

The fourth edition of the ASX Corporate Governance Principles and Recommendations looks to transform non-financial disclosure in order to address emerging investor expectations on ESG performance.



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With its changes to the fourth Edition of the Corporate Governance Principles and Recommendations, the ASX has responded to investor demands for more extensive and relevant non-financial disclosures; reflecting the current pace of change and future direction of disclosure in Corporate Australia.

The fourth edition of the Corporate Governance Principles and Recommendations has been released after a long, and at times polarizing, consultation process. The inclusion in the draft of the term ‘social licence to operate’ sparked debate across corporate Australia, with some stakeholders seeing the term as too vague and elastic to allow companies to meaningfully respond to the proposed new guidance.

In response, references to social licence have been removed from the final version released in February 2019; however, the sentiment remains. The ASX has now set a very clear expectation that listed companies in Australia need to be more transparent in articulating how they “*instill and continually reinforce a culture across the organisation of acting lawfully, ethically and responsibly*”.

Since their inception in 2003, the Australian Securities Exchange (ASX) Corporate Governance Council’s Corporate Governance Principles and Recommendations (CGPR) have influenced the governance, disclosure and operational practices of listed entities in Australia. The principles have been reviewed, consulted on, and refined over the years to include recommendations on risk management, diversity, remuneration practices and environmental and social issues.

The CGPR fourth edition may be similar in form and structure to the prior edition, but it introduces several changes with significant ramifications. The new guidance outlines expectations for a substantial improvement in the quality of corporate governance disclosures, reflecting emerging domestic and global issues, and most notably the growing lack of trust in institutions.

In this update we focus on the key changes which are expected to impact organisation’s **non-financial disclosures**. These changes are consistent with recent guidance or requirements in environmental, social and governance (ESG) disclosure being issued by many other stock exchanges in the Asia-Pacific region and globally, and with the expectations of the Sustainable Stock Exchanges (SSE) Initiative, which the ASX joined in June 2017.

#### Summary of key changes:

1. **Stronger focus on corporate culture, reputation and standing in the community** (*Principle 3*), with the inclusion of a recommendation for entities to articulate and disclose their values. The ASX outlines that entities need to protect their reputation and standing in the community and with key stakeholders to create sustainable value for security holders.
2. **Verification of any periodic corporate reports is now a recommendation** (*Recommendation 4.3*), which includes integrated reports and sustainability reports, recognising that investors are relying on a broader range of corporate reports than audited or reviewed financial statements to inform their decisions.
3. **More explicit guidance for disclosure of material exposure to environmental and social risks** (*Recommendation 7.4*), with the ASX highlighting that how an entity manages its environmental and social risks can affect its ability to create long-term value for security holders. This sets a clear expectation that all companies should be disclosing information on environmental and social risks, with a specific focus on climate risks, both transition and physical risks and guidance on the use of **Task Force on Climate-related Financial Disclosure** (TCFD).

## Key changes impacting non-financial disclosures

### Principle 3: Instil a culture of acting lawfully, ethically and responsibly

*“A listed entity should instil and continually reinforce a culture across the organisation of acting lawfully, ethically and in a socially responsible manner.”*

There are substantive changes within Principle 3 that encourage entities to place greater attention on their corporate culture and values, and the processes they have in place for ensuring cultural alignment across the business to act in a socially responsible manner. This is a subtle shift for the ASX, but with big implications.

The ASX quotes Commissioner Hayne from the *Interim Report, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, 28 September 2018, Volume 1, pp. 54- 5:

*“As [a commercial enterprise], [a listed] entity... rightly pursues profit. Directors and other officers of the entities owe duties to shareholders to do that. But the duty to pursue profit is one that has a significant temporal dimension. The duty is to pursue the long-term advantage of the enterprise. Pursuit of long term advantage (as distinct from short term gain) entails preserving and enhancing the reputation of the enterprise... And, lest there be any doubt, it also entails obeying the law. But to preserve and enhance a reputation... the enterprise must do more than not break the law. It must seek to do “the right thing”.”*

This sets a clear expectation that listed entities should be disclosing how the organisation articulates and reinforces its values such that it creates competitive advantage over time. Further, the ASX suggests that this is achievable by preserving and protecting its reputation and standing in the community by considering the interests of key stakeholders - not only shareholders.

### Principle 4: Safeguard the integrity of corporate reports

A new Recommendation 4.3 requires:

*“A listed entity should disclose its process to verify the integrity of any periodic corporate report it releases to the market that is not audited or reviewed by an external auditor.”*

The ASX defines periodic corporate reports *“as an entity’s annual directors’ report, annual and half yearly financial statements, quarterly activity report, quarterly cash flow report, integrated report, sustainability report, or similar periodic report prepared for the benefit of investors.”*

The introduction of this new recommendation was overwhelmingly supported by investor groups through the consultation, noting that this would provide them with greater confidence in the quality of these reports. There was some opposition to this, suggesting that it may discourage entities from producing reports that are not legally mandated. However, the ASX kept the recommendation, noting that investors are increasingly relying on a broader range of corporate reports to inform their investment decisions anyway.

This observation is consistent with EY [2018 Investor Survey](#), which found that nearly all (97%) investors undertake informal or structured evaluations of ESG disclosures.

In the consultation draft the ASX noted that, to fulfil this new requirement, the financial auditor’s obligation under ASA720 (The Auditor’s Responsibilities Relating to Other Information) was not sufficient. Although this clarification has been removed from the final edition, we suggest that entities carefully consider what processes they have in place to test the quality and reliability of information being publicly disclosed and, in particular, to provide investors with the confidence they demand for materially accurate and balanced accounts of organisational performance.

### Principle 7: Recognise and manage risk

Recommendation 7.4 has clarified what was a new inclusion in the third edition, requiring:

*“A listed entity should disclose whether it has any material exposure to environmental or social risks and, if it does, how it manages or intends to manage those risks.”*

The wording has been simplified to refer only to ‘environmental and social risks’, removing ‘economic risks’, which provides clarity that the expectation here relates to sustainability or non-financial risks to the business.

Significant changes to the commentary in 7.4 include:

- ▶ A challenge to “entities that believe they do not have any material exposure to environmental or social risks” to carefully reconsider. The ASX makes it very clear that they believe all listed entities face non-financial, or environmental and social risks, suggesting the entity should prove it does not by benchmarking against peers and disclosing this.
- ▶ Clarification that how an entity manages its environmental and social risks can affect its ability to create long-term value for security holders. Further, a suggestion that being more transparent will enable investors to properly assess these risks.
- ▶ A suggestion that publishing a sustainability report or an integrated report (e.g. prepared in accordance with the International Integrated Reporting Council’s *International <IR> Framework*) may meet this requirement.
- ▶ Specific identification of climate risk as a source of environmental risk, with an encouragement for entities to implement the Recommendations of the [Task Force on Climate-related Financial Disclosure](#) (TCFD).

**Companies with a December year end will be expected to measure their governance practices against the new recommendations for 31 December 2020 reports. June year end companies will need to comply for reports covering the year ending 30 June 2021. The ASX encourages early adoption.**

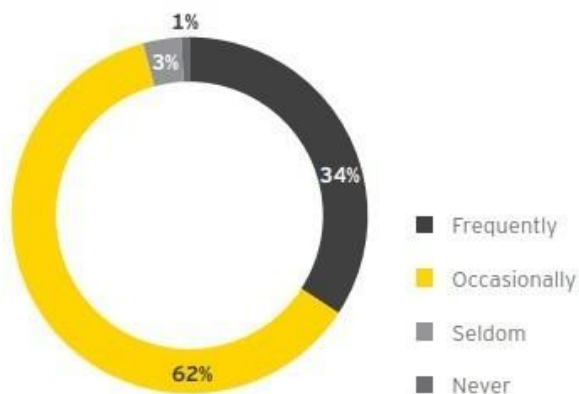
## Implications for reporters

### Meeting investor expectations for non-financial disclosures

EY 2018 Investor Survey demonstrates the growing importance of providing reliable and relevant ESG disclosures to the market, with almost all investors (96%) indicating that such information has played a pivotal role in decision making.

Figure 1. Use of ESG information in decision making

In the last 12 months, how frequently has a company's nonfinancial performance played a pivotal role in your investment decision-making?



Source: EY, 2018, 'Does your nonfinancial reporting tell your value creation story?'

Yet despite the almost universal use of ESG information; investors continue to call out for higher quality disclosures, especially those that provide more comparable information and investment-grade data. The 2018 survey found a high level of support (59%) for the development of prescriptive accounting standards for non-financial information, with strong support (70%) for national regulators to lead the charge in developing such standards. Providing clear evidence that sustainability or ESG disclosures should be held to the same level of scrutiny as financial information is.

## What next?

### Key dates

The CGPR fourth edition will come into effect for an entity's first full financial year commencing on or after 1 January 2020, however early adoption is encouraged.

Entities with a 30 June balance date will be expected to measure their practices against the CGPR fourth edition in the financial year ended 30 June 2021.

Entities with a 31 December balance date will be expected to measure their practices against the CGPR fourth edition in the financial year ended 31 December 2020.

The new guidance from the ASX helps to remedy this challenge, by encouraging more transparent reporting on environmental and social risks (Recommendation 7.4) and for all periodic corporate reports to be verified (Recommendation 4.3).

### Realising the benefits

Boards have ultimate responsibility to understand and manage sustainability risk and to improve the content and robustness of corporate reporting. Directors will therefore need to ensure that entities have a robust approach for assessing and disclosing sustainability risks, including how those risks are being managed and mitigated.

There is an urgent need for companies to be genuinely transparent in explaining to core stakeholder groups how their corporate culture is effective in maintaining the organisation's reputation, and ultimately, its standing in the community. The CGPR fourth edition provides listed entities with the opportunity to reassess reporting priorities and processes for identifying and managing environmental and social risks, to meet the shifting expectations of investors, regulators, customers and other stakeholder groups.

### Risks of inaction

As non-financial disclosures become more sophisticated and responsive to stakeholder needs, laggards that fail to disclose relevant and timely sustainability information will be under a spotlight.

The key risk for companies that ignore the new recommendations is that they may compromise their access to capital by hampering investors' ability to make informed decisions. Companies that underplay the importance of being truly transparent will disclose information that is less comparable, offers limited insight and is potentially of lower quality.

As highlighted by the ASX, a stronger understand of broader social and environmental risks and demonstrated management of these risks can 'affect an organisations ability to create long-term value for security holders'.

Further, there are likely to be significant costs from delaying action and needing to play 'catch-up' to peers or to respond reactively to customer, investor, NGO and media expectations

### Call to action

With mounting evidence of a trust deficit in corporate Australia, it is critical that organisations use the opportunity afforded them to have an open and honest conversation with their stakeholders on their purpose and plan for long-term value creation. Now is the time to review your approach to non-financial disclosure, and assess the impacts of the introduction of the fourth edition of the Corporate Governance Principles and Recommendations.

EY welcomes the opportunity for a discussion with you about the impact of the amended Principles and Recommendations on your business and how to best structure your response to the new guidance in order to manage environmental and social risks, and deliver long-term value.

## Five key steps to prepare for the CGPR fourth edition

### Start preparing early

Listed entities that proactively consider the amendments in the fourth edition, and review their corporate governance and disclosure practices accordingly, will see the most benefit when navigating the changes. Prepare now by developing a roadmap to incorporate the amended principles and recommendations to ready the organization and its stakeholders.

### Carry out a gap analysis and assess material risks

Map your current practices and disclosures, as well as those of peers, against the new guidance to identify areas of improvement and opportunities to build upon existing strengths. A clear and well-constructed gap analysis will provide a solid foundation to engage your internal and external stakeholders, and an evidence base for the board to decide on the proposed course of action.

Conducting a materiality assessment to determine significant environmental and social risks will also support the organisation identify those issues which should be prioritised.

### Engage with investors and other stakeholders

Early engagement with key external stakeholders can help ensure that any measures introduced to respond to the fourth edition will meet their expectations. Investors, customers and industry groups, in particular, can strengthen the organisation's response by providing insight. Alternate perspectives should, however, be balanced and aligned to each stakeholder groups' potential to influence the entity.

For example, engaging with stakeholders on climate risk, will be critical to integrating their perspective into a risk assessment of the transition and physical risks will are likely to impact the organisation, and which should be disclosed to support investor decision making.

### Engage internally and assign accountabilities to enhance current practice

It is critical to establish alignment between the corporate governance and corporate communications teams with the executive and Board when communicating your environmental and social risks, and broader organisational values. Establish roles and responsibilities across reporting teams to coordinate and share the burden of revising your disclosure strategy.

Furthermore, ensure accountabilities are assigned to deliver upon improvement plan; ensuring that management actions are assigned for each material risk identified.

### Improve disclosures, assess and monitor ongoing improvements

Look to enhance current disclosures and consider early adoption to get ahead of peers and set the standard of disclosure in your sector.

Assess the organisation's approach to verifying all information publicly disclosed, and determine whether additional and/or independent assurance activities should be introduced. For example, consider undertaking an assurance readiness exercise to ready the organisation for future verification activities.

Ensure that there is an effective management process for monitoring and measuring progress. This will be essential for identifying continuous improvement opportunities. Expectations of regulators and the broader society are expected to continue tightening over time. Proactively responding to this will likely continue to challenge many organisations, particularly those with significant public profiles.

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