Risk management disclosure in volatile markets

In volatile markets, companies with sound risk management practices and comprehensive disclosure of risk policy become increasingly attractive to investors. And, in periods of heightened risk, such as in the current market conditions, these practices are likely to be key differentiating factors both for equity investors and debt financiers.

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RISK MANAGEMENT IS EMBEDDED in a number of the Australian Securities Exchange (ASX) Corporate Governance Council's Principles of Good Corporate Governance. Companies are encouraged to disclose elements of their risk management framework. This article is based on a study of a sample of 20 ASX 200 companies to assess the disclosure of their approaches to risk management.

The financial and credit crisis of late 2007 (continuing into 2008) has placed risk management firmly back in the minds of investors. For many companies, the business environment is also less favourable than it was over the past few years due to a slowing economy and a range of cost pressures. The occurrence of adverse (risk) events will have far greater consequences in a less buoyant environment. More than ever, potential investors and shareholders should understand how companies evaluate and manage risks.

The formal disclosures of risk management structures and processes are found on company web sites and in their annual reports. Annual reports referenced in this article relate to the 2007 financial year. The approaches to risk management reflected in the disclosures of the vast majority of companies in the survey were therefore determined before the credit crisis took hold.

All of the companies in the survey include some or all of the following on their web sites: a general discussion on risk management, risk management policy and a risk committee charter. The corporate governance sections of the directors' reports also contain a description of the risk management approach adopted. The implementation and practice of sound risk management is far more important than disclosure. However, companies that have documented a comprehensive and meaningful risk management policy, a charter for their risk committee and description in their annual report, are likely to foster a greater 'risk aware' culture, which is obviously beneficial to investors and debt providers.

This study focused on disclosure of:

- risks to the company;
- structures in place to address risk management;
- duties and responsibilities of the risk management committee (often combined with the audit committee); and
- application of Australian or international standards and regulations.

The survey revealed that the extent of disclosure varies quite substantially from comprehensive explanations of risk management throughout the organisation to fairly bland summaries of generic risk management practices. Companies may want to consider a number of issues related to their risk management disclosures, particularly in a more risk aware environment (and in a more litigious environment). These include:

- whether disclosure of risks is adequate;
- whether disclosure of risk management structures, duties and responsibilities of risk committee(s) are accurate, appropriate and of a similar standard to their peers;
- whether the description of risk management in the policy and charter on the web site is consistent with the details disclosed in the directors' report; and
- the potential benefits to corporate reputation of more specific and detailed disclosure of risks and risk management.

Scope of the study

The study covered a diverse sample of industrial and resource companies. The companies spanned a range of industries including transport, health, retail and services sectors operating in Australia and overseas. Financial institutions were excluded as their risks are more specialised. In a brief article such as this, it is impossible to mention every company's disclosure. Therefore, when referring to an example of good disclosure by one company, there may be other companies that provide similar examples of good disclosure.

Identification and communication of risks

The first edition of the ASX principles (2003) recommends that: 'This system (risk oversight and management) should be designed to — identify, assess, monitor and manage risk — inform investors of material changes to the company risk profile'. The guidance note states that: 'The risk profile should be a description of the material risks facing the company. Material risks include financial and non-financial matters. The risk profile should be regularly reviewed and updated'.

Existing and potential shareholders would be better informed if companies disclosed their perceived key risks. Furthermore, it would provide a basis for understanding the risk management approach being adopted, including the risk management structure such as board risk committees and management risk committees and their duties and responsibilities. Many of the surveyed companies do not appear to explicitly disclose risks while others provide a generic description of risks, in one or two sentences. There are, however, some examples of detailed and company specific disclosure of risks.

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BHP discloses 16 risk categories in section 6.6.2 of the corporate governance statement of its 2007 annual report. As expected, the first two risks are fluctuations in commodity prices and exchange rates. Thereafter, a range of operational, financial, environmental and strategic risks are disclosed such as: 'inability to successfully integrate acquired businesses; operating cost pressures and shortages; influence of China and an impact of a slowdown in consumption; and actions by governments and the political events in the countries in which we operate'.

Brambles discloses the 'principal risks and uncertainties' facing the company. These include 18 risk areas such as: global economic and business conditions; loss of senior management; limitation on ability to obtain additional capital; credit risk on counterparties; equipment control and quality; contract management; system and technological failures; and service disruption. Woodside also provides more focused disclosure of 'a number of industry risks which may impact on Woodside's business as an exploration and production group with international operations'. These are found in the enterprise risk and internal control policy on the company's web site.

The second edition of the ASX Corporate Governance Council's guidance note on the interpretation of Principle 7 of the Principles of Good Governance (to apply during the 2009 calendar year) is, however, somewhat less specific on the disclosure of risks. Companies are instead referred to Section 299A of the Corporations Act which states that 'the Directors Report … for a listed public company must also contain information that members of the company would reasonably require to make an informed assessment of … the entities, business strategies and prospects for future financial years'.

Companies registered under US Securities Exchange Commission (SEC) laws and regulations are required to report on risk factors in their annual Form 10K reports in 'plain English' (as described in the SEC's General Instructions to Form 10K). US companies also provide detailed descriptions of risk factors in their annual reports under the management discussion and analysis section. These are instructive examples of risk reporting under a clearly different regulatory regime.

Structure to address risk management

All companies in the survey have established at least one board committee to oversee risk management. Some companies have a separate risk committee and a separate audit committee, but most combine audit and risk in one committee. Other naming variations include the audit, risk and compliance committee and the risk and compliance committee.

The guidance notes on the composition of the audit committee (which in the case of combined committees will apply to risk as well) state that it should comprise only non-executive directors, a majority of independent directors and be chaired by a director who is not the Chairman of the board. Among at least three directors should be a director who is financially literate and qualified (qualified accountant). Some members should have an understanding of the industry in which the company operates. The number of directors on the boards of the companies surveyed generally enabled these requirements to be met.

A challenge facing combined committees is the vast range of potential topics to manage i.e. audit (relationship with external auditor and financial reporting cycle), risk (enterprise-wide risk management program) and compliance (legalistic slant across a wide range of topics, from health and safety to trade practices). This is most likely the reason that nine out of the 20 companies surveyed (45%) have established a second risk committee and/or a related committee that has relevance to risk management. The following table provides some examples of additional committees and their primary focus.

A number of companies have an ethics committee or compliance committee that, while not directly related to risk management, addresses key exposure areas such as legal compliance, trade practices, and dealings with government. Coca-Cola Amatil has a compliance and social responsibility committee that covers occupational health and safety, environmental protection, product safety, trade practices and other legislation the committee or board sees fit. Leighton's has an ethics committee that 'examines and makes recommendations to the Board regarding the nature of any changes considered necessary to the Group's code of Ethics'.

There is no assurance that the creation of a separate committee that focuses on a specific area of risk as part of its duties will be more effective than if the topic were included in the primary audit and risk committee. However, it does result in specific board focus through reporting, specific director focus by those on the committee and, possibly, it generates more interaction with management in key risk and compliance areas, all of which should enhance overall risk management.

Many companies disclose the relationship between the board risk committee and the executive management risk committee. This disclosure refers to and describes one or more executive management risk committees and the interaction between the risk committee and executive risk

TABLE 1: Additional committees

Company	Committee	Description
Qantas	Safety, environment and security committee	The committee assists the board in fulfilling its corporate governance responsibilities in regard to: • occupational heath, the protection of the environment and operational security; and • operational risk management and compliance with all operational, legal and regulatory obligations (other than business risks and compliance dealt with by the audit committee).
Orica	Health, safety and environment committee	The committee assists the board in the effective discharge of its responsibilities in relation to safety, health and environment. Responsibilities include: • considering safety, health and environment issues that may have strategic business and reputational implications for the Orica Group and reviewing appropriate measures and responses, including the identification of key risks and appropriate mitigation strategies.
Cochlear	Medical science committee	The medical science committee consists of two non-executive directors and the CEO. The key responsibilities of the committee include: • maintaining a watching brief on medical and scientific developments in the Cochlear implant and allied fields; and • monitoring risk management and appropriateness of internal controls with the management of medical episodes associated with the company.

management committee. BHP provides comprehensive disclosure of the link between the board and a range of executive committees. Each customer service group (CSGs are the operating divisions of BHP) has its own risk and audit committee which reports to the board risk committee. BHP also discloses the existence of a financial risk management committee which reviews the effectiveness of internal controls relating to commodity price risk, counterparty credit risk, currency risk, interest rate risk and insurance. Minutes of this committee are also provided to the board.

Many companies disclose the key foundations of risk management (risk identification, evaluation, controls and monitoring) in the description of risk management in the directors' report or in their assessment of compliance with ASX principles. Reference is made to a wide range of procedures and reports. As expected, these include regular monthly financial reporting, annual budgets, capital expenditure controls, delegated authorities and internal audit procedures.

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Duties and responsibilities of the risk committee

There is considerable variation in the extent of disclosure of duties and responsibilities of the risk committee. These duties and responsibilities are typically found in both the corporate governance statement of the annual report and also in the charter of the risk committee on the company's web site. This limited research study only concentrated on the disclosure of risk management duties and responsibilities and not on duties and responsibilities in relation to the annual audit, in cases where the committee is combined.

In most cases the disclosure of duties and responsibilities is limited to a handful of 'dot points' while only a minority of companies provides detailed disclosure. The duties of the risk committee can be highly focused on risk management topics or sometimes cover a range of related topics (see Fosters and Amcor disclosure below). Most companies explain that the risk committee is not directly involved in risk management but oversees the framework under which risk management is applied in the company. Typically, the committee is charged with the responsibility of overseeing management's actions in evaluating, monitoring and reporting on operational, financial and strategic risks.

An interesting example of comprehensive disclosure of a broad scope of duties is Fosters Group where the risk and compliance committee's key responsibility is 'to recommend to the Board and then promulgate and maintain a sound system of risk oversight and management and internal control'. The detailed duties and responsibilities of the committee are divided into two main categories: corporate governance and risk management. Corporate governance duties are wide ranging including 'reviewing and recommending to the Board changes to the Board Charter'. In addition, this category includes environmental, occupational health and safety policies, compliance with obligations to stakeholders including customers and employees, and reviewing delegated authorities. The risk management duties include 'ongoing assessment of the risk profile' and 'assessing and recommending to the Board an acceptable level of risk'. (From an enterprise-wide risk management approach, this combination of duties provides more support to a combined risk and compliance committee than an audit and risk committee.)

Among the companies surveyed it is common for a few business functions to be specifically mentioned as coming under scrutiny of the risk committee. The most common are treasury policy and processes (including foreign exchange and interest rate risk) and insurance. These are important finance department responsibilities and fit comfortably with a more accounting and finance-oriented risk committee. Other specific topics mentioned on a number of occasions — indicating more enterprise-wide risk orientated committees — include procurement policies, disaster recovery and business continuity plans, and environmental risks. Interestingly, while computerised systems play such an integral part in business operations today, only one company specifically mentioned IT systems in their risk disclosure; a duty of Telstra's Audit Committee (which covers risk) is 'understanding and overseeing Telstra's IT strategy and its IT governance and IT security arrangements.'

A number of companies disclosed that their risk management programs are subject to ongoing formalisation and development. 'During the year the Company codified its approach to risk management with the adoption of a Global Risk Management Policy and Framework' (Worley Parson). Westfield reports that 'in conjunction with KPMG each country and the corporate head office identified and assessed relevant risks' and 'a profile was created with respect to each risk detailing current controls and planned improvement in these controls'. Investors in Fairfax were advised that: 'The process for assessing and reporting on risks, internal controls and internal compliance is being standardized, enhanced and formalized across the Group in accordance with best practice guidance. This is an ongoing process'.

Most risk committees meet between two and four times per annum. A general statement in most charters also provides for more frequent meetings if required. The charter of the Amcor Audit and Compliance Committee, which also includes risk management, provides further disclosure by indicating which quarterly meetings will address particular topics. The timetable provides an insight into the coverage a particular topic receives. For example, while the committee reviews 'policies and practices and systems for managing the impact of taxation' once per annum, each quarterly meeting covers 'policies and practices for whistle blowing procedures'.

While this study was not an audit, a number of differences were noted when comparing the description of risk management on the companies' websites (risk committee charter and policy) and in the annual reports (directors' report). In some cases, a specific area of focus is included in the annual report but not listed in the duties in the charter or is treated differently. In some cases, reference is made to an enterprise-wide approach to risk in the directors' report but is not referred to on the website description. In one case, the risk policy refers to a managing director who is no longer with the company.

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Standards and international compliance

Companies that disclose that they are complying with a particular standard such as AS/NZ 4360 (2004) provide useful information. This discloses a benchmark for their risk management and compliance program. AGL refers to its 'formal holistic enterprise-wide risk program based on Standards Australia's AS/NZ 4360:2004'. Stockland notes 'an annual risk profile exercise is conducted … and is performed in accordance with Australia, New Zealand Risk Management Standard AS/NZS4360'.

Companies that are also listed on international exchanges refer to relevant standards and internal control guidelines. BHP complies with the UK Combined Code on Corporate Governance (Turnbull Guidance). In addition, BHP also addresses the evaluation and documentation of internal controls as required by the Sarbannes–Oxley Act.

Conclusion

In adverse business conditions when profitability is pressured and capital is limited, risk management is likely to become a higher priority in investment assessment. Ideally, documentation of risk management and its disclosure in the annual report should be a good proxy for the operationalisation of sound risk management. Companies with sound risk management and disclosure are likely to be regarded more highly by investors, especially in prevailing volatile market conditions. There is scope for those companies with more generic, bland and abbreviated disclosure to be more expansive and provide disclosure specific to their companies. A future study in 2009 may reveal just that.

The challenge for small cap listed companies

From an investor's perspective, risk management in a small cap listed company is critical. Often key operations are highly dependent on one market or product or service and the company may not have the financial reserves and capacity to meet a setback. Small companies do not have the resources and structure to implement all the recommended risk management guidelines. They are also unlikely to have the resources to maintain the level of disclosure that large companies manage e.g. disclosure of key risks, risk management framework, risk management policies, risk committee charters. However, in today's heightened risk environment, sound practices and comprehensive disclosure of risk management practices are likely to be key differentiating factors for both equity investors and debt financiers.

Acknowledgement

Thanks to Dr Mark Shying, Senior Policy Adviser (Financial Policy and Governance) CPA Australia Limited, for his review and comments.