



# Material business risk in the carbon-constrained economy — avoiding 'boilerplate' reporting against Principle 7

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- *ASX to focus on reporting against Principle 7: Recognise and manage risk*
- *Current reporting often perceived to be 'boilerplate' regarding the scope and quality of disclosure*
- *A gap exists between disclosure and real material business risk management*
- *International experience and anecdotal evidence in Australia indicates this area is difficult to master; companies should see it as a journey towards real compliance*

It has been touted as the single biggest structural change for the Australian economy since the impact of globalisation and the opening up to international markets back in the 1980s.

The Federal Government's major policy response to climate change — the Carbon Pollution Reduction Scheme (CPRS) — promises to exert fundamental, inexorable and almost certainly disruptive force on the manner in which Australian corporates operate.

Doing business in a carbon-constrained economy will be utterly different for corporate Australia; and not just for the largest 1,000 emitters or energy-intensive trade-exposed (EITE) companies.

In line with the global financial fallout from the US subprime mortgage crisis, it is a market development that presents significant potential

risk to a corporation's strategy and operations, flowing through to scenario planning and risk management and therefore to governance and compliance.

Management of this significant new material business risk will need to be reported under Principle 7 (Recognise and manage risk) of the ASX Corporate Governance Council's (CGC) revised *Corporate Governance Principles and Recommendations* (Principles).

Yet it would appear this issue is not even on the agenda of many boards and, one can speculate therefore, is being less than fully and effectively risk managed across the corporation by executive management.

In this article I explore some of the issues of which company secretaries need to be aware in assisting their corporations report against the revised Principle 7. This is by way of background to placing this emerging material business risk associated with climate change under the governance lens.

## Principle 7 reporting — the current state of play

I want to start by recapping the key requirements of revised Principle 7 as well as the growing dissatisfaction with 'boilerplate' reporting.

The revised Principles have been in operation now for over 12 months. The revisions were the result of an extensive consultation and review process and their incorporation into the Australian corporate governance framework has gone largely unremarked.

In early 2009, ASX will conduct its first review of reporting against with the revised Principles for companies with 31 December 2008 balance dates, the first group required to report against the revised Principles. Companies with 30 June 2009 balance dates will be reviewed in late 2009 or early 2010.

The ASX has flagged its intention to focus on Principle 7 reporting in its reviews, with special mention of sustainability and environmental risks. (See the Companies Update in December 2008 where it reported that non-compliance for Principle 7 hovers in excess of 20 to 25 per cent compared to the other Principles with less than ten per cent non-compliance.)

Basically there are four key areas of concern.

### Reality check 1 — are you aware of how Principle 7 is now different?

The first area of concern is around the disclosure itself. It is clear from conversation with many companies that a broad section of executive management are not fully aware of the changes in the revised Principle 7. However companies who think they will report adequately against the revised Principle — because they were reporting against the previous Principle — need to consider the additional requirements that the revised Principle imposes.

The key change in the revised Principle 7 is its expanded scope to require companies to report on whether ‘material business risks’ have been managed effectively. As outlined in the joint Deloitte/Group of 100 publication, *Recognise and manage risk: a guide to compliance with ASX Principle 7*,<sup>1</sup> this includes all material business risks, not just financial or financial reporting risks, but risks emanating from across the corporation, whether occupational health and safety, environmental, trade practices, production capacity, people or skills related. Specifically the Deloitte/Group of 100 publication suggests that:

- ‘material’ should be interpreted by reference to accounting standards on materiality and have regard to both quantitative and qualitative factors
- ‘business’ requires a risk to have some connection with the four categories of the COSO ERM model being strategic, operations, financial reporting and compliance
- material business risks should be considered at a whole-of-company level
- material business risks are a subset of the company’s entire risk profile
- ‘non-material’ business risks should not necessarily be ignored. These may have a significant impact when taken in conjunction with other risks or may become material in the future. Management may still recognise and manage such risks in a formalised manner but not necessarily report to the Board on the effectiveness of their management.<sup>2</sup>

### Reality check 2 — what are you really saying?

The second issue with regard to Principle 7 reporting centres on the quality of the disclosure.

In November 2008, at the joint ASX/ASIC seminars held on *Continuous disclosure and corporate governance*, Peter Abraham, former General Counsel and Company Secretary at Rinker, and member of both the CGC’s Implementation Review Group and the judging panel for the Australasian Reporting Awards said that he was continually reading:

the same old hackneyed phrases and motherhood statements [in annual reports] ... Within a paragraph or two I can easily sort the wheat from the chaff in terms of disclosing what is really going on...but in the current economic climate generic motherhood statements just won’t cut it.<sup>3</sup>

In seeking to address this issue in its *Revised Supplementary Guidance to Principle 7* in June 2008, ASX posted on its website hypothetical examples of ‘helpful’ and ‘unhelpful’ disclosures.

In its commentary on unhelpful disclosure, the CGC draws a distinction between an outline of responsibilities and a description of a company’s ‘risk management policies and systems, and how accountability for such policies and the processes for oversight and management of material business risks is developed and overseen within the organisation’.<sup>4</sup> It also notes that one of its ‘unhelpful’ examples does not provide any indication of whether or not the company’s approach to the management and oversight of material risks is effective.<sup>5</sup>

Company secretaries would be well advised to read this commentary, not for ‘boilerplate’ guidance, but for its explicit and instructive rendering of an overall framework of risk management and oversight, as well as its perception and assessment of the industry and context-specific risks in which the company operates.

Further assistance is also available in the Deloitte/Group of 100’s *Guide to Principle 7 compliance*. Designed to supplement the ASX’s *Supplementary Guidance*, the Deloitte/Group of 100 publication provides some additional suggestions as to what companies should include in their disclosures and reporting:

[D]isclosures on the following items could be made on the company’s website or in its Corporate Governance Statement:

- an overview and details of the key elements of the company’s risk management and internal control model (or a reference to the COSO model if adopted by the company)
- roles and responsibilities of the Board and management in this model
- information on the key risk exposures of the company
- concise and focused descriptions of the key internal control processes adopted and relied upon by management for minimising the impact of the key risk exposures, and ensuring compliance with the Principles (for example,

internal audit function, control self-assessment etc)

- the procedures directors have performed in overseeing the reports from management on the effectiveness of the risk management and internal control system as well as management of the material business risks in the previous 12 months.<sup>6</sup>

### Reality check 3 — are you really doing what you are saying?

The third issue in connection with reporting under ASX *Principle 7* concerns whether the disclosures actually bear any semblance to reality — whether there is a disconnect between disclosure and the underlying reality of risk management and oversight within the organisation.

This is the area that most concerns me and I am not alone. CSA is concerned<sup>7</sup>, and the CPA is concerned.<sup>8</sup>

Suffice to say a greater degree of checking of all disclosures is needed. Internal audit can play a vital role here and should be asked to do so.

### Reality check 4 — is what you are doing sufficient?

The fourth and most difficult issue in reporting against Principle 7 relates to the degree of detail and rigour in risk management that your company needs to achieve. This is a matter for each company to determine. However we are finding that this has not been revisited in the spirit and intent of the new Principle 7.

Companies are not standing back and asking themselves from a governance viewpoint how risk mature they want to be and then building their risk practices around this vision.

Individual risks need to be moved with the times rather than being dumbed down. They need to be regularly reviewed against the external environment — and any shocks to it — to make sure the current risk profile is still valid and actions appropriately prioritised. Risk needs to be dynamic, perhaps more than ever in light of recent global events.

There are many aspects of risk management to consider. As a baseline the Deloitte/Group of 100's *Guide to Principle 7 compliance* suggests the following:

In respect of reporting from management to the board, it is important to note that this reporting should be occurring throughout the year with a summary report at year-end. Some reporting documents and suggested content are set out below:

- Material business risk profiles:
  - should be provided throughout the year at a level of detail and frequency consistent with residual risk rating (that is, the higher the rating the more detail and more frequent the reporting)

- contents may include:
  - o appropriate description of risk
  - o responsibility
  - o management control rating
  - o overall residual risk rating and consequence and likelihood elements
  - o context of risk (why is this important to the company)
  - o details of controls/risk response
  - o details of any management assurance

- Annual risk summary report:
  - should be provided at the same time the annual report is considered and approved along with the necessary CEO/CFO certification(s) from management
  - outlines the process followed throughout year covering:
    - o review of risk policy
    - o review of risk framework and matrix
    - o summary of process and results of risks identification and rating process
    - o summary of material business risk profiles
  - may contain statement (if board requests) from CEO and/or Group Risk/other executives.<sup>9</sup>

Australian corporates are not alone — or lagging behind deliberately — in being challenged to fully operationalise the types of requirements now entailed in *Principle 7*. In the United Kingdom for example, despite many more years of experience with the Combined Code, companies still find managing and monitoring risk a challenge even though their identification of risks has improved enormously.

In May 2008 Deloitte's UK practice, in association with the Institute of Internal Auditors (UK and Ireland), conducted a survey of 275 major organisations, of whom more than 20 per cent have a turnover in excess of £1 billion. Only half the respondents to the survey felt their organisations had a good understanding of the risks they faced, could prioritise those risks, and respond to them effectively.<sup>10</sup>

From the benchmark work Deloitte is doing for companies in Australia it is clear that Australia is very much on the same risk management journey. The gaps in effective risk management caused by the lack of coordinated efforts within an organisation have not had the same visibility as the business case to reduce costs and duplication. They are often not uncovered except by crisis management scenario role play, itself a management technique that is often overlooked, except by some of Australia's largest corporates. Even worse, they seem to be discovered too late and altogether too publicly when something goes wrong. The recent headlines following the current

crisis in global capital markets are only the most recent in a long tradition.<sup>11</sup>

### Does this sound like your company?

Company A has in train a multitude of programs designed to enhance the effectiveness (and efficiency!) of its management of material business risks. These programs are being driven by many different internal functions including, among others, risk, internal audit, finance, regulatory affairs/compliance and IT. Many of the programs are to meet the requirements of multiple governance 'committees' — both internally and externally — with different objectives, requirements and deliverables.

There is awareness among executive management that the cumulative impact of the multitude of projects is resulting in inefficient and costly overlap and duplication, as well as 'demarcation' conflicts.

There is also awareness that the lack of coordination extends to multiple measurement systems based on multiple databases and tracking mechanisms, and consequently, from a board or senior management perspective, fragmented and disjointed reporting. There is, as a result, some confusion around the degree of risk the company faces as well as the urgency and prioritisation of proposed risk mitigation strategies.

For reasons of cost reduction, executive management is very much aware of the need for 'convergence'; that is, the need to align the myriad of governance, risk and compliance processes. There is some growing understanding of the risks associated with not having entity-wide control policies, centralised testing teams, common risk assessment, a common control deficiency framework, control efficiency analysis, a consolidated IT solution facilitating one view of the organisation or harmonised board reporting.

The company thus wishes to harmonise, synchronise and rationalise its controls programs. It has now established a common 'language' through standardising policies, practices and reports. It is clarifying roles and responsibilities, and producing a portfolio view to better understand and manage risk interactions and corporate performance outcomes.

It is now seeking to coordinate activity cross-functionally to reduce multiple impacts on the 'front line'. It is moving to coordinate timing of requests for information and consolidated reporting. It is then hoping to eliminate gaps and redundant structures, processes and controls.

I have no doubt that many company secretaries would recognise where on the continuum their corporation currently sits. The point of my 'hypothetical' example is really this: risk management is very much a journey or a work in progress and should be recognised as such.

Many Australian corporates are only part way down the path. Many just need to formalise what they have and take it to the next level. A realistic assessment of where your organisation is on the journey, and an awareness that any residual risks accord with your organisations' stated risk appetite, are key to the reporting and assurance requirements of Principle 7.

### Material business risk in the carbon-constrained economy

Which brings me to the *issue du jour*: the material business risk of doing business in a carbon-constrained economy.

The hypothetical example of Company A was designed to illustrate the fact that Principle 7 reporting is an ongoing journey which requires continual review and updating of the corporation's risk management plans. This is particularly the case with the emerging issue of climate change. For the first time, many companies are confronting the issue of managing their direct and indirect exposure to impending changes in their operating environment and the associated material business risks occasioned by the Federal Government's policy response to the issue of climate change and the need to reduce greenhouse gas emissions.

The National Greenhouse Emissions Reporting Scheme (NGERS) is now in play for companies from 1 July 2008 and the proposed Carbon Pollution Reduction Scheme (CPRS) — as released in the white paper dated 15 December 2008 — is to take effect as from 1 July 2010. Along with the various state-based mandatory renewable energy usage requirements — these schemes are in the process of inducing fundamental structural change in the Australian economy.

To date companies have had to manage considerable uncertainty affecting their forecasting, business strategy and portfolio management given key elements of the CPRS are still to be finalised (even if the directional intent of the proposals being considered has been growing steadily clearer). This situation will remain for some time to come.

Management of the material business risks associated with what can be expected to be a slow but inexorable force on the economy will present major challenges for boards and executive managements as relative prices and costs, and demand structures and supply chains change, presenting opportunities to some companies and sectors and limiting them in others.

There are a host of immediate and pressing considerations for companies to deal with in managing the material business risks in transitioning to and doing business in a carbon-constrained economy. A list of some of the most fundamental risks facing corporate Australia include:

- determining exposure to a carbon price by assessing carbon footprint and emissions intensity
- establishing status as a liable 'entity' under NGERs
- testing compliance readiness under NGERs of emissions monitoring, accounting and reporting systems
- evaluating tax implications
- identifying opportunities and key growth sectors for investment
- identifying supply chain efficiencies and economies to minimise the carbon costs that will be passed on
- determining ability to pass on carbon costs to customers
- determining qualification for EITE status
- planning permit trading and carbon reduction strategies.

Despite this enormously significant change in the environment in which Australian companies operate — as well as the ASX's publicly stated focus on the reporting of management of material business risks in its next round of annual report reviews — there is evidence that Principle 7 reporting in this area will be far from satisfactory.

In August 2008 CSA surveyed companies about the place which climate change was being accorded on the board agenda. Of 89 leading ASX companies sent the survey, 22 responded. And the findings? Thirty-six per cent of boards surveyed were not spending more time managing the risks associated with climate change. Seventy-seven per cent of boards had not set up a committee to consider the implications of climate change reforms on their business, and 60 per cent had not considered what additional skills might be needed. In all, it could be suggested that at least a third of boards in the top 300 ASX listed companies do not have the impact of the government's climate change policies on the agenda.<sup>12</sup>

The survey's results prompted key stakeholders — namely the Australian Institute of Superannuation Trustees and the Australian Council of Superannuation Investors — to send boards a message about the need to better disclose environmental risks and to better manage them. Fiona Reynolds, Chief Executive of the Australian Institute of Superannuation Trustees is on the record as saying:

Companies need to realise that climate change is no longer a fringe issue that is owned by the environmentalists and the tree-huggers. It's a material investment risk. Super funds will expect, and do expect, companies to get their act together...they are not going to invest in companies that are not managing risk, and climate change is a risk.<sup>13</sup>

## Conclusion

There is no doubt that climate change — along with reassessing all risk profiles relative to corporate strategies in the current global volatility — will be a 'litmus test' or 'lead' indicator of the robustness of a company's overall approach to reporting in relation to Principle 7 and therefore will separate performers from non-performers.

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## Notes

- 1 Deloitte/Group of 100 *Recognise and manage risk: a guide to compliance with ASX Principle 7*, August 2008, <[http://www.deloitte.com/au/corporate\\_governance](http://www.deloitte.com/au/corporate_governance)> or <<http://www.group100.com.au>> [18 December 2008]
- 2 *ibid*, p 10
- 3 Abraham P, ASX & ASIC Listed Companies Conference (Continuous Disclosure & Corporate Governance), Westin Hotel, Sydney, 12 November 2008
- 4 See Appendix A: Hypothetical example of unhelpful disclosure: Hypothetical unhelpful example A, ASX Corporate Governance Council (CGC) *Revised Supplementary Guidance to Principle 7*, 30 June 2008, <<http://www.asx.com.au/corporategovernance>> [18 December 2008]
- 5 *ibid*
- 6 Deloitte/Group of 100 *Recognise and manage risk*, *op cit*, p 18
- 7 Sheehy T, Chief Executive, Chartered Secretaries Australia 'Business underestimating climate change challenge' MR 2008/8; CSA Rapid Response Survey No 30 'How prepared is your organisation for the government's proposed climate change reforms', August 2008, <<http://www.csaust.com>> [18 December 2008]
- 8 Rankin G, Chief Executive, CPA Australia 'A façade of good governance' *Business Spectator*, 23 September 2008
- 9 Page 18, Deloitte/Group of 100 *Recognise and manage risk*, *op cit*
- 10 See Executive Summary, Institute of Internal Auditors (UK and Ireland) in association with Deloitte, *Towards a blueprint for the internal audit profession: research by the Institute of Internal Auditors — UK and Ireland in association with Deloitte*, April 2008
- 11 Rankin G, *op cit*
- 12 See CSA's Rapid Response Survey No 30, *op cit*
- 13 Reynolds F, cited in Hepworth A, 'Super funds give boards green ultimatum', *Australian Financial Review*, 26 September 2008 ●