

14 September 2007

Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Parliament House
Canberra ACT 2600
corporations.joint@aph.gov.au

Dear Sir/Madam

Re: Inquiry into Shareholder Engagement and Participation

The Institute of Chartered Accountants in Australia ('the Institute') welcomes the opportunity to make a submission to the Committee's inquiry into the issue of shareholder engagement and participation. This is a timely inquiry, given the large increase over the past decade in the number of people who have become shareholders.

The Institute believes that it is important to balance shareholder engagement with the need for corporations to be managed effectively and in a cost effective way in the interests of those shareholders. It is also essential that the interests of the majority of shareholders are reflected, and not those of any activist minority.

The Institute is confident that the Committee will carefully weigh all the relevant issues in preparing its report and recommendations, and would welcome the opportunity to appear before the Committee to discuss further the issues raised in our submission.

The Institute's contact officer is Dr Barbara Carney, Manager of Government Relations, on 02 6282 0501 or at carney@icaa.org.au.

Yours sincerely



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Chartered Accountants

NUMBER ONE IN NUMBERS

**THE PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS
AND FINANCIAL SERVICES**

**INQUIRY INTO SHAREHOLDER ENGAGEMENT AND
PARTICIPATION**

SUBMISSION

COMMENTS ON TERMS OF REFERENCE

1. **Barriers to the effective engagement of all shareholders in the governance of companies**

And

2. **Whether institutional shareholders are adequately engaged, or able to participate, in the relevant corporate affairs of the companies in which they invest.**

It is important that all parties concerned – companies, shareholders, legislators and the interested public – work from the same definition of what corporate governance is. In its recently released second edition of *Corporate Governance Principles and Recommendations*, the Corporate Governance Council of the ASX defines Corporate Governance as "the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations". The *Principles* go on to comment that "[corporate governance] encompasses the mechanisms by which companies and those in control are held to account. Corporate governance influences how the objectives of the company are set and achieved, how risk is monitored and assessed, and how performance is optimized" (page 3).

This concept of corporate governance therefore recognises that decision-making and control is by necessity concentrated in the hands of a small number of directors and professional managers, as opposed to many of the owners. However, this seeming imbalance is addressed through the mechanisms that companies put in place to increase accountability and transparency.

The Institute sees this as practical and appropriate. We believe that any consideration of the engagement and participation of shareholders should be in the context of accountability and transparency rather than decision-making and control.

In regard to barriers to the effective engagement of all shareholders in the governance of companies and whether institutional shareholders are adequately engaged or able to participate in the relevant corporate affairs of the companies invested in, these references imply a distinction between shareholders according to their level of economic interest. This distinction already exists to some extent by virtue of the voting rights attached to shares. The Institute believes that it is essential that any changes that might be contemplated in relation to these matters do not inadvertently weaken good governance structures. The ASX *Principles* characterise these as enhancing the corporation's ability to create value "through entrepreneurialism, innovation, development and exploration and provide accountability commensurate with the risks involved" (page 3).

One of the barriers to more effective engagement is the reporting and communications "toolkit" used by companies to report to all shareholders, including institutional shareholders. Financial reports issued by companies comprise reports on past financial performance and the current financial position in accordance with accounting standards. In their current form, these reports do not address the company's strategy, its success or

failure in implementing it, or insights into what future performance might look like if the strategy is well executed. There are also gaps and inconsistencies in other parts of the “toolkit”, including corporate governance reporting required by the ASX principles, and voluntary reporting, through so-called “investor reports”, to capital markets (e.g. analysts and investors) and other stakeholders.

These gaps can significantly impede the precision of decision-making by all stakeholders (including institutional investors) about governance, strategic management and future prospects. For instance, there is little guidance available on how to report, and inconsistency between reporting on a company's strategy, performance and prospects.

In particular, the “tool-kit” approach means that there is little meaningful information available about how the objectives of the company are set, how risk is monitored and assessed, how performance is optimised and whether a company has the ability to create value through entrepreneurialism, innovation, development and exploration, providing accountability commensurate with the risks involved.

These matters are very important for informed decision making by current and potential investors.

If such matters are not reported on effectively, there will be a significant gap in the engagement and/or participation of all shareholders in governance and relevant corporate affairs. Business reporting and communications are the mechanism through which a company drives effective engagement and participation.

3. Best practice in corporate governance mechanisms, including selection and election of directors and the conduct of Annual General Meetings.

These are matters that are best addressed by organisations that represent specialists in these areas and hence the Institute does not propose to comment.

4. The effectiveness of existing mechanisms for communicating and getting feedback from shareholders

And

5. The particular needs of shareholders who may have limited knowledge of corporate and financial matters.

The chief mechanisms are through the provision of the annual financial report and the annual general meeting. Members of the Institute play a major role in these areas as either preparers or auditors of financial reports. Historically, these reports have fulfilled a corporate stewardship function and provided information on the financial performance and position of the company. However, This model is coming under increasing pressure from users who want to obtain information on other measures of performance, such as the environmental impact of the company's operations. There is a greater demand for information about the risk management systems and strategic outlook of companies. In addition, users of corporate reports want more contemporary information, rather than a retrospective snapshot.

The traditional financial reporting model, even supplemented with additional voluntary reporting and communications, still falls short of the needs of institutional investors if they are to make precise capital allocation decisions based upon a company's strategy, performance and prospects, as pointed out in relation to Terms of Reference 1 and 2.

There is therefore some pressure on the "one size fits all" concept of the annual financial report as the preparers seek to respond to the information needs of sophisticated institutional capital market investors through a report that is also provided to retail investors. Many companies have sought to meet the differing needs of retail investors through the use of "shareholder friendly" media (DVDs etc). Anecdotal evidence suggests that most retail investors do not use the annual report to make capital allocation decisions. This group of investors is more likely to rely on the business media, company announcements and analysts' comments as primary sources of reference. This factor, coupled with increasing demands for additional information on non-financial aspects of company performance suggest that a much more holistic approach is required with respect to shareholder communication.

The Institute contends that such an approach should encompass both financial and non-financial performance reporting, the use of technology both for data collection and delivery and, most importantly, the varying requirements of users.

The Institute believes that what is needed is a business reporting and communications model that promotes a common understanding of these matters by all stakeholders, including institutional investors.

The Institute considers that the issue of corporate performance reporting is so important as to warrant detailed and separate consideration, and urges the Committee to consider this possibility. We also believe that no changes to existing legislative and regulatory regimes in this regard should be recommended before all the relevant issues associated with reporting have been canvassed. Prominent amongst these is the best way to inform unsophisticated retail investors.

6. The need for any legislative or regulatory change.

The Institute believes that the most efficient and effective way to promote good corporate governance is through companies being and rewarded for, and encouraged to adopt, good corporate governance by the market through their share price performance. We also support the ASX's "if not why not approach" enunciated in its *Corporate Governance Principles and Recommendations* whereby a company that does not implement a particular recommendation can explain why it has taken that decision and what its alternative approach is. We do not consider that there is presently any need for legislative or regulatory change. However, as stated, the Institute considers that it is important to monitor both how non-financial data is presented, and the extent and nature of any proforma adjustments to information set out in the financial statements to ensure this does not result in the information being misleading.

The Institute believes that any shortcomings which may be identified in this area are best overcome by proactive voluntary corporate action rather than prescriptive regulation. We will be closely monitoring evolving practice with a view to encouraging such action if it is demonstrated that it is required.