless an opportunity is provided to correct misrepresentations on the public record;
- representation of information displayed on the ACNC Register to better align to user needs;
- thresholds for reporting;
- introduction of a 'fit and proper person' test for responsible persons (board members); and
- enforcement powers granted to the commission.

There are also a number of small issues in the legislation that may be regarded as errors in legislative drafting. The AICD will be taking an active role in the review process.

Lucas Ryan GAICD, Senior Policy Adviser, AICD

For more information please contact

t: 1300 739 119

e: contact@aicd.com.au

w: companydirectors.com.au/edu

06000-1_17