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John Kluver
Executive Director
Corporations and Markets Advisory Committee
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Futureeye
Real eye openers

CAMAC Inquiry into Corporate Social Responsibility and Directors' Duties

Dear John,

Futureeye is pleased to respond to a number of the key issues discussed and questions posed by the CAMAC Discussion Paper on Corporate Social Responsibility (CSR).

Futureeye is fortunate to have had previous involvement with this CAMAC inquiry, in the form of a roundtable we arranged to facilitate discussion between yourself and a number of our corporate clients who are engaged in implementing CSR strategies and approaches within large Australian corporations.

Futureeye has also previously made a submission to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Corporate Responsibility. That document addresses many of the broad themes covered by the CAMAC enquiry.

This response should thus be read as a supplement to the Parliamentary Joint Committee Submission, providing further detail on specific questions posed by the CAMAC Discussion Paper. These supplementary comments will focus on two key areas: directors' duties and sustainability reporting.

In the responses below, questions posed in the CAMAC paper that Futureeye has selected for response are highlighted in the blue break-out boxes.

About Futureeye

Futureeye is a strategic advisory firm that helps organisations to address the challenges of sustainable development. Our clients include a wide range of large domestic and major multinational corporations, primarily in the mining, energy resources, forestry, pharmaceuticals, banking and telecommunications industries. We also undertake a broad range of work for government departments and authorities, and government-owned enterprises.

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Futureye provides specialist research, communication, strategic planning and stakeholder engagement services to develop proactive organisations that will succeed in the new stakeholder era. Our clients earn greater trust and become more responsive to their major risks and opportunities, meeting changing expectations of organisational behaviour.

Futureye's direct experience in assisting organisations in meeting new expectations means we are well placed to give comment on the matters set out in the CAMAC Discussion Paper.

Key Issue 1: Directors Duties

- *Do companies feel constrained by their understanding of the current law of directors' duties in taking into account the interests of particular groups who may be affected, or broader community considerations, when making corporate decisions?*
- *If so, is there any useful scope for clarifying the current law in this respect?*
- *Does the current law give directors sufficient flexibility to balance long-term and short-term considerations in their decision-making?*
- *Should the Corporations Act be revised to clarify the extent to which directors may take into account the interests of specific classes of stakeholders or the broader community when making corporate decisions?*

Discussion amongst executives at the CAMAC round table hosted by Futureye indicated that in general, executives with responsibility for driving CSR initiatives and approaches do not feel that directors' duties, either under common law or under the Corporations Act, present a barrier to advancing a 'CSR agenda' within their companies. This view has also been shared in most responses by large Australian corporations to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry on Corporate Responsibility.

Other executives and directors, however, have suggested that there are times when current requirements on directors do prevent them for addressing the full range of social and environmental costs and impacts created by their business, where they are not obliged under law to do so. Most prominently, Meredith Hellicar, Chair of James Hardie, has taken an advocacy role on this issue. She has suggested that the actions of James Hardie directors in severing the company's asbestos-related liabilities from its balance sheet were motivated from consideration of the directors' legal responsibilities to their shareholders, and called for changes to the Corporations Act to enable a more enlightened approach:

What one needs is a safe harbour for directors to be able to integrate corporate social responsibility into their decision making without fear that they are going to be sued both personally, and as a company, by their shareholders.¹

With the company's establishment of the Special Purpose Fund to meet future asbestos liabilities, Hellicar has suggested that even with approval for the plan by a

¹ Bill Phesant, 'Directors Need a Safe Harbour: Hellicar', *Australian Financial Review*, 17 March 2005, p3.

majority of shareholders, “there is no doubt of the threat of a shareholder suit”² against the directors from minority shareholders who do not agree. UNSW law professor Paul Redmond has supported Hellicar’s call, stating that there is ‘no clear licence in the current law’ for directors to internalise external costs and impacts where they are not obliged by law to do so.³

The James Hardie example is a poignant reminder of just how narrow the views of shareholder value and corporate ‘best interests’ applied in Australian corporate boardrooms can be. It illustrates the clash between traditional views of directors’ duties, and the broader expectations of society. In many ways, the high cost of the James Hardie incident, to both society and the firm, is directly traceable to a long-term failure by the company to take stakeholder views or impacts into account. The company clearly failed to recognise the direct costs in terms of legal and reputational liability, consumer boycott, government intervention and ultimately share price, that such failure could exact.

A more transparent approach by James Hardie at a much earlier date would have seen the company disclose all negative impacts of their products and operations as they became known, publicly declaring the dilemmas involved and working with stakeholders to address the issues. Whilst such an approach might have had a higher initial cost to the firm, there can surely be little question that, had it effectively managed its stakeholder-related risks as they arose, the company would find itself in far better position in the present time. A company more focussed on its stakeholders would have been better placed to create long-term shareholder value.

Traditional views of shareholder value and corporate ‘best interests’ are woefully inadequate in the present time. They meet neither society’s best interests, nor the long-term best interests of shareholders. Whilst broader interpretations of these concepts may not be directly prevented by existing legislation on directors duties, it is important to point out that neither does the status quo encourage such broader considerations.

Futureye therefore submits that changes to the Corporations Act to elaborate on the considerations that should be made by directors with regard to stakeholder interests, long-term value, and intangible assets like corporate reputation, seem warranted.

- *Does the Corporations Act need to be amended to adopt a pluralist, an elaborated shareholder benefit, or some other, approach to directors’ duties?*
- *Would any suggested change be intended to go beyond the current law or would it be intended as a clarification only?*
- *If an elaborated shareholder value benefit approach were to be adopted:*
 - *what form should it take?*
 - *would the UK Company Law Reform Bill clause be an appropriate precedent, either as drafted or with amendments?*

With regard to the approach taken in any such changes to the Corporations Act, Futureye supports an elaborated shareholder value approach.

² Fiona Buffini, ‘Calls to protect corporate conscience’, *Australian Financial Review*, 13 November 2005, p3.

³ *Ibid.*

In the wake of a wide range of corporate scandals, in which profit-focussed corporate behaviour has been demonstrated to fall far short of community expectations, a pluralist approach to directors' duties has evident attractions in requiring directors to consider a broader range of interests in making key decisions.

The pluralist approach, however, suffers from seemingly insurmountable pitfalls. Attractive as it is, it seeks to replace a clearly defined, well understood and enforceable legal accountability with one that is ill-defined and unenforceable.

Further, as a number of critics have pointed out, the dilution of the profit-maximising principle in directors' duties has significant potential implications for the effective operation of a wide range of goods and capital markets. Profit maximisation is, of course, regarded by orthodox economic theory as fundamental principle by which markets achieve efficient resource allocation.

Many contemporary market mechanisms are of course imperfect, as they externalise costs borne by the environment, particular non-shareholder stakeholders, and society as a whole. Nonetheless, most would argue that the appropriate mechanism to correct such problems is improved regulation and enforcement with regard to corporate social and environmental conduct. Effective regulation has the power to improve the operation of markets by accurately pricing in otherwise externalised costs. By contrast, redefining the purpose of the corporation to focus less on profitability and shareholder value, and more on the broadly-defined needs of other stakeholders, has the potential to undermine market efficiency, by diluting the extent to which decisions are made on the basis of 'rational self-interest'.

Finally, it is also unclear how much impact such a pluralist approach would in fact have on corporate behaviours. As Bill Beerworth has pointed out, it is financial markets and the incentives that they offer, rather than the dictates of directors duties, that are the most powerful force in shaping corporate behaviour:

Most have deeply absorbed the principle of shareholder primacy, which holds that the primary goal of management is to maximise shareholder wealth without undue concern about other interests except to the extent required by corporate reputation and the expectations of customers. The architecture of corporate capitalism is predicated on this objective and the model is sanctified by the securities market. Corporations are ranked in accordance with the financial returns they provide or are likely to provide. Companies that provide superior returns attract premium market prices. They can easily raise new capital, and its cost falls.⁴

Ultimately, it is the operation of financial markets, more than it is the requirements of directors' duties, that shapes the primacy of shareholder value creation as the overarching aim of corporations. Efforts that seek to improve the consideration given by corporate decision makers to a company's impacts on non-shareholder stakeholders must work within a framework compatible with that of market decision making if it is to achieve genuine results.

In Futureye's submission to the Joint Parliamentary Committee Enquiry, we have pointed out what we view as a need to further focus company directors and management on the creation of long-term value, and on the creation of long-term alignments between shareholder and stakeholder interests. It is becoming

⁴ Bill Beerworth, 'Corporate social responsibility turns off investors', *Australian Financial Review* 11 November 2005, p75.

increasingly clear that in the long-run, ability to meet increasing community expectations of corporate social and environmental performance is the fundamental factor determining a company's licence to operate, in establishing reputation and brand equity, in determining its ability to attract and retain talented staff, and in shaping the regulatory environment in which corporations operate.

An elaborated shareholder value approach to directors' duties could have a major impact in focusing directors on these issues. The power of such an approach lies in requiring directors to consider the long-term impact of their decisions, and the strategic risks and opportunities that are presented by social and environmental impacts and changing community expectations.

The virtue of such an approach is the effective balance it strikes between a prescriptive and a permissive approach. While it does not prescribe a direct duty toward non-shareholder stakeholders, it does more than merely permit consideration of their interests. By requiring directors to have consideration for these impacts in making decisions about shareholder value, the elaborated shareholder value approach makes explicit the impetus for creating long-term value by aligning shareholder and stakeholder interests.

Futureye thus generally supports the *UK Company Law Reform Bill* as an appropriate precedent for change. It represents a well-considered attempt to establish an elaborated shareholder value approach. Additionally, as the Public Interest Law Clearing House (PILCH) has identified in its submission to the Joint Parliamentary Inquiry, adoption of the approach taken in the UK Company Law Reform Bill would "reduce some of the uncertainty relating to the new formulation of directors' duties by giving Australian company directors the benefit of both Australian and United Kingdom jurisprudence in informing their decision-making".

The provisions of the *UK Company Law Reform Bill* as a precedent for change might be further strengthened by an additional requirement on directors to ensure regular consultation with local communities in relation to all activities that have a significant impact on the natural environment.⁵ Requiring such consultation might be one means of ensuring that companies with significant environmental impacts better understand the nature of their social licence to operate, and the strategic threats and opportunities arising from changing community expectations of their performance.

Key Issue 2: Sustainability Reporting

- *Should the Corporations Act require certain types of companies to report on the social and environmental impact of their activities?*
- *Are any changes to current statutory requirements needed to ensure better disclosure of the environmental and social impact of corporate activities?*
- *Are any changes desirable to any other reporting requirements, such as the ASX Listing Rule requirements, the ASX Corporate Governance Principles or relevant accounting standards, to provide more relevant non-financial information to the market?*
- *In relation to any proposed further reporting requirements, should desired information be in a narrative or quantitative form?*
- *Is it possible to specify criteria to assist in comparing narrative disclosures, including by valuing or quantifying intangibles?*

⁵ Proposed in the submission to the Joint Parliamentary Inquiry by Dr Anthony Forsyth, Monash University.

Reporting on sustainability / social and environmental performance is a major tool for encouraging a focus on long-term value and hence on stakeholder interests. The key value in sustainability reporting lies in the 'materiality' of a report – the extent to which it provides transparent data and information that matches the concerns of the stakeholder audience to which it is targeted.

As sustainability reporting has mushroomed in recent years, too many reports have been produced that have been one-size fits all documents, full of the data required by standards such as the Global Reporting Initiative, but failing to adequately address the fundamental concerns held by an organisation's stakeholders.

In order to produce sustainability reports that accurately reflect stakeholder concerns, corporations must engage those stakeholders in order to understand what the issues of concern to them are. They must then ensure that these are adequately reported on in a manner deemed by the Board to be transparent – that is fully disclosing all known negative social and environmental impacts of interest to stakeholders.

Stakeholders engaged in this process should include:

- Employees;
- NGOs/activists;
- Investment community;
- Industry;
- Customers;
- Communities in which they operate; and
- Government.

Above all, effective sustainability reports must demonstrate that the impact of decisions on long-term value are being incorporated into strategic planning and decision making. This should include an analysis of risks in regard to stakeholder expectations, and the impact of these on long-term value. It should also include demonstration of engagement by senior corporate leadership with questions regarding the long-term changes required to create more sustainable business models.

Genuinely 'material' reporting by all large corporations would promote corporate learning, reflection and innovation, encouraging corporations that have not yet recognised the impact of stakeholder concerns on long-term shareholder value to engage with these issues.

Such reporting, if undertaken by all large corporations, would also be a significant tool in improving the information available to financial markets about the long-term risks and benefits associated with social and environmental performance. Such a move, when viewed in conjunction with the adoption of social and environmental screening practices in mainstream investment practices that is already beginning to occur, could be a major influence in improving corporate focus on long-term, 'enlightened' shareholder value, and thus on improving the extent to which stakeholder concerns are considered and acted on in organisational decision making.

Futureye therefore supports a mandated requirement for all large corporations to report annually on social and environmental impacts. Where reporting is not mandatory, it seems reasonable to expect that only 'good' performers will seek to take it up, as a strategy to build or protect their reputations. It is arguable, however, that it is through full-disclosure by the poorer corporate performers that society has

the most to gain. Under the current, purely voluntary approach, these companies seem to be the least likely to report.

Reporting effectively on social and environmental impacts is a resource intensive activity and one which, as a result, is appropriate to enforce on large, publicly traded businesses, though not on small-to-medium enterprises (SMEs). One obvious means of enforcing such requirements solely on publicly traded companies would be to incorporate them into ASX listing requirements. As the CAMAC Discussion Paper notes, this approach has already been taken in South Africa, where companies listing on the Johannesburg Stock Exchange (JSE) are required to report annually on a range of social and environmental issues, using the Global Reporting Initiative (GRI) framework as a basis.

For the purpose of providing meaningful information to financial markets on social and environmental risks and opportunities, it is vital that reporting should occur in a way that enables direct comparison between companies. The GRI currently represents the most useful available tool in this regard. The GRI provides a useful benchmark on key social and environmental impacts that should be addressed in any thorough sustainability report, as well as providing guidance on how impacts should be reported. The widespread adoption of the GRI standard in recent years makes it the best available standard to ensure comparability.

In its current form, however, GRI compliance does little to ensure that companies are focussed on addressing the issues of greatest concerns to relevant stakeholder groups. Nor does GRI compliance require companies to show that reporting is being used as a means of corporate engagement with the risks and opportunities posed by social and environmental performance. As a result, Futureye recommends that any mandated reporting requirements should also focus on:

- Requirements to ensure that such reporting addresses the principle impacts and issues of concern to relevant stakeholder groups;
- Requirements to ensure that reporting is transparent, fully disclosing known negative social and environmental impacts of interest to stakeholders or of potential relevance to balance sheet considerations (ie potential future risks/liabilities/increased costs);
- Requirements to ensure that reporting examines the threats to and opportunities for long-term value posed by such impacts; and
- Requirements to report on governance approaches to the management of stakeholder-related risks, including mechanisms for disclosing negative impacts, sharing dilemmas, consulting communities and stakeholder groups, and resolving complex issues;
- Requirements to ensure that reporting includes an examination of the longer-term changes to strategies and business models needed to minimise such risks in the future.

Concluding Remarks

Futureye makes the above comments as the result of significant experience working with leading corporations on issues of social responsibility, sustainable development, and stakeholder engagement.

We would be happy to discuss any of these issues further with the CAMAC.



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