Australian Business Reporting Leaders Forum

10 September 2015

Mr John Brogden
Managing Director & Chief Executive Officer
Australian Institute of Company Directors
Level 30, 20 Bond Street
Sydney NSW 2000

Dear John

THE "HONEST AND REASONABLE DIRECTOR DEFENCE" AND AN ALTERNATIVE DEFENCE PROPOSAL

I refer to our recent meeting, and thank you for your time. I would like to follow up on that meeting, focusing on the AICD's 2014 paper advocating an "honest and reasonable director defence" and my thinking on this matter. At our meeting, I understood you to say that you support integrated reporting per se, but see that director liability for the forward-looking and risk-oriented statements to be included in integrated reports remains a key barrier to widespread adoption of integrated reporting in Australia. The 2014 paper does not contain a specific request for feedback. However, as Chairman of the Australian Business Reporting Leaders Forum (BRLF) and a Company Director, I have some comments which I hope may assist you in taking your recommendations forward.

Dealing with the question of director liability is a critical aspect of corporate reporting reform which is gathering significant global and national momentum[1], and finding an appropriate adoption pathway for integrated reporting in Australia is important for all in our capital markets, not only directors. Accordingly, the matter is at the top of the BRLF's agenda.

The Business Reporting Leaders Forum

The BRLF has existed since 2010. It is a forum where various members of the corporate reporting supply chain come together and consider trends and issues in relation to corporate reporting, and explore solutions which are suited to Australian capital markets. It is focused on making corporate reporting more conducive to investment, and promoting ideas on how to dismantle the current volume, complexity and red tape in corporate reporting in Australia, which has built up over time through a myriad of requirements from a number of government agencies.

The forum's purpose was advanced in 2013-14 with the appointment of a new federal government and its focus on cutting red tape, together with the release of the International Integrated Reporting <IR> Framework in December 2013, March 2014 changes to the ASX Corporate Governance Principles, and Australia's Presidency of the G20 and B20 in 2014, with their focus on growth and jobs, investment and infrastructure, and financial stability.

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[1] Corporate reporting reform, and Integrated Reporting in particular, are now on the agenda of the International Financial Reporting Standards Foundation, which in its August 2015 Trustees' Review of Structure and Effectiveness noted (paragraph 26) that "…developments in wider corporate reporting have continued to be made, most notably in the area of integrated reporting, <IR> …". It went on, "Integrated reporting is now a 'hot topic' that is increasingly being referred to in discussions on financial reporting. For example, in a report commissioned by the B20 (the business forum that advises G20 governments) the six largest global accounting networks15 have endorsed <IR> as a key innovation that will make corporate reporting more conducive to long-term investment." The Trustees (paragraph 28) noted that "the Trustees believe that it is important for the Foundation and the IASB to participate in such developments …" and requested comment by November 2015 on whether, among other things, the IASB should play an active role in developments in wider corporate reporting. The matter of corporate reporting reform as an enabler of more infrastructure and other long term investment has continued to be a focus of the 2015 Turkey B20, which is expected to recommend to individual G20 nations that they take action to promote widespread adoption of Integrated Reporting, which in Australia would involve addressing the director liability issue. Finally, the International Auditing and Assurance Standards Board in July 2015 issued a working group publication designed to inform stakeholders about the IAASB's ongoing work to explore assurance on integrated reporting and other emerging developments in external reporting.

It has been further advanced through the 2015 Turkey 2015 process. The International Integrated Reporting Council (IIRC) has secured a key role at the overall B20 level to advance its global advocacy of integrated reporting, and I am a member of the 2015 B20's Infrastructure & Investment Taskforce. The current draft of the Taskforce's report contains an integrated reporting recommendation, and notes that individual G20 nations will need to take their own actions to address blockages and challenges to widespread adoption of integrated reporting. In Australia, one of the key barriers is director liability for the forward-looking and risk-oriented statements which are fundamental to integrated reports prepared under the IIRC's Integrated Reporting Framework (the <IR> Framework).

The BRLF believes that corporate reporting reform has a critical role to play in supporting all of these important change agenda items. It will drive better reporting for all users and less work for preparers, therefore increasing transparency and utility whilst reducing cost. In addition most of us believe that <IR> is a valuable framework to effect corporate reporting reform as it now has global recognition and increasing levels of acceptance.

I wrote to the Hon Josh Frydenberg and Senator Mathias Cormann on this matter in 2014, noting explicitly the need for government to assist directors and investors to come together to resolve the director liability matter to their mutual satisfaction.

This work has been continued in 2015 in the light of the 2015 B20 process. In recent months I have met with officials from The Treasury and the Attorney-General's Department, along with the Secretary of the Treasury, Mr John Fraser, to advocate director liability reform in the interests of enabling better information to flow into capital markets through integrated reports. I have also written to the Attorney-General requesting that the matter of director liability reform be referred to the Australian Law Reform Commission in the improved capital markets context.

An important momentum shift has occurred, which we believe is important in the context of the AICD's aims as the AICD's paper makes explicit reference to legislative action required to enable directors to make more forward-looking and risk-oriented statements in corporate reports, as contemplated by the IIRC's <IR> Framework, and indeed ASIC's regulatory guide (RG 247) on the content of the Operating & Financial Review in the Annual Report of listed Australian companies.

The AICD Paper: The "honest and reasonable director defence"

Proposal:

The AICD paper recommends that a broad defence for directors covering breaches of the entire Corporations Act and ASIC Act should be inserted into Chapter 9 of the Corporations Act, which deals with Miscellaneous matters.

The idea is that the defence should cover two broad areas of director liability under the Act:

- 'Direct' liability for directors, for duties imposed directly on directors under specific provisions of the Act (e.g. continuous disclosure, financial reporting and insolvent trading); and
- 'Indirect' liability for directors (also known as the 'stepping stone approach'), whereby a director may be found to be in breach of the general duty of care and diligence under s180 (1) through the director causing the corporation, or personally, to be found to have breached the 'misleading or deceptive conduct' duty in s1041H of the Act.

The AICD paper argues that the 'business judgement rule' defence in s180(2) of the Act is not available to directors when they breach specific director duties ('direct' liability) as use of the defence requires there to have been a business judgement or decision. Complying with provisions to make continuous

disclosures when required, to comply with accounting standards, and to not trade while insolvent, do not require judgements or decisions – they are obligations and so s180(2) cannot apply. [2]

Some Comments and Concerns:

The case argued in the paper is compelling from the perspective of directors. It is a case made out by the AICD in an area where it not only has a vested interest as an Institute, but also an area where at least perceived conflicts of interest and differences of views arise between the protection of directors and the best interests of investors. The needs of investors and the benefits of the defence are not explained in compelling fashion from the perspective of investors. This is important as such a defence would also be asking investors to give up some of their rights to take action against directors in relation to breaches of the Act. Why should investors (institutional investors, intermediate fund managers, and superannuation fund trustees, i.e. the real audience that needs to be convinced) consent to such a wide defence without getting something in return? That question does not appear to be addressed or answered in the AICD paper.

As a broad request of government, it will take time for the government to see that there is general agreement among all interested parties about the need for the proposed change; that is if and when investors agree, and take action. We believe that the business case for the "honest and reasonable director defence" requires significant strengthening beyond the case made in the AICD paper on behalf of directors. Reciprocity from the perspective of investors needs to be introduced.

In addition, the paper is arguing for a 'one step' adoption of this broad-based defence. We believe that it may be better to approach the matter in steps, one of which is the subject of this letter. We believe that a more modest change to the legislation, a clarification of s180(2), is achievable in the short term as it will likely have the support of investors, and can deliver what is required to enable directors to make more forward-looking and risk-oriented statements now in corporate reports.

Corporate Reporting Reform – Critical to Enabling Infrastructure and Long Term Investment

Importance:

It is now well recognised that today's corporate reporting model is in need of reform if it is to be more conducive to enabling long term investment, in infrastructure in particular. This is an imperative for the Australian government as reflected in the 2014 Federal Budget, and was also central to the B20's recommendations to the G20 under Australian leadership in 2014. As mentioned above, this focus is continuing in the 2015 Turkey B20 process. In other words, corporate reporting reform is an essential component of reducing 'short-termism' in the capital markets.

This matter was addressed in a 2014 report by the major six global accounting firms to the 2014 B20[3] which examined how corporate reporting can be made more conducive to long term investment, and infrastructure investment in particular. The paper recommended that the 2014 B20 should make the following recommendation to the G20:

> "Encourage corporate reporting innovations and initiatives that provide investors with a longer-term and broader perspective on shareholder value creation to complement the historical financial performance and current financial position perspective provided by financial statements. The B20 notes the particular relevance of integrated reporting as an example in this respect."

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[2] *Centro* is cited as an example of a case dealing with such duties. It was a regulated financial reporting case, and not one about voluntary corporate reporting.

[3] 'UNLOCKING INVESTMENT IN INFRASTRUCTURE - Is current accounting and reporting a barrier?' B20 Panel of six international accounting networks, June 2014

The paper also noted that each G20 nation would need to find its own pathway to adopting this recommendation:

> "Each G20 Finance Minister should assess and address any practical, legal or statutory barriers to improved corporate reporting and work towards removing such barriers in order to make corporate reporting more conducive to infrastructure and other long-term investment."

This has been the basis of our discussions with the Australian Government in 2015.

The AICD identifies barriers to directors making more forward-looking and risk-oriented statements in Australia, including under the International Integrated Reporting Council's Integrated Reporting Framework and in Operating and Financial Reviews using the guidance in ASIC's 2013 RG 247, given uncertainties about potential personal liability for directors for doing so. The AICD notes that any statement about the future is by its nature uncertain, and that directors are concerned that making any statement, even if made on reasonable grounds, may later expose them to personal liability with the benefit of hindsight if things turn out differently. However, if preparing integrated reports under the IIRC's <IR> Framework is clearly identified as a business judgment, as will be argued below, there is existing protection for directors under the current business judgment rule as contained in s 180(2).

Public Policy Grounds for Greater Legal Certainty:

Legislative change in this area should be aimed to strike a balance between the protection of directors and the interests of investor, with an aim of improving capital markets. This balance is justifiable based on public policy grounds: Reasonable protection for directors when a company is preparing integrated reports under the IIRC's <IR> Framework will ensure improving the flow of information to the capital markets. Inevitably this will lead to improved and longer term information being made available to investors, resulting in corporate reporting becoming more future-oriented.[4] This will also enable improving the flow of monies (e.g. superannuation and institutional investors) to essential long term projects, infrastructure in particular by making investment propositions clearer. Furthermore, this would be a development well aligned to the pressing needs for large amounts of new infrastructure investment; the elimination of short termism; and the very aims of integrated reporting.

We do not believe that directors require the very wide and subjective protection suggested by the AICD with their "honest and reasonable director defence" to ensure that they can make forward-looking and risk-oriented statements for the benefit of investors as an integral part of integrated reporting. We believe that the necessary protection can be accomplished through a clarification of the existing business judgement rule under s180 (2).

Clarifying the Business Judgement Rule – Incrementally Adjusting an Existing Defence

Directors may be exposed to s180 (1) liability if they engage in misleading and deceptive conduct under s1041H, which includes a need for there to be reasonable grounds to make forward-looking and risk-oriented statements. Directors have a defence if they have met the conditions of the 'business judgement rule' under s180 (2).

s180(2) of the Corporations Act takes as given that any judgement (e.g. deciding on the content of a forward-looking and risk-oriented statement outside of a financial report, for instance, in a non-mandatory integrated report prepared under the IIRC's <IR> Framework) **was** made on reasonable grounds **if** the director(s):

- made the judgement in **good faith** for a **proper purpose**;
- do not have a material personal interest in the subject matter of the judgement;

[4] The decision-support benefits to investors of corporate reporting reform are more fully analysed in the recent KPMG paper, 'Corporate reporting reform – better alignment with investor decision making - The Journey to Better Business Reporting Continues'. KPMG, July 2014.

- **inform themselves about the subject matter** of the judgement to the extent that they **reasonably believe** to be **appropriate**; and
- **rationally believe** that the judgement is in the **best interests** of the corporation.

The section concludes by stating that the director's belief that the judgement **is** a rational judgement **unless** the belief is one that no reasonable director in that position would hold. Directors properly applying the IIRC's <IR> Framework can be confident that they have properly informed themselves about the subject matter of the report and have acted in the best interests of the corporation for reasons explained below, and in more detail in the attached appendix.

Adoption of the IIRC's <IR> Framework is not mandatory, and nor should it be. Accordingly, all decisions made in preparing an integrated report will by definition be business judgements, which are subject to the duties contained in s180(1) of the Corporations Law and which should be covered by the 'business judgement rule' defence in s180(2). This is most evident in relation to the forward-looking and risk-oriented information in such reports which by their nature involves uncertainty and judgements about the future.

That being the case, it must have been intended that the defence in s180 (2) would be available in relation to such reporting judgements. Judgements made in reporting forward-looking and risk-oriented information must not involve misleading and deceptive conduct, and judgements must be made on reasonable grounds. However, if they are so made, directors should not be penalised for reporting information designed to enable investors to make better capital allocation decisions.

It should be possible to change the law in a small way to explicitly recognise this in the interests of providing better information to investors and other users of corporate reports, and so improve capital markets and reduce excessive short-termism.

An Alternative Proposal: Protecting Reasonable Forward-Looking and Risk-Oriented Statements Under s180 (2)

Accordingly, we believe that the AICD and others should consider pursuing a first step change to better protect directors by focusing on forward-looking and risk-oriented statements in corporate reports on public policy grounds while they continue to pursue the "honest and reasonable director defence" if they so choose. We also believe that the protection should be specifically tied to application of the integrated reporting IIRC's <IR> Framework, and forward-looking and risk-oriented statements within integrated reports.

It appears likely that s180 (2) would already apply to protect directors meeting its requirements in relation to integrated reports under the IIRC's <IR> Framework. It certainly should. However, given the infancy of integrated reporting in Australia, and the untried application of s180 (2) to it, we recommend that the AICD ask that the availability of the s180 (2) defence for proper application of the IIRC's <IR> Framework (its fundamental concepts, guiding principles, content elements and certain required content) be made explicit in s180 (2) in the short term on public policy grounds, possibly through a second 'Note' to the section.

A second note to s180(2) could make clear that judgements include forward-looking statements in integrated reports prepared under the IIRC's <IR> Framework, and are afforded the defence of s180(2) given the benefits that this brings to capital markets.

Investors should concur with this change, given the requirements that directors must meet the conditions of s180 (2) to be able to use it, the proven nature of the integrated reporting framework, and the resulting improvement in investors' ability to make precise capital allocation decisions.

Governments would see that the required groundswell for change is in place, as well as being able to deliver on their own commitment to enabling more infrastructure and other long term investment.

Which Report?

The IIRC's <IR> Framework makes clear that its adoption need not add another report to the corporate reporting portfolio:

> "An integrated report should be a designated, identifiable communication." (paragraph 1.12)
>
> "An integrated report may be either a standalone report or be included as a distinguishable, prominent and accessible part of another report or communication. For example, it may be included at the front of a report that also includes the organisation's financial statements." (paragraph 1.15)

Some Australian companies, notably Stockland and NAB as participants in the IIRC's pilot programme, have been applying the IIRC's <IR> Framework outside of their annual reports in separate documents styled as 'annual reviews'. As voluntary reports, with judgement applied to elect their preparation, as well as to develop their content, the application of s180 (2) is most obvious.

Many Australian companies are already applying elements of the IIRC's <IR> Framework following the release of the Framework in December 2013 and ASIC's RG 247 in April 2013. They have been reluctant to fully apply the Framework, particularly regarding forward-looking and risk-oriented statements, because of doubts about the availability of the business judgement rule defence under s180 (2).

The IIRC's <IR>Framework contemplates this situation. Paragraph 1.14 of the Framework notes that an integrated report:

> "… may be prepared in response to existing compliance requirements. For example, an organisation may be required by local law to prepare a management commentary or other report that provides context for its financial statements. If that report is also prepared in accordance with the Framework it can be considered an integrated report."

An example of a commentary is the Operating & Financial Review required to be included in Directors Reports under the Corporations Act.

Paragraph 1.14 continues:

> "If that report is required to include specified information beyond that required by this framework, the report can still be considered an integrated report if that other information does not obscure the concise information required by this Framework.

Accordingly, there is scope to include a specific carve out in s180 (2) to make it clear that the 'integrated report' component of the Operating & Financial Review is a business judgement as contemplated by the s180 (2) defence, notwithstanding that the 'integrated report' is contained within a report that is required to be made out by directors under the Corporations Act. A possible wording of such a note is set out below. The second note to s180(2) contemplated below could also make clear that judgements regarding forward-looking statements in integrated reports such as those prepared under the IIRC's <IR> Framework, are afforded the defence of s180(2) given the benefits that this brings to capital markets.

<u>Proposed Addition to Note to s180 (2) of the Corporations Act</u>

Notes:

(1) This subsection only operates in relation to duties under this section … [as currently drafted]

(2) This subsection operates in relation to any integrated reports prepared in accordance with the Integrated Reporting Framework issued by the International Integrated Reporting Council, including integrated reports forming part of Operating & Financial Reviews in Directors Reports required under this Act, and integrated reports included in other non-mandatory corporate reports. Such integrated reports, including forward-looking and risk-oriented statements therein, are business judgements for the purposes of s180 (2).

<u>Proposed s299A (4) of the Corporations Act</u>

A director of a company is liable for loss suffered as a result of any untrue or misleading statement in relation to the information required by s299A(1)(c) only if he or she :

(a) Knew, or should have known, the statement to be untrue or misleading or was reckless as to whether it was untrue or misleading, or

(b) Knew, or should have known, that any omission from the statement would make the statement misleading.

The Appendix to this paper sets out a more detailed explanation of how applying the IIRC's Integrated Reporting (<IR>) Framework should be an effective basis for demonstrating that the requirements of the business judgement rule in s180(2) have been met.

You should note that note that not all members of the BRLF support the recommendation to amend s180 (2) in this way at this time, but are actively considering it as a potential way forward. In addition, some members would prefer that a broader reference to 'corporate reporting' be used, rather than having reference specifically tied to Integrated Reports prepared in accordance with the <IR> Framework issued by the International Integrated Reporting Council.

<u>Implications</u>

Directors now have the opportunity to clearly define the positioning of an integrated report, alternatively, within their Operating & Financial review or within a separate voluntary report such as an annual review as they define and disclose their 'corporate reporting portfolio' as contemplated under the March 2014 Third Edition of the ASX Corporate Governance Principles and Recommendations. Principle 4 replaced references to 'financial reporting' with references to 'corporate reporting'. More guidance for directors on this matter is contained in a 2014 KPMG paper for company directors[5].

CFO's have the opportunity take charge of these significant changes in the corporate reporting agenda through reviewing and refining their corporate reporting strategies in consultation with their boards of directors as they re-define their corporate reporting portfolios to make them fit for the purpose of reporting their strategies, performance and prospects to investors (and other key stakeholders); at the same time as cutting the clutter in corporate reporting progressively and appropriately managing director liability under the Corporations Act. More guidance for directors on this matter is contained in a 2014 KPMG paper for CFOs[6].

[5] 'Oversight of corporate reporting by company directors, The Journey to Better Business Reporting Continues'. KPMG, July 2014.

[6] 'CFOs driving the corporate reporting reform agenda, The Journey to Better Business Reporting Continues'. KPMG, July 2014.

Directors may choose to obtain some form of assurance on their integrated reports, whether included in the Operating & Financial Review or a separate existing report such as an annual review, to assist in discharging their duties. In time, there is likely to be a separate assurance framework or standard for integrated reporting, which will assist in this area.

The case for investor support for this proposal in the improving the ability to make effective capital allocation decisions is set out in the 2014 KPMG paper referred in in Footnote 3.

Assurance on integrated reports is now on the agenda of the IIRC and the International Auditing and Assurance Standards Board (IAASB). A paper discussing integrated reporting assurance was issued by the IAASB in July 2015. The second note to s180 (2) could be amended further in future years to make assurance by a qualified independent assurance provider a condition of the defence of s180 (2) if the benefits that assurance brings to capital markets are proved.

In the short term, we believe that there is a significant public policy case for ensuring that the business judgement rule defence in s180(2) is amended to make it clear that it covers judgements made in preparing integrated reports under the IIRC's <IR> Framework, including forward-looking and risk-oriented statements, in separate (voluntary) annual reviews, mandatory operating and financial reviews, or in other formats defined by individual boards of directors to comprise part of their corporate reporting portfolio.

I look forward to discussing these matters further with you. We would be delighted to work with you in progressing this matter with government. Please contact me on 0418 314 975 (in my absence, Michael Bray mgbray@kpmg.com.au or Nick Ridehalgh nridehalgh@kpmg.com.au of KPMG) if you need anything further in advance of this.

Yours sincerely

John Stanhope
Chairman, Australian Business Reporting Leaders Forum

Cc Senator George Brandis - Attorney-General

Appendix

The following table explains how applying the IIRC's <IR> Framework should be an effective basis for demonstrating that the requirements of the business judgement rule in s180(2) have been met:

Essence of s180(2) requirement …	**… should be met by applying <IR> Framework**
Good faith … for a proper purpose	**Integrated Report Defined - <IR> Framework paragraph 1.1** An integrated report is a concise communication about how an organisation's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value over the short, medium and long term.
Directors: • inform themselves about the subject matter to the extent they reasonably believe to be appropriate • rationally believe that the judgement is in the best interests of the corporation. That the judgement is a rational one is a given unless the belief is one that no reasonable director would hold.	**Integrated Reporting Governance - <IR> Framework paragraph 1.20** An integrated report should include a statement from those charged with governance that includes: • An acknowledgement of their responsibility to ensure the integrity of the integrated report • An acknowledgement that they have applied their collective mind to the preparation and presentation of the integrated report • Their opinion or conclusion about whether the integrated report is presented in accordance with this Framework or, if it does not include such a statement, it should explain: • What role those charged with governance played in its preparation and presentation • What steps are being taken to include such a statement in future reports • The time frame for doing so, which should be no later than the organisation's third integrated report that references this Framework. **Integrated Report Guiding Principles – Freedom From Material Error (para 3.46)** Freedom from material error does not imply that the information is perfectly accurate in all respects. It does imply that: • Processes and controls have been applied to reduce to an acceptably low level the risk that reported information contains a material mis-statement • When information includes estimates, this is clearly communicated, and the nature and limitations of the estimation process are explained
Without having a material personal interest in the subject matter of the judgement	**Integrated Report Guiding Principles – Reliability & Completeness** An integrated report should include all material matters, both positive and negative, in a balanced way and without material error **Integrated Report Guiding Principles – Balance (para 3.44)** A balanced integrated report has no bias in the selection or presentation of information. Information in the report is not slanted, weighted, emphasised, de-emphasised, combined, offset or otherwise manipulated to change the probability that it will be received either favourably or unfavourably.