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Risk management is not a matter of choice

June 13, 2009 - 12:08AM

As we approach the end of one of the most volatile financial years on record, the noose is starting to tighten around the necks of those ASX-listed companies that have failed to implement risk management and internal control frameworks properly.

They now face a new problem: how to frame their annual corporate governance disclosure statements without running the significant commercial risk of being exposed for the inadequacy of their internal systems. Conversely, those that persist with inadequate disclosure run the risk of being on the wrong end of a class action, defending allegations of misleading and deceptive conduct.

After the introduction of the ASX revised corporate governance principles and recommendations, all eyes will be on the new batch of 2008-9 annual reports as they come off the presses. The reason is simple.

For the first time those ASX-listed companies with a reporting deadline of June 30 will be required to fully disclose the effectiveness of their risk management and internal control frameworks in managing not only financial risks, but also material business risks.

Add the recent James Hardie decision to the mix and this is where things start to be very interesting. While directors and officers have lived with the ever-present threat of personal liability, the James Hardie judgment has sharpened the focus on directors' and officers' obligations to ensure timely and accurate disclosure.

This combination of sharpened focus and increased disclosure obligations must have the litigation funders and class-action lawyers licking their lips in anticipation.

Unfortunately - or fortunately, depending on your perspective - the revised CGPRs (and the supplementary guidance note to principle 7) set out in detail what companies are expected to do on the development of risk management and internal control frameworks. They also set out examples of what the ASX refers to as "unhelpful disclosure".

The devil is in the detail, however. Principle 7 of the CGPRs points to the Australian standards for risk management (AS/NZ 4360) and compliance (AS 3806). In simple terms these standards require structured and systematic processes to be in place to identify, analyse, evaluate, monitor and control risks.

On disclosure guidelines, the ASX makes it clear that it expects a comprehensive summary of a listed company's approach to risk management and internal control, as well as relevant information on whether management has provided a report to the board on the overall effectiveness of these controls in managing material business risks.

The choice for listed companies is stark. They must either, in effect, implement a risk management and internal control framework or explain to investors, and other key stakeholders, why they have not done so. Simply to state that risk is managed by the audit committee providing details of the charter with little or no further explanation is manifestly inadequate. Unfortunately, this is what many have been doing.

Those not willing to make a commitment to the process, and which think they can get by with some vaguely worded disclosure in their 2008-9 annual reports are on notice. There is a storm cloud looming which involves the convergence of regulators, litigation funders, class action lawyers, directors' and officers' insurers and the media.

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- **Surveillance:** Regulators are under increasing pressure to act to protect stakeholder interests and have made no secret of the fact that they are increasing their surveillance and enforcement activities. At the recent Chartered Secretaries Annual Corporate Update in Perth, the ASX made it clear that compliance with principle 7 of the CGPRs was a key focus.
- **Litigation:** Litigation funders and class-action lawyers appear to be just warming up. Advertisements seeking investors who have lost money are appearing with greater regularity. The value of class actions led by IMF rose from \$400 million in 2007 to more than \$1.2 billion by the end of last year.
- **Focus on disclosure:** Class actions involve extensive investigation by plaintiff lawyers who diligently scrutinise the finest details of the defendant company's internal documentation. Particular focus is directed towards public disclosures that may be considered inadequate, misleading or deceptive.
- **Directors' and officers' insurance:** Recent reports have highlighted the fact that this insurance market is rapidly tightening. It is now common within D&O applications to see insurers asking applicants to disclose whether they have a risk management system. Those that tick the box without having established an effective risk management program are in danger of having their claims disallowed.
- **Activism:** In the past five years the media has become far more savvy about governance issues. Many financial journalists and shareholder representatives know how to ask the right questions to expose non-compliant companies and their executives.

All this activity seems to point in one direction. It is now becoming a legal and a commercial imperative for ASX-listed companies to ensure their risk management and internal control programs are in place and working effectively. The danger for those that do not comply - and for their directors and officers - is that if an adverse risk event occurs they will be exposed to reputational damage and the threat of possible action by regulators and class-action lawyers.

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This story was found at: <http://business.smh.com.au/business/risk-management-is-not-a-matter-of-choice-20090612-c65g.html>