Australian Government

The Treasury

Parliamentary Joint Committee on Corporations and Financial Services

Inquiry into Corporate Responsibility

Submission by the Treasury

March 2006

CONTENTS

Contents iii

Introduction..... 1

Profile of the corporation 2

Corporate governance and social responsibility 3

Separation of ownership and control 3
Agency problems 4
Scope for socially responsible conduct 6
Private sector initiatives 8
Government initiatives..... 9
International initiatives 11

Corporate disclosure and non-financial reporting 12

Current disclosure requirements 12
Scope for mandating greater disclosure of non-financial information 14
Private sector initiatives 14
Government initiatives..... 16
International initiatives 16

International developments 17

United Kingdom 18
United States..... 20
France..... 21

Conclusion..... 22

INTRODUCTION

Corporations, large and small, multinational and local, play a fundamental, multi-dimensional and evolving role in promoting economic growth and improving the living standards of all Australians.

Given the broad economic, social and environmental impact of corporate activities, there is an understandable interest in the legal framework in which directors of corporations make decisions. There is currently a debate on the extent to which directors can or should take into account notions of corporate social responsibility and the interests of stakeholders other than shareholders when making decisions.

Corporate social responsibility lacks a universally accepted definition. However, it can be described as a company's management of the economic, social and environmental impacts of its activities to ensure these impacts are not adverse. Another definition of corporate social responsibility is:

> *the continuing commitment by business to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well as the local community and society at large.*[1]

Corporate social responsibility is wider than corporate philanthropy, which may be financed through activities which are damaging to the communities in which business is conducted.

This submission will examine four key features of the debate, including:

- the profile of the corporation in Australia;
- the current corporate governance framework and private and public sector initiatives to promote socially responsible conduct;
- the current corporate disclosure framework and private and public sector initiatives to promote enhanced non-financial reporting; and
- international developments, focusing on a summary of recent developments in the United Kingdom, United States and France.

---

1 R Holmes and P Watts, *Corporate Social Responsibility: Making Good Business Sense*, World Business Council for Sustainable Development, Geneva, 2000.

PROFILE OF THE CORPORATION

The nature of the corporation has evolved over a number of years. A key concern has been to provide a vehicle for individuals to pool their resources for a common purpose, via a form of association that is stable and identifiable. This allows for the accumulated resources of a group of individuals to be combined in large-scale ventures and for the risk of the venture to be spread across those involved.[2]

The economic and social benefits of this vehicle have been widely recognised. For example, the Hon Justice Michael Kirby has stated:

> *the idea of an independent corporation, governed by directors and accountable to shareholders, was a brilliant one. It permitted people to raise capital from the public, to invest it without, in most cases, a danger of personal risk and to engage in entrepreneurial activity which, otherwise, would probably not occur.*[3]

Corporations dominate other forms of joint business where there is a need to combine experts and large amounts of capital. As such, they have a significant and wide-ranging impact on various aspects of national and global economies. Key figures include:

- There are over 1.4 million companies in Australia. This includes approximately 1,900 listed companies with a market capitalisation of $1.1 trillion.[4] More than 120,000 new companies were registered in 2004-05.[5]
- In 2004, an estimated 55 per cent of adult Australians or approximately 8 million people owned shares directly or indirectly (via a managed fund or self-managed superannuation fund).[6]
- For the year ended 31 December 2005, company profits before tax totalled $105.3 billion.[7]

---

2 R Tomasic, S Bottomley and R McQueen, *Corporations Law in Australia: Second Edition*, The Federation Press, Sydney, 2002, p2.

3 The Hon Justice Michael Kirby, *The Company Director: Past, Present and Future*, luncheon address to the Australian Institute of Company Directors, Tasmanian Division, Hobart, 31 March 1998.

4 G Greene, *2005 ASX year-end statistics*, media release, ASX Limited, Sydney, 18 January 2006.

5 ASIC, *Patrolling a Broad Territory: ASIC Annual Report 2004-05*, Sydney, 2005, p58.

6 *Australia's Share Owners: An ASX study of share investors in 2004*, ASX Limited, Sydney, 2005.

7 Australian Bureau of Statistics, *Business Indicators*, ABS cat. no. 5676.0, AGPS, Canberra, December 2005. Excludes businesses in the agricultural, forestry and fishing sector.

- Companies helped to finance government services and infrastructure through the payment of taxes and charges, such as an estimated $48.2 billion in company income tax receipts in 2005-06.[8]

CORPORATE GOVERNANCE AND SOCIAL RESPONSIBILITY

Separation of ownership and control

Shareholders

Shareholders contribute capital to corporations in the furtherance of an agreed objective. In return, they obtain a number of rights including a residual claim over the assets of a corporation.

The position of shareholders can be contrasted to that of creditors, who have a right to a fixed income stream, or customers, whose rights are generally specified under contract. The gains and losses of good or bad company performance are ultimately the lot of shareholders, whose claims stand last in line.[9]

Company officers

Generally, the board of directors is provided with broad management powers[10] (with day-to-day decision-making often delegated to managers), with a limited number of key matters being reserved to shareholders through voting at the general meeting.[11]

The relationship between shareholder and company officers can be compared to that of a principal and agent.

> *In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while*

---

8 *Mid-Year Economic and Fiscal Outlook 2005-06*, AGPS, Canberra, December 2005, p256.

9 F H Easterbrook and D R Fischel, *The Economic Structure of Corporate Law*, Harvard University Press, Cambridge, 1991, p67.

10 For example, section 198A of the *Corporations Act 2001* (Corporations Act) is a replaceable rule conferring broad powers on the board.

11 For example, removing the directors of a public company (section 203D), altering the share capital of a company (section 256C) or altering the company constitution (section 136).

conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom.[12]

Specialisation in roles

The separation of ownership and control allows for specialisation in both risk-bearing and management.[13]

In relation to risk-bearing, the separation of ownership and control means that shareholders do not need to be an expert in (or even be interested in) the operations of a company before investing in it. This allows for greater risk-spreading by investors, reducing the overall cost of capital for companies.

In relation to management, the separation of ownership and control allows for business decisions to be made by those with valuable relevant knowledge. Where valuable information is diffused among many people, delegation of decision-making to specialist managers becomes more efficient.

Agency problems

As with other agency relationships, the separation of ownership and control in corporations introduces agency problems. These arise because the interests of shareholders (who bear the wealth effect of corporate decisions) may not always align perfectly with the interests of the company officers (who make corporate decisions). Unless these agency problems are appropriately addressed, an inefficiently low level of capital will be made available by equity investors.

For corporations, agency problems may be managed through market forces and through the system of responsibilities and accountabilities imposed on directors and corporate actors under corporate law.

Market forces

There are a range of market forces that may operate to limit the scope for company officers to act in a manner inconsistent with the interests of shareholders.

---

12 M Friedman, 'The Social Responsibility of Business is to Make Profits', New York Times Magazine, 13 September 1970.

13 R A Posner, *Economic Analysis of Law: Fifth Edition*, Aspen Law & Business, New York, 1998, p451.

Management underperformance may reduce the competitiveness of the company in the product markets in which it operates, calling into question the long-term viability of the company.

As the market incorporates information about management underperformance into the share price for a company, the share price will fall relative to similar companies. This provides a visible signal of underperformance, as well as making it more difficult for the company to compete in the market for finance.

As the share price of a company falls, there is a growing potential for a takeover and replacement of management: that is, the market for corporate control operates to eliminate poor management.

Finally, underperformance may limit the ability of a manager to compete successfully in the labour market in the future: that is, a company is less likely to hire or promote a manager with a poor performance history.[14]

Corporate governance

The preamble to the OECD Principles of Corporate Governance emphasises the importance of corporate governance in addressing the agency problem:[15]

> *Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. … While a multiplicity of factors affect the governance and decision-making processes of firms, and are important to their long-term success, the Principles focus on governance problems that result from the separation of ownership and control.*

In the absence of contracts that can address every possible eventuality, company officers are said to owe broad fiduciary duties to the companies that they serve. The basic fiduciary duty is to act honestly for the good of the company. Related fiduciary duties include the duty to act for a proper purpose and the duty to avoid actual and potential conflicts of duty. These common law rules have been augmented by statute.[16]

In some limited cases, directors may owe a fiduciary duty to creditors.[17] This reflects a view that, as a company nears insolvency, the true owners of the

---

14 E F Fama and M C Jensen, 'Separation of Ownership and Control', *Journal of Economics and Law*, vol. XXVI, June 1983, 301 at 312.

15 Organisation for Economic Co-operation and Development, *OECD Principles of Corporate Governance*, OECD, Paris, 2004, p11.

16 For example, sections 180 through 184 of the *Corporations Act 2001*.

17 *Walker v Wimborne* (1976) 137 CLR 1 at 6-7.

corporation (or the person with the residual claim over the corporate assets) become the creditors. As such, it does not amount to a significant departure from the idea of corporate governance as a response to the agency problem.[18]

Part 5.8A of the Corporations Act provides a clearer example of a departure from the notion of corporate governance as a response to the agency problem. Part 5.8A makes it an offence for any person to enter into agreements and transactions with the intention of defeating the recovery of employee entitlements. This protection for employees reflects the community's concerns about the vulnerability of these involuntary creditors, and a view that those who are essential to the profit creation of the company should not be abused in the event of its failure.

Matters separate to the agency problem may also be dealt with through legislation other than the Corporations Act. This approach was supported in the 1989 Senate Standing Committee on Legal and Constitutional Affairs *Company Directors' Duties Report*.[19] The Committee stated that:

> *It is appropriate that matters external to the company be dealt with in separate and specific legislation... This is because companies legislation should deal only with corporate structure and organisation and matters arising as and between the constituents of the corporate body.*[20]

An important benefit of issue-specific legislation is that it ensures a consistent approach to social and environmental issues across businesses that are conducted through different types of legal entity (including companies, partnerships and sole traders).

Scope for socially responsible conduct

Company officers have a broad discretion to exercise their powers and discretions with a view to promoting the broader interest of society, provided such actions also promote the interests of the corporation.[21]

Examples of such activities may include promoting a sustainable business environment, including the payment of a fair wage to employees, and ensuring

---

18 This view is also reflected in the statutory 'duty' to prevent insolvent trading (section 588G of the Corporations Act).

19 Senate Standing Committee on Legal and Constitutional Affairs, *Company Directors' Duties: Report on the Social and Fiduciary Duties and Obligations of Company Directors*, AGPS, Canberra, 1989.

20 ibid., p99.

21 *Hutton v West Cork Railway Co* (1883) 23 Ch D 654 at 673.

that business operations are not overly harmful to the environment and that they will not produce products that will harm consumers.

Corporate philanthropy may also be justified where it improves the reputation of a company or delivers some other indirect benefit.

ABS data suggests that Australian businesses gave $1.5 billion to the community in 2000-01 (or 1.7 per cent of operating profits before tax). Most ($1.3 billion) was in the form of sponsorships and donations.[22]

In a survey of its members, the Business Council of Australia (BCA) found that in 2001-02 BCA companies contributed $195 million and 219,000 staff volunteer hours to social and community programmes. They also contributed $292 million and 425,000 staff hours to environmental projects, largely concentrated among the minerals and resources corporations.[23]

However, furthering the interests of the company in a fairly direct way must be the intent behind these activities.[24]

Amending the regulatory framework to allow activities that did not benefit the company at all could result in a subordination of the interests of those with a residual claim to the assets of the company to the interests of the broader community. Such a subordination would be a significant departure from the current corporate governance model and the agency approach to corporate governance.

Removing the clear duty to act in the interests of the company could weaken the current corporate governance regime, perhaps to the point where company management is effectively autonomous. This could occur because questionable decisions could be justified *ex post* as being in the interest of the community as a whole or some stakeholder. This concern is exacerbated by the absence of a consensus about what corporate social responsibility is and how it should be implemented in an operational context. In any case, directors may not always be in a position to make an informed decision about how best to promote the interests of stakeholders or the community as a whole.[25]

---

22 Australian Bureau of Statistics, *Generosity of Australian Businesses*, ABS cat. no. 8157.0, AGPS, Canberra, June 2002.

23 Business Council of Australia, *The Community of Business — The Role of Big Business in Australia*, BCA, Melbourne, 2004.

24 Senate Standing Committee on Legal and Constitutional Affairs, *Company Directors' Duties: Report on the Social and Fiduciary Duties and Obligations of Company Directors*, op cit., p86.

25 ibid. p97-98.

Private sector initiatives

Voluntary schemes

Different industries face differing sets of social responsibility issues. As such, methods for improving social responsibility have varied across industries and across time. Voluntary schemes have allowed directors to make decisions in the best interest of their companies about how to improve social responsibility in order to advance shareholder interests and sustainably maximise shareholder value.

Some elements of Australian business have adopted the idea of social responsibility and adapted it to their own needs through the use of codes of best practice and charitable foundations, and the introduction of specific targeted programmes or activities within the local community, such as crime prevention or financial literacy initiatives.

Within the current corporate governance framework, for corporate social responsibility to be accepted by the business community at large, it must be seen to be relevant, adaptable, able to be integrated into existing structures and, most importantly, beneficial to the business. There is evidence that these qualities are beginning to be realised by companies.

> *For many companies, managing corporate social responsibility well is no longer seen as an extra cost or burden on hard pressed management. Rather, [corporate social responsibility] is increasingly viewed, not only as making good business sense, but also contributing to the long-term prosperity of companies and ultimately its survival.*[26]

Socially responsible investment funds

All four major banks and several of the larger institutional investment houses have introduced socially responsible investment funds, indirectly encouraging socially responsible business practices. Although there is no standard for what socially responsible investment funds define as socially responsible, they do offer a broad range of products that are tailored to the ethical and social concerns of investors.

Various reports have studied the relationship between good corporate governance (measured in various ways) and share prices. However, the existence and significance of any correlation continue to be disputed.

---

26 R Holmes and P Watts, *Corporate Social Responsibility: Making Good Business Sense*, op cit.

Standards Australia

Standards Australia has published standards on good governance principles, organisational codes of conduct, and corporate social responsibility (see for example Standard 8003-2003 *Corporate social responsibility*), which are similar to the Australian Stock Exchange Corporate Governance Council principles (see below) but aimed at non-listed companies and not-for-profit organisations. The standards provide guidance to directors on how to implement effective good governance and corporate social responsibility policies in their organisations voluntarily.

Industry codes

There are also voluntary and mandatory industry codes governing various industries such as the oil industry. Mandatory industry codes, such as the franchising code of conduct, are regulated under part IVB of the *Trade Practices Act 1974*. Such codes regulate the conduct of industry members towards each other and towards consumers.

Australian Stock Exchange Corporate Governance Council

In March 2003, the Australian Stock Exchange (ASX) Corporate Governance Council released the Principles of Good Corporate Governance and Best Practice Recommendations (BPR). Recommendations 7 and 10 set out voluntary standards of corporate behaviour for Australian-listed entities that include environmental and social factors.

ASX listing rule 4.10.3 requires listed companies to report on their adoption of the BPR. In May 2005, the ASX released its *Analysis of Corporate Governance Practices*. The survey found that 84 per cent of listed companies and 93 per cent of the top 500 companies satisfactorily met their reporting requirements, by either confirming adoption of the BPR or providing 'if not, why not' reporting.

Government initiatives

Prime Minister's Community Business Partnership

The Prime Minister has established the Prime Minister's Community Business Partnership (the Partnership), which advises and assists the Australian Government on issues concerning community business collaboration in order to develop and promote a culture of corporate and individual social responsibility.

The Partnership has undertaken a range of activities to further these objectives. The Partnership:

- administers the Prime Minister's Awards for Excellence in Community Business Partnerships, which reward and recognise those businesses and community organisations that come together to generate outcomes that have a long-term benefit for the community;

- is currently undertaking a major initiative to encourage medium and large businesses to implement workplace giving programmes (where employees can donate to charities directly from their pay);

- runs an annual corporate social responsibility essay competition for secondary school and university students;

- seed-funded the National Community Business Partnerships Brokerage Service, which provides advice and information about establishing and maintaining community business partnerships to small and medium-sized businesses and community groups and assists them to identify partners;

- established the annual National Community Business Partnerships Week, which involves a week of activities in all capital cities to showcase good practice in partnerships and to provide networking and learning opportunities for businesses and not-for-profit organisations; and

- commissioned or funded a number of studies, such as:

  – Triple Bottom Line Reporting: Measuring the Intangible;

  – Giving Australia: Research into Philanthropy in Australia, relating to business giving including giving through community business partnerships; and

  – Corporate Community Involvement: Establishing the Business Case (Centre for Corporate Public Affairs and Business Council of Australia).

Further information on the activities of the Partnership is available from the Partnership's Secretariat within the Department of Families, Community Services and Indigenous Affairs.

Business Roundtable for Sustainable Development

The Government established the Business Roundtable on Sustainable Development (the Roundtable) in 2003 to provide advice to the Australian Government on ways to increase the uptake of sustainable business practices in Australia. Its membership is comprised of chairs or chief executives of significant Australian and international companies. It has developed a vision

of sustainable development from a business perspective and agreed to both lead by example and advise the Government on current and emerging sustainability issues. It meets three times a year with the Minister for the Environment and Heritage and the Minister for Industry, Tourism and Resources attending at least twice a year.

The main issues discussed to date include: sustainable water use, energy efficiency, increasing workforce participation and skills development, climate change, waste management, increased resource use efficiency and product stewardship.

Further information on the Roundtable is available from the Roundtable's Secretariat within the Department of Industry, Tourism and Resources.

OECD Guidelines for Multinational Enterprises

Australia is a signatory to the *OECD Declaration on International Investment and Multinational Enterprises,* non-binding guidelines that provide voluntary principles and standards for responsible business conduct consistent with applicable national laws. The OECD Guidelines for Multinational Enterprises (OECD guidelines) are recommendations jointly addressed by governments to multinational enterprises operating in or from the 30 OECD member countries and 9 non-member adhering countries. They establish principles covering a broad range of issues, including human rights, information disclosure, employment and industrial relations, environment, combating bribery, consumer interests, science and technology, competition and taxation, which apply to the activities of multinational enterprises in OECD and non-OECD countries alike.

Observance of the OECD guidelines by enterprises is voluntary and not legally enforceable. However, governments adhering to the OECD guidelines are committed both to promoting the guidelines and establishing National Contact Points to act as a forum for discussion of all matters relating to the guidelines, including the review of 'specific instances'. An important aspect of the OECD guidelines is the formal review mechanism that allows parties to raise 'specific instances' in which the behaviour of enterprises may have been inconsistent with the guidelines. The Australian National Contact Point for the OECD guidelines is the Executive Member of the Foreign Investment Review Board.

International initiatives

UN Global Compact

In an address to the World Economic Forum on 31 January 1999, the United Nations (UN) Secretary-General, Kofi Annan, launched the UN Global Compact. The Global Compact is a voluntary initiative that seeks to promote

responsible corporate citizenship so business can meet the challenges of globalisation and realise a more sustainable and inclusive global economy.

The Global Compact works to advance 10 universal principles drawn from the Universal Declaration of Human Rights, the International Labour Organization Declaration on Fundamental Principles and Rights at Work, the Rio Declaration on Environment and Development and the UN Convention against Corruption. Broadly, the principles call for business to support and protect human rights, respect workplace rights, take greater environmental responsibility and work against all forms of corruption.

Companies voluntarily participating in the Global Compact have the opportunity to engage in a range of policy dialogues, local networks, opportunities to share experiences with other participating companies, and UN-backed projects in partnership with community organisations to assist them to implement and advocate the principles. Companies are encouraged to develop their examples of corporate change into larger case studies for peer review and are expected to publish in their annual report or sustainability report a description of the ways in which they are supporting the Global Compact and its 10 principles.

CORPORATE DISCLOSURE AND NON-FINANCIAL REPORTING

Current disclosure requirements

Accurate and prompt information is fundamental to the operation of an efficient market. With the exception of small proprietary companies, all companies must prepare a financial report and a directors' report for each year. These reports include information about the financial and non-financial performance of a company.

Non-financial reporting not only informs decisions by external stakeholders, it can also bring issues to the attention of senior decision makers within a company, facilitating improved future performance.

Directors' reports — listed companies

Subsection 299A(1) of the Corporations Act, introduced in the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (CLERP 9 Act), requires directors of listed companies to include in their directors' reports information that members of the company would reasonably require to make an informed assessment of the operations of the entity, the financial position of the entity and the entity's business strategies and prospects for future financial years. This provision requires directors to provide a narrative or descriptive report and is intended to provide users of

financial statements with an analysis of a company's business as seen through the eyes of the directors.

The content requirements have been expressed in broad terms, so as to enable directors to make their own assessment of the information needs of members of the company and tailor their disclosures accordingly, and to provide flexibility in form and content of the disclosures as the information needs of shareholders, and the wider capital market, evolve over time.

Directors' reports — general information

Paragraph 299(1)(f) of the Corporations Act requires companies to report if the entity's operations are subject to any particular and significant environmental regulation under a law of the Commonwealth or of a State or Territory, giving details of the entity's performance in relation to environmental regulation. Although not widely reported against (likely due to the materiality threshold), paragraph 299(1)(f) provides a link to environmental law and offers the community a measure of compliance with applicable laws in an annual report.

Australian Stock Exchange listing rule 4.10.17

ASX listing rule 4.10.17 requires listed companies to include a review of their operations and activities for the reporting period in their annual reports. The listing rule is based on section 299 of the Corporations Act. The guidance material for listing rule 4.10.17 does not stipulate any particular format to be followed for compliance, but does suggest companies look to the Group of 100 Incorporated (G100) guidance publication *Guide to the Review of Operations and Financial Condition*[27] to satisfy the requirements. The explanatory memorandum to the CLERP 9 Bill also makes this suggestion.

The G100 is a group comprising the major private and public business enterprises and global enterprises operating in Australia. The guide, originally issued in 1998, was updated in 2003.

The G100 guide states that the review should provide users with an understanding of the company by providing a short-term and long-term analysis of the business as seen through the eyes of the directors. This will be facilitated by providing useful financial and non-financial information and analysis. A contemporary review should include an analysis of industry-wide

27 Group of 100 Incorporated, *Guide to the Review of Operations and Financial Condition*, G100, Melbourne, 2003.

and company-specific and non-financial information that is relevant to an assessment of the company's performance and prospects.[28]

Product disclosure statements

Under paragraph 1013D(1)(l) of the Corporations Act, a person who sells a financial product with an investment component must disclose the extent to which they took into account labour standards or environmental, social or ethical considerations when selecting, retaining or realising the investment. Such disclosure occurs through a product disclosure statement.

Scope for mandating greater disclosure of non-financial information

As with any regulatory requirement, an assessment of a proposal for greater disclosure of non-financial information by companies needs to include an assessment of the costs and benefits to the community.

While it may be possible reasonably to quantify the costs of a new reporting requirement, it may be more difficult to assess the benefit to the community.

A requirement for large or listed companies to disclose greater information about the social and environmental impact of the company's activities, either in the form of a descriptive or of a quantified report, would give stakeholders access to more information on which to base decisions about whether to deal with the company. Where this information influences stakeholder behaviour, it will in turn likely influence corporate decision-making. However, it is difficult to assess in advance the extent to which stakeholders may change their behaviour in response to new information. This would depend on a variety of factors, including the accessibility of the information to stakeholders, and the preferences of stakeholders.

An additional complication is that there are uncertainties in describing and quantifying the environmental and social impacts of a company's operations, as well as methods to verify the company's reports independently.

Private sector initiatives

Sustainability reporting

The *State of Sustainability reporting in Australia 2004* report, commissioned by the Department of the Environment and Heritage, found that 116 of the top 500 companies (made up of ASX 300, top 100 private and top 100 unlisted public

28 ibid.

companies) published sustainability reports. Further information is available in the Department of the Environment and Heritage's submission to the Parliamentary Joint Committee on Corporations and Financial Services (PJC).

Market indices

A range of private sector organisations have developed voluntary non-financial reporting indices on which companies agree to be ranked against their performance.

For example, the St James Ethics Centre oversees the Corporate Responsibility Index (CRI), a voluntary self-assessment tool for businesses to develop, measure and communicate socially and environmentally responsible corporate conduct.

The index is made up of four components that require participating companies to show how they have dealt with corporate responsibility issues:

- *corporate strategy*: companies are asked to identify their corporate values in relation to four key areas of corporate responsibility — community, environment, workplace and marketplace. Companies have to demonstrate who has responsibility for these areas at a senior executive level and how they are linked to their overall corporate strategy, risk management and policies;

- *integration*: this highlights how effectively a company's corporate responsibility is translated from corporate strategy into mainstream management practice;

- *management*: participants must identify the key community, environmental, marketplace and workplace issues (risks and opportunities) that are material to their businesses. They must show how these issues are addressed through the setting of objectives and targets, stakeholder engagement and how these issues are monitored and communicated; and

- *performance and impact*: participants must choose two environmental impacts, two social impacts and two other impacts — social or environmental, and link these to material issues identified in the management component.

Ernst & Young has validated and collated the results for the last two years. Of the invited companies (Australia's top 250 companies and other members of the BCA), 27 companies volunteered to participate in the CRI in 2004.

Other indices developed in Australia include the SAM Sustainability Index and the Reputex SRI Index.

These market-based approaches provide directors with flexibility in choosing which index is most useful given the particular circumstances of a company; however, one criticism has been that there can be inconsistencies in the content and presentation of information to the market. Another criticism is that there are difficulties in monitoring compliance, exacerbated by inherent uncertainty about how and what to report and how the information may be interpreted.

Government initiatives

Standardisation of non-financial reporting

On 20 September 2005, the Minister for the Environment and Heritage, Senator the Hon Ian Campbell, requested the ASX Corporate Governance Council to consider mechanisms to enhance non–financial reporting in Australia. In response to the Minister's request, the ASX Corporate Governance Council has established a Working Group to examine the issue.

In addition, the Department of the Environment and Heritage has developed a framework for public environmental reporting in the Australian context.[29] The framework defines public environmental reporting as the public disclosure of information about an organisation's environmental performance, including its impacts on the environment, its performance in managing those impacts and its contribution to ecologically sustainable development. The framework can be used by directors to discharge their duty if they are obliged under paragraph 299(1)(f) to report on the company's environmental impact. This facilitates the adoption of standardised reporting, rather than mandating it through legislation.

Further information about these projects is provided in the submission by the Department of the Environment and Heritage to the PJC.

International initiatives

International Accounting Standards Board

The International Accounting Standards Board (IASB) has recently released a paper discussing the requirements for 'management commentary' reports. The IASB is of the view that management commentary reports prepared to complement financial statements should set out and discuss the key resources,

---

29 Department of the Environment and Heritage, *Triple Bottom Line Reporting in Australia: A Guide to Reporting Against Environmental Indicators*, June 2003.

risks and relationships relating to the entity that will assist in the pursuit of its objectives.

The IASB states that these key resources, risks and relationships will largely relate to the non-financial aspects of the business. The IASB acknowledges that this process should include an assessment of reputation risks and employee satisfaction, and could encompass broader corporate social responsibility factors and their impact on the short-term and long-term performance of the entity. The question of to what extent these risks need to be reported and assessed in management commentary should be determined by the entities themselves with regard to how the information will assist investors in assessing the strategies adopted by the entity and the potential for successfully achieving them.[30]

Global Reporting Initiative

The Global Reporting Initiative (GRI), an independent multi-stakeholder body, has developed and disseminated guidelines for sustainability reporting. The GRI guidelines are designed for organisations wishing to report voluntarily on the economic, environmental and social dimensions of their activities, products and services, and are emerging as one of the most widely used international frameworks.

The framework presents reporting principles and specific content indicators to guide the preparation of organisation-level sustainability reports.

Further information about the GRI is provided in the submission by the Department of the Environment and Heritage to the PJC.

INTERNATIONAL DEVELOPMENTS

The various approaches to corporate governance have at their core two main models: the 'insider model' and the 'outsider model'.

The insider model of corporate governance has generally been adopted by civil law countries, such as France. It posits that firms should be run in the interests of all stakeholders (including employees, creditors, customers and the community), not just shareholders. The company is seen more as a partnership between capital and labour, rather than a method of facilitating joint action by contributors (shareholders). Companies in Europe may be constituted with two boards, the executive board, responsible for the direction and management of the company, and a supervisory board, which is responsible

30 A Teixeira et al, *Discussion Paper: Management Commentary*, International Accounting Standards Board, London, October 2005, p43.

for the hiring and monitoring of the executive board. The supervisory board is generally comprised of shareholder and employee representatives.

The outsider model, generally adopted by common law countries such as Australia, the United Kingdom and the United States, is one where a company has a single executive board. This model emphasises shareholder interests largely to the exclusion of the interests of other stakeholders.

It is arguable which model promotes a more socially responsible company, as the insider model still emphasises shareholder interests and is primarily concerned with profit maximisation, while the outsider model is flexible enough to allow for company officers to take into account the interest of their stakeholders where that is consistent with their primary duty to their shareholders.

A summary of recent developments in three jurisdictions, the United Kingdom and the United States (our major trading partners outside Asia) and France (a leading civil law jurisdiction) is provided below.

United Kingdom

The UK Government has announced that it aims to encourage the adoption and reporting of corporate social responsibility through best practice guidance and, where appropriate, intelligent regulation and fiscal incentives. The UK's then Minister for Corporate Social Responsibility stated in 2002 that the UK Government does not believe in excessive regulation in this area:

> *moving [corporate social responsibility] into the realm of regulatory red tape … would merely stifle the creativity and innovation, which are the most valuable feature of [corporate social responsibility] today.*[31]

In 2001, the UK Government introduced legislation to require trustees of occupational pension schemes to state their policy regarding the extent to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments.

The UK Government has recently announced that in order to reduce regulatory burden on business it will repeal the requirement for quoted companies to prepare and publish an operating and financial review (OFR) as part of their annual reports.[32] The OFR provisions required a quoted company

---

31 Speech by the then Minister for Corporate Social Responsibility, Mr Stephen Timms MP, 21 November 2002.

32 Rt Hon Gordon Brown MP, Chancellor of the Exchequer, speech at the CBI Annual Conference, London, 28 November 2005.

from the current reporting period onwards to prepare a narrative report setting out its business objectives, its strategy for achieving them and the risks and uncertainties that might affect their achievement. This process would have required companies to report on other matters where these were necessary for an understanding of the business, including employee, environmental and social and community issues.

The UK Government will instead require all British companies, except those meeting the definition of small companies[33], to prepare a similar, though less prescriptive, business review.[34] In a business review, companies must disclose information that is material to understanding the development, performance and position of the company, and the principal risks and uncertainties facing it. This will include information on environmental matters and employees, on the company's policies in these areas and the implementation of those policies. Moreover, key performance indicators must be used where appropriate (including those specifically relating to environmental and employee issues).

In relation to employees, section 309 of the UK Companies Act 1985 provides that directors owe a duty to the employees of the company. However, the duty is solely enforceable in the same way as other fiduciary duties by the company members, not by the employees themselves. Effectively, employees will only have recourse against directors under this duty if shareholders consider such action is in their best interests. Ireland has mirrored this duty and method of enforcement in its company law.

In relation to directors' duties, the UK Government has drafted a Bill, currently before the UK Parliament, that aims to codify the duties owed by directors. The new provision has been drafted to take into account an 'enlightened shareholder value' approach to directors' duties. The draft provision maintains that directors owe their duties to the company, rather than a broader group of stakeholders, but seeks to provide a broader context for fulfilling those duties. The draft provision aims to set out the various stakeholder groups the interests of whom directors must (so far as reasonably practicable) take into account when making decisions.

---

33 A small company is one which satisfies two of the following criteria: turnover not more than £5.6million, balance sheet total not more than £2.8m, not more than 50 employees. However, a small company cannot take advantage of this exemption if it is a public company, if it has permission under Part 4 of the Financial Services and Markets Act 2000 to carry on one or more regulated activities, or if it carries on an insurance market activity.
Companies that meet the statutory definition of a medium company (turnover not more than £22.8million, balance sheet total not more than £11.4m, not more than 250 employees) have to prepare the business review, but are not required to include information about key non-financial performance indicators.

34 HM Treasury (UK), *Pre Budget Report*, December 2005, p3.39-3.42.

The explanatory material to the Bill explains this approach in these terms:

> *the basic goal for directors should be the success of the company for the benefit of its members as a whole; but that, to reach this goal, directors would need to take a properly balanced view of the implications of decisions over time and foster effective relations with employees, customers and suppliers, and in the community more widely. … This approach … is most likely to drive long-term company performance and maximise overall competitiveness and wealth and welfare for all.*[35]

If enacted, this provision would be part of the first statutory statement of directors' duties in the UK corporations legislation.

United States

The US Government has instituted a range of initiatives to endorse and encourage the adoption of corporate social responsibility. Federal programmes facilitate corporate social responsibility primarily by providing information, funding and incentives to key players to engage in socially responsible behaviour. As an example, the Department of State offers an Award for Corporate Excellence. The Department of Commerce facilitates corporate social responsibility by training its commercial service officers specifically on corporate stewardship. The US Agency for International Development's Global Development Alliance provides an example of a federal programme that forms partnerships with corporations to leverage additional resources. Finally, some agencies, such as the Overseas Private Investment Corporation, mandate corporate social responsibility by requiring companies to meet criteria consistent with corporate social responsibility as a prerequisite to obtaining their services.[36]

A majority of States in the US have adopted 'corporate constituency' statutes, which permit directors to broaden the groups or constituencies that they may take into account in corporate decision-making. These statutes were enacted as a response to the increased activity in the market for corporate control in the 1980s and 1990s. Generally, they permit a board, in considering the best interests of the corporation, to take into account the effect of any action by the board on employees, suppliers and customers of the corporation, or

---

35 Department of Trade and Industry (UK), *Company Law Reform White Paper*, March 2005, p20-21.

36 United States Government Accountability Office, *Globalization: Numerous Federal Activities Complement US Business's Global Corporate Social Responsibility Efforts*, August 2005.

communities in which offices or other establishments of the corporation are located.[37]

Under the Securities and Exchange Commission Regulations, reporting companies are required to report the 'material effects that compliance with environmental laws may have on the capital expenditure, earnings and competitive position'.[38]

The US Environmental Protection Agency and Department of Energy have a number of voluntary guidelines for environmental reporting by companies, including reporting on greenhouse gas emissions.

There has been a steady increase in the extent to which US companies are voluntarily reporting on environmental and social issues. Companies wishing to participate in the Dow Jones Sustainability Indexes must submit to a corporate social responsibility assessment and prepare a sustainability report. While much of the reporting is currently inconsistent, US companies that are preparing sustainability reports have generally followed internationally accepted benchmarks, such as the Global Reporting Initiative.

The American Institute of Certified Public Accountants and the Canadian Institute of Chartered Accountants have formed a joint Task Force to explore issues relevant to sustainability reporting. Recently the Task Force has been focusing on accounting services related to greenhouse gas emissions trading and assurance services for sustainability reports.

France

French companies law provides an example of the outsider model of corporate governance. Under French law, public companies are able to opt for one of three types of incorporation: a limited partnership with share capital (société en commandite par actions), a corporation (société anonyme) having a board of directors (unitary structure), and a corporation having a management board and a supervisory board (dual structure).

---

37 See for example section 8.85 of the *Business Corporation Act 1983* of Illinois (805 ILCS 5/8.85): In discharging the duties of their respective positions, the board of directors, committees of the board, individual directors and individual officers may, in considering the best interests of the corporation, consider the effects of any action upon employees, suppliers and customers of the corporation, communities in which offices or other establishments of the corporation are located and all other pertinent factors.

38 Securities and Exchange Commission Rules and Regulations, Part 299 Regulation S-K, Item 101-Description of Business.

For both unitary and dual board structures, French law provides that a company's articles of association may voluntarily stipulate that up to five directors chosen by the company's employees may sit on the board of directors, with the right to vote. These directors are in addition to those appointed by the general meeting.

In addition, the general meeting of a company whose employees hold more than 3 per cent of the shares must appoint at least one director from amongst these employee-shareholders, or, if applicable, from among employees sitting on the supervisory board of a mutual fund that holds shares in the company.

In May 2001, the French Parliament passed a number of amendments to the New Economic Regulations (nouvelles régulations économiques) to oblige publicly listed companies to publish triple bottom line reports. The aim is to empower shareholders by giving them information on a company's financial, social and environmental performance. Hence, in accordance with Article 116 of Company Law, annual reports must now 'contain information on how the company takes into account the social and environmental consequences of its activities'.

The law is neither a framework nor a guideline for reporting; rather it is an attempt on the part of the Government to systematise and regularise triple bottom line reporting. In other words, while it does oblige companies to report on a certain set of qualitative as well as quantitative social indicators, it does not describe how this should be done.

CONCLUSION

Corporations provide efficient investment vehicles facilitating business activity that may not otherwise occur. The facilitation of entrepreneurial risk-taking and of large scale ventures leads to increased economic growth that has the potential to benefit the wellbeing of the Australian people.

A concept that is fundamental to the corporate governance framework is the separation of ownership and control. This allows for specialisation in management and facilitates diversification of shareholdings, but introduces agency costs. Market forces and the imposition of fiduciary duties on company officers limit these agency costs. Company officers have considerable flexibility to act in a socially responsible manner without breaching their duties. A range of private sector initiatives have already been implemented in Australia to promote and facilitate socially responsible behaviour, including socially responsible investment funds and industry codes. These are complemented by Government initiatives such as the Prime Minister's Community Business Partnership.

Non-financial reporting can provide important information to stakeholders and company officers. There are a range of non-financial reporting obligations in the current law, including in the directors' report and product disclosure statements. A range of private sector initiatives have been implemented in Australia to promote non-financial reporting, including the Corporate Responsibility Index administered by the St James Ethics Centre. These initiatives complement regulatory reporting requirements and provide a flexible means for facilitating and promoting socially responsible conduct. Government initiatives in this area have focused on the standardisation of non-financial reporting.

An examination of international approaches identifies two key models — the 'insider model' and the 'outsider model'. It is not clear that either model promotes a more socially responsible company. Recent developments in the United Kingdom, United States and France indicate that the promotion of corporate social responsibility is an issue of importance across jurisdictions.