

Across the board



Peter Nash
Australian Chairman

Introduction

In the current environment of global uncertainty, access to capital will become an increasingly important issue for most businesses.

In this issue of *Across the Board*, Michael Bray discusses the worldwide push towards improved communication with the capital markets through integrated reporting. He argues that integrated reporting will result in an improved basis for capital allocation, reduced reporting costs and better business performance through improved organisational clarity. It is an important and timely message in the present difficult and uncertain business environment.

Prevention and detection of fraud, corruption and misconduct is another governance issue which should not be neglected by boards. We examine why the control of fraud and corruption needs to be elevated to the board agenda and the impact of new legislation in the UK and elsewhere.

In the wake of the 2011 reporting season, now is the time for directors to reflect on the processes in place in relation to financial reports and other market disclosures. With this in mind, we provide an overview of the financial results of the ASX 50 as well as some practical tips on how directors can respond to the Centro decision.

Finally, we ask whether your organisation is making appropriate use of the social media phenomenon. Social media is now a firmly entrenched part of popular communication, yet many businesses continue to ignore its commercial power. It could be an opportunity missed.

As always, please contact us if you would like to discuss any of the matters raised in this issue of *Across the Board*.

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Michael Bray

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Performance insight through integrated reporting

Around the world the push for integrated reporting is gaining momentum.

In an increasingly complex world, moves for the adoption of 'integrated reporting' may be considered an unnecessary distraction from more pressing issues. As the European monetary system threatens to unravel, the US grapples with a runaway federal budget deficit and a stalling economy, and the rest of the world worries whether China can sustain its turbocharged economic growth rate, directors can hardly be blamed if they fail to get too excited about another set of proposals for reforming business reporting, however worthy they may be.

Paradoxically, the present environment of uncertainty and scrutiny over financial reporting is putting a premium on access to capital and good business decision-making, both of which stand to benefit from the adoption of integrated reporting.

So what precisely is integrated reporting?

Integrated reporting involves bringing together information about an organisation's strategy, performance and prospects in a manner that reflects the commercial, social and environmental contexts within which the organisation operates. For directors, integrated reporting offers a clear and concise way of explaining their company's 'story' to the capital markets and other stakeholders. This, essentially, is the definition of integrated reporting adopted by the International Integrated Reporting Committee (IIRC).

The IIRC was established in 2010. Its members include leaders from the corporate, investment, regulatory and academic sectors. It seeks to build a global consensus on how reporting needs to evolve, creating a more flexible reporting framework better able to accommodate uncertainty and complex long term investment propositions.

The characteristics of integrated reporting include strategic focus, the connectivity of the information

presented, a future orientation, responsiveness to stakeholder concerns and conciseness, reliability and materiality.

The benefits of integrated reporting include an improved basis for capital allocation and potentially a lower cost of capital, streamlined reporting processes, reduced reporting costs and enhanced organisational clarity in terms of business strategy and operational decision-making.

Limitations of conventional reporting

The growing interest in integrated reporting reflects, at least in part, increasing frustration with the limitations of traditional reporting including:

- Key features of financial performance are often buried in voluminous financial statements, resulting in workarounds and alternate measures such as 'underlying profit'.
- Annual reports have become divorced from the time horizons and information needs of the capital markets and other users.
- Sustainability reports seldom demonstrate the real role that corporate social responsibility and environmental stewardship play in business strategy formulation and value creation.
- Current reporting and management discussion lack an overriding strategic framework. The real story about business performance and prospects goes untold.
- Conventional financial reporting looks backwards rather than forward. Boards can be uncomfortable about discussing their firm's future performance and prospects — a not altogether unreasonable concern given their potential legal liabilities in jurisdictions such as Australia.
- The language of reporting is often too dense with technical jargon, or it is too imprecise.



- Information is presented without adequate context and background.

Integrated reporting represents an opportunity to break free from these self-imposed constraints.

In its recently released discussion paper, *Towards Integrated Reporting: Communicating Value in the 21st Century*, the IIRC identifies six categories of capital on which organisations rely to create and sustain value.

- Financial capital - financial resources available to operate a business, generate a surplus and invest for future growth.
- Manufactured capital - physical resources in the form of buildings, plant and equipment and infrastructure used to produce goods and services.
- Human capital - the skills, experience, ingenuity and motivations of the people who contribute to an organisation's activities.
- Intellectual capital - patents, copyrights, trademarks, formulae, software and systems as well as intangibles such as brand recognition and organisational reputation.
- Natural capital - productive inputs such as water, land, minerals and forests and, more broadly, biodiversity and ecosystem health, which are

necessary for the organisation to function and create value.

- Social capital - the values and behaviours and the relationships, trust and loyalties an organisation has developed internally and externally, as well as its 'social licence to operate'.

Obviously these different capitals will affect different organisations in different ways. Nevertheless, the returns an organisation can generate from these resources lie at the core of integrated reporting. They provide a framework for an integrated, balanced discussion of the strategic, risk, financial and sustainability factors that have determined an organisation's past performance and that will influence its future.

Where to now?

We all need to make the change from a heavily prescriptive, rules-oriented approach to business reporting in favour of a more flexible, principles-based approach. Here, the publication of the IIRC discussion paper is an important step forward. The committee plans to build on this initiative by releasing an exposure draft of an international integrated reporting framework during 2012. A final integrated reporting framework, endorsed by the IASB and G20, is targeted for 2013.

For boards, the journey to improved communication with the capital

markets can and should start now. With the Centro decision still fresh in our minds, directors may want to be involved earlier in the development of the company's centrepiece report, to ensure it is balanced, fair and meets the information requirements of key stakeholders. Now is also a good time for directors to rethink their corporate reporting processes and practices and to identify issues that should be taken into account when developing their FY12 plans and agendas.

Directors should engage in the debate on integrated reporting as a way of presenting their organisation's story via a concise, candid and strategically relevant integrated report that will be useful and read by their key stakeholders. Active governance may result in robust discussion with executive management, which should deliver a balanced report.

Development of integrated reporting is an opportunity for businesses to be on the front foot in defining a new and better approach to business reporting, rather than merely reacting to the demands of regulators, investors and capital providers. That would be a welcome and beneficial change. For some directors, it will be more than just a new way of reporting business performance — it will be a new and potentially transformative way of thinking about the organisations they govern.

Responding to Centro – 5 ‘to dos’ for directors

1. **Know your obligations:** The Centro judgement made it clear that the obligation to approve the financial statements rests with the directors and cannot be delegated. Whilst directors can place reasonable reliance on others, there are clear limits as to when reliance ceases to be reasonable. Directors cannot substitute the advice of management (or the auditors) for their own examination of a matter specifically within their responsibilities.
2. **Understand the key issues:** Be aware of the key matters impacting your organisation’s financial report, how management and the auditors have approached these issues, as well as the relevant accounting requirements.
3. **Ask questions:** Demonstrate the application of an enquiring mind by facilitating open discussions at meetings and by asking appropriate questions.
4. **Plan early:** With the FY11 financial year fresh in our minds, now is a good time to plan agendas, consider material such as the internal and external audit plans, and to ensure that robust processes are in place in relation to the preparation and review of financial statements and other market disclosures.
5. **Document your processes:** Consider how you evidence the conduct of a robust process. For example, do meeting minutes identify the papers the directors had before them when considering financial reports?



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Fraud, corruption and misconduct stalk company boards

Boards are finding it increasingly difficult to insulate themselves from the criminality and the bad behaviour of their companies’ employees and agents.

When people do bad things to companies – like defrauding them – there is an expectation that the perpetrators will be identified and punished. Ditto for those whose misbehaviour exposes their employers to legal sanction and public backlash.

There is nothing new about this. What is perhaps new is the way in which these matters are increasingly intruding into corporate governance. Indeed, they are transforming the corporate risk landscape as it is viewed from boardrooms around the country.

Many boards and individual directors still believe they cannot be held responsible for the acts of rogue individuals, especially those well down the company food chain. That belief has never been entirely true and in the modern world it can be a dangerous delusion. Legislators, regulators, law enforcement agencies and investors are increasingly seeking to sanction boards for their failure to exercise sufficient diligence, or for allowing circumstances to arise in which bad things are more likely to happen. These concerns embrace frauds against companies, corrupt acts by company officers and employees (usually the giving or taking of bribes), tax evasion, wilful breaches of environmental and safety standards, and various forms of misconduct such as bullying and sexual harassment.

In this context, directors need to realise that the legal environment is becoming less forgiving of both companies and their boards, and that these legal threats can come from unexpected places.



To take just one example, new UK anti-bribery legislation (the *Bribery Act 2010*) can apply to Australian companies that carry on any part of their business in Britain. The legislation is very broad, covering the activities not only of employees, but also of contractors and sub-contractors, agents, providers of outsourced activities and other 'associates'. It covers activities conducted via UK branches or subsidiaries, or that involve partnerships, joint ventures, consortia and similar commercial arrangements. It extends to bribery involving private individuals and entities, as well as British and foreign public officials, it prohibits so-called 'facilitation payments' made to public officials and it introduces a new offence of failing to prevent bribery. Offences under the act can take place in any part of the world, not just Britain. Senior company officers (including directors) can be prosecuted for their 'consent or connivance' in an offence under the Act if they are British subjects, or normally resident in Britain.

Plenty of Australian business will be covered by the UK *Bribery Act*. Many of them remain unaware of their potential liabilities.

Other countries, including Australia and the US, possess legislation designed to prevent and punish bribery of foreign public officials. Thus under the *US Foreign Corrupt Practices Act*, Australian companies issuing securities in the US or lodging returns with the US Securities and Exchange Commission can be prosecuted for bribery offences, even those that take place in third countries.

When it comes to fraud, boards are often unaware of what is happening right under their noses.

A recent KPMG global study of fraud patterns analysed 348 major fraud cases from 69 countries. The study found that the people most entrusted with a company's sensitive information and who have the ability override controls are statistically more likely to be perpetrators, with senior management more frequently implicated than junior staff. Board members made up 18 percent of fraudsters, while nearly two thirds were managers or senior managers, including CEOs and those working close to CEOs. Greed and work pressures (such as meeting budgets and targets, enhancing bonuses or safeguarding loss of employment) are the most common motivations for fraud.

It might sound trite, but fraud prevention really does start at the top. Organisations and their boards should make intolerance of fraud a part of the corporate culture and should set realistic and achievable targets for employees. Warning signs should not be ignored and robust, adequately resourced control systems and risk management frameworks should be in place. Boards should consider external, independent input to alert them of new and emerging risks associated with fraud, corruption and misconduct and to verify the effectiveness of existing controls and frameworks.

Serious incidences of fraud, corruption or misconduct represent a failure of corporate governance. While a board may avoid legal liability for a major scandal, its reputation for probity and competence is unlikely to survive intact.

The 2011 reporting season – a mixed bag

KPMG's analysis of the financial results of the top 50 companies listed on the Australian Securities Exchange (ASX) in the latest reporting season (1 January to 30 June 2011) shows mixed results and increasing uncertainty in the market. As expected, the mining sector was the standout performer with unrivalled growth in revenues, profits and operating cash flows.

While the mining sector has gone from strength to strength and the Big 4 banks continue their recovery, the remaining 42 companies have achieved mixed results, with a slow recovery from the GFC over the past five 6-month periods and a worrying stagnation over the last three 6-month periods.

Key insights:

- **Profits** – statutory profits for the twelve months ended 30 June 2011 increased 33 percent against the previous period while underlying profits increased 26 percent. Following ASIC's focus on this form of reporting, 20 percent fewer companies reported underlying profits.
- **Revenues** – total revenues increased 2 percent compared to the previous six month period and 11 percent on the corresponding six month period in the previous year.
- **Operating cash flows** – excluding the Big 4 banks, operating cash flows improved 12 percent on the previous 6-month period and 43 percent on the corresponding 6-month period in the previous year.
- **Balance sheets** – overall, balance sheets remained stable with 66 percent of ASX 50 companies maintaining gearing levels within 5 percent of their December 2010 levels.
- **Big 4 miners** – the Big 4 miners account for 78 percent of the year-on-year profit growth.
- **Big 4 banks** – the Big 4 banks account for 21 percent of the year-on-year profit growth.
- **Top 42 excluding Big 4 miners and Big 4 banks** – there has been only 1 percent growth in statutory profits for the 12 months ended 30 June 2011 and a 17 percent reduction in the 6-month period ended 30 June 2011 compared to the 6-month period ended 31 December 2010. This reflects a period that included the impact of several natural disasters and continued uncertainty in the global economy.

Social media is now mainstream in the population – where is your business?

Recently, there has been an interesting irony in the volume of 'old media' being consumed with reports and analysis of new 'social' media. The riots in the UK, for example, attracted significant attention in relation to the role of social media. On any interpretation, social media is now firmly in the mainstream of popular communication methods.

Yet despite this reality, KPMG research shows that just 42 percent of Australian businesses have any form of external social media presence. This compares with around 70 percent of the Australian population. Australians spend an average of 7 hours per month on social media, one of the highest rates in the world. In short, there is a big disconnect between where consumer businesses and their customers spend their time. Even for business to business organisations, social media is now an increasingly important tool that should not be ignored.

So why the disparity? Our research and experience suggests two primary factors. Firstly, a concern that social media increases the risk to an organisation's intellectual property, competitive intentions, or reputation. Secondly, a concern that social media will increase costs. In our research, KPMG did not come across any organisation that believed it had suffered significant damage due to social media. Few employees deliberately seek to damage their employer and for those who do, they will find a way irrespective of social media. Perhaps comfortingly, we have heard many anecdotes that the strongest response to inappropriate employee comments in social media come from affronted fellow employees.

In relation to cost, for consumer businesses in particular, if the majority of your customers are spending significant time in a forum in which you are not present, surely the only question

is why are you not there? Social media is now a strong sphere of influence and a high proportion of consumers now use social media to inform their purchasing choices. Nonetheless, if you are unconvinced of revenue potential, set your organisation the challenge to enter social media on a cost neutral basis.

Before actively engaging in social media, we suggest two key actions. Firstly, secure your real estate, that is, ensure that your key brand and product names in all the major networks and platforms are reserved to your organisation. Secondly, spend some time listening to what is being said about your business in social media. This may be simultaneously surprising, uplifting and confronting. Above all it will be educational.

For business-to-business organisations, there are a range of areas where social media is relevant:

- Monitoring key suppliers who claim to have ethical work practices, for example conditions in third world factories.
- Reputational checking of companies, their directors and management as part of due diligence in an acquisition or major tender.
- Monitoring general sentiment that could impact your share price, or helping to minimise the premium on some insurances for example, D&O.

While we are still in the early dawn of social media for both businesses and individuals, some pertinent lessons



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from those who have been using social media for several years include the following:

- It is ok to start slowly and without a comprehensive social media strategy in place from day 1.
- Policies are appropriate, but they should guide, not throttle, conversations.
- Be led by your audience – they will guide you on what constitutes value to them so actively listen and respond accordingly
- Mistakes will happen – it is how you respond that matters. Be open, human and truthful.

If you remain a sceptic, ask yourself how your business would function today without mobile phones or the internet. Then, consider these questions for your senior management:

- Do we know what our major competitors are doing?
- Do we know what is being said about our organisation and brand in social media?
- Where could we trim costs modestly to enable early social media engagement on a cost neutral basis? Examples include old media advertising, a passive non-revenue earning website or traditional backward-looking research.
- Most critically – what are the risks to our organisation of not being in social media?

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