

Deloitte Review

ISSUE 10 | 2012

Complimentary article reprint



Integrated Reporting: **THE NEW BIG PICTURE**

BY NICK MAIN AND ERIC HESPENHEIDE
> INFOGRAPHICS BY JANKO WILLIAMS

Deloitte.

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

This publication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or its and their affiliates are, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your finances or your business. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser.

None of Deloitte Touche Tohmatsu Limited, its member firms, or its and their respective affiliates shall be responsible for any loss whatsoever sustained by any person who relies on this publication.

Copyright 2012 Deloitte Development LLC. All rights reserved.
Member of Deloitte Touche Tohmatsu Limited



Integrated Reporting: THE NEW BIG PICTURE

BY NICK MAIN AND ERIC HESPENHEIDE

> INFOGRAPHICS BY JANKO WILLIAMS

At first blush integrated reporting may sound like a topic solely for accountants. In concept it includes systems to record data, the inclusion and valuation of assets and liabilities and the presentation of complex information according to a set of standards—all of which may sound familiar. But integrated reporting as defined by the International Integrated Reporting Committee aims to incorporate everything from strategy to risk management, from financial reporting to the inclusion of other capitals (think societal and environmental impacts). It aspires to meet the needs of a wider group of stakeholders—e.g., investors, employees and Non-Governmental Organizations (NGOs). And it intends to interlink these elements in a way that makes their interdependencies clear. Everyone in an organization, not just the accountants, is likely to be touched by integrated reporting.

The potential importance extends beyond a reconstitution of traditional corporate reports. Corporate reports—whose growing sophistication and range have been a reflection of the development of the global economy over the past two centuries—are in some sense the rulebook that investors and society at large use to “keep score.” Change the rulebook and you will almost certainly change the game. The movement toward integrated reporting potentially represents the most significant change to the rulebook that we will have seen in years.

YOU DON’T KNOW WHAT YOU’RE MISSING (REALLY)

Financial statements are becoming increasingly long and complex with vast tomes of technical detail, requiring a high level of financial expertise to interpret. Complicating matters further, the world has at least two primary sets of standards under which these financial statements are prepared, although a convergence project is underway.

But financial statements are not the end of it. Companies produce an increasing array of reports not necessarily linked to the financial statements. Governance issues including executive pay are sometimes reported on, as well as at least some of the impacts of the business on society and the environment. But these are often reported to different audiences, in different formats and at different times. In this context, the idea of simplifying all the reporting under a consistent banner—integrated reporting—is very attractive. Note that integrated reporting is a more comprehensive concept than just an integrated report (see inset below).

INTEGRATED REPORTING DEFINED

According to the International Integrated Reporting Committee, integrated reporting combines the different strands of reporting (financial, management commentary, governance and remuneration, and sustainability reporting) into a coherent whole that explains an organization’s ability to create and sustain value. The main output of integrated reporting is an integrated report; a single report that the IIRC anticipates will become an organization’s primary report.¹



Beyond the financial reporting complexity issues noted above, there is the reality that the tangible assets included in financial statements reflect a steadily diminishing component of shareholder value. Since 1983, when tangible assets represented 83 percent of market value, to 2009, when they represented only 19 percent, there has clearly been a change in business models that may not be fully reflected in traditional financial statements.² Current financial statements often do not include the “true” value of inputs from, or reliance on, natural capital and other forms of capital. Conditions are ripe for new ideas.

The two organizations at the forefront of the development of new ideas regarding integrated reporting are:

The Integrated Reporting Committee of South Africa (IRCSA), which, under the chairmanship of Professor Mervyn King, produced a report built on a pronouncement on corporate governance in South Africa (King III), which proposed that integrated reports become the preferred form of corporate reporting.

The International Integrated Reporting Committee (IIRC), which was formed in 2010 under the aegis of the Prince of Wales Accounting for Sustainability Project and the Global Reporting Initiative. In addition to business executives and investors, representatives from the major accounting bodies, standards setters and security regulators sit on this committee.

THE BASIC IDEA

Integrated reporting is a process, not a product: The report periodically delivered to stakeholders is an output of an extensive underlying effort that precedes it. Reporting on an organization’s current state and future prospects requires a comprehensive understanding of the strategies being adopted, the risks the organization is facing, the opportunities it is pursuing, details of its operations, its impact on the environment and the wider society, and more.

The complexity sounds daunting, and for some good reasons, as we will describe. The processes and the products of integrated reporting are intended to provide benefits to both the company and its stakeholders. For the company, an important value lies in the preparation—the selection of metrics, the scrutiny and analysis of the business impacts and risks, the resultant insights and the subsequent adjustments to operations and even strategy. According to Novo Nordisk,

“... the primary benefit of integrated reporting is that it allows a company to better understand, manage and report on multiple dimensions of value. We believe this can help companies make better decisions and to manage businesses in a way that creates shared value.”³



Additionally, a properly designed set of performance measures reported on as part of regular management processes gives the incentive and ability to improve performance. For the stakeholder, the report is intended to increase the understanding of the company—its management, strategy and operations, and its perils and prospects.

In the end, integrated reporting, when executed with requisite rigor, can allow both the company and its stakeholders to make better-informed decisions. It has been suggested that the integrated report will become an organization's primary report, which links in with various supporting, more detailed, reports.

No single, agreed-upon definition yet exists for an “integrated report.” However, there are two representative interpretations:

According to the IRCSA:

An integrated report tells the overall story of the organization. It is a report to stakeholders on the strategy, performance and activities of the organization in a manner that allows stakeholders to assess the ability of the organization to create and sustain value over the short, medium and long term. An effective integrated report reflects an appreciation that the organization's ability to create and sustain value is based on financial, social, economic and environmental systems and by the quality of its relationships with its stakeholders. The integrated report should be written in clear and understandable language in order for it to be a useful resource for stakeholders.⁴

According to the IIRC:

Integrated Reporting brings together the material information about an organization's strategy, governance, performance and prospects in a way that reflects the commercial, social and environmental context within which it operates. It provides a clear and concise representation of how an organization demonstrates stewardship and how it creates value, now and in the future. Integrated Reporting combines the most material elements of information currently reported in separate reporting strands (financial, management commentary, governance and remuneration, and sustainability) in a coherent whole, and importantly:

- *Shows the connectivity between them; and*
- *Explains how they affect the ability of an organization to create and sustain value in the short, medium and long term.*

So the idea is deceptively simple. Integrated reporting is designed to collate all the relevant data about an organization's strategy, risks and opportunities,

risk management, environmental and societal impacts and financial data and results. Organizations could use this data to create a report or reports that are transparent, focused on value creation in the long term as well as short-term profitability, and explain how all these elements form a coherent whole.

Before integrated reporting becomes a reality, however, much work needs to be done to develop frameworks, standards and measurements, among other issues.

HOW DOES INTEGRATED REPORTING RELATE TO OTHER REPORTING FRAMEWORKS?

The thinking behind the integrated reporting approach is somewhat different than the thinking behind the development of existing reporting frameworks and standards. Again, according to the IIRC:

Integrated Reporting reflects what can be called “integrated thinking”—application of the collective mind of those charged with governance (the board of directors or equivalent), and the ability of management, to monitor, manage and communicate the full complexity of the value-creation process, and how this contributes to success over time. It will increasingly be through this process of “integrated thinking” that organizations are able to create and sustain value. The effective communication of this process can help investors, and other stakeholders, to understand not only an organization’s past and current performance, but also its future resilience.⁵

Integrated reporting is likely to draw on existing financial reporting measurement standards, which will continue to be the basis for the measurement of the existing use of and returns on financial capital—possibly in a globally converged model.

Environmental and societal impact reporting standards, however, are less well developed. An early incarnation, environmental reporting, took hold in the 1980s for a variety of reasons: Some companies were driven by progressive environmental practices; others may simply have wished to portray themselves in that manner; and many others were likely spurred by litigation—or the threat of litigation—that surrounded industrial waste sites, environmental disasters and the like. Early efforts were mostly sporadic and fragmented, such as inserting brief sections on environmental issues into annual reports, with no linkage to strategy or performance and no attempt to obtain independent assurance.

A decade later, as reports were broadened to include other social issues, they became known as corporate social responsibility, citizenship or sustainability reports. In both their earlier and later forms, these reports were often published separately from financial reports.

Standardization, however, remains elusive. The closest thing to a uniform sustainability reporting framework is the Sustainability Reporting Guidelines (GRI Guidelines) by the Global Reporting Initiative (GRI), which is a sustainability reporting framework widely used around the world.⁶ The GRI Guidelines document was a response to a somewhat free-form reporting in corporate social responsibility reports and established a framework of appropriate disclosures for various environment, social and governance indicators. In more recent years this has extended to industry-specific requirements. The GRI Guidelines are a voluntary standard and lack any regulatory mandate.

According to the GRI, more than 4,000 professionals around the world have been trained in the use of the GRI Guidelines, which are available in 25 languages. Yet despite this progress, out of more than the estimated 63,000 multinational corporations around the world, only a fraction produces sustainability reports.⁷ The Corporate Register, a UK-based organization collecting reports from all regions, sectors and companies of all sizes, states that more than 4,700 sustainability reports were issued in 2010, up from approximately 3,200 in 2007.⁸ At the GRI's website, fewer than 2,000 reports explicitly stating that they were created using the GRI Guidelines were registered in 2010.

Viewed in context, this pace of adoption may not be as slow as it seems. Consider that financial reporting has struggled to adopt a global uniform framework for nearly 100 years. Despite the small overall numbers, the uptake of sustainability reporting has been exponential, with a dampened but still aggressive growth rate during the global financial crisis.

Beyond the GRI Guidelines a proliferation of competing sustainability-related frameworks, principles, codes and management systems has arisen. The list includes AccountAbility's AA1000 principles for managing and reporting sustainability performance; the Connected Reporting Framework; Social Accountability International's SA8000 for managing labor practices; International Standards Organization's ISO26000 on sustainability management; the Greenhouse Gas Protocol; and many more. Add in a regulatory patchwork—the US Security and Exchange Commission's Management Discussion and Analysis (MD&A) disclosure rules; the UK's Enhanced Business Review requirements; the EU's Modernization Directive 2003 (now adopted by all member states) to include nonfinancial key performance indicators in the annual report; Australia's National Greenhouse and Energy Reporting requirements—and there's little wonder that some organizations are unsure of where to turn.

But if integrated reporting is a framework for putting together a balanced view of the organization, integrating inputs regulated or created by other frameworks and standards, where are the gaps?

The most obvious appears to be in environmental reporting. As we have noted, the GRI Guidelines may be the premiere framework for corporate responsibility reporting, but they are completely voluntary. Standards on reporting greenhouse gas emissions are also voluntary, while standards for measuring and disclosing water use and water impacts are both voluntary and emerging. The thinking about standards and measurement techniques for areas such as ecosystem services consumed by business has only just started.

Moreover, some information about strategy and environmental and societal impacts cannot be reduced to financial metrics. Much of this will be disclosed as narrative or nonfinancial performance indicators; developing standards for measuring and reporting these impacts will be yet another challenge.

WHAT MIGHT AN INTEGRATED REPORT LOOK LIKE?

To help generate discussion to guide the development of the International Integrated Reporting Framework, the IIRC has published in its discussion paper a series of principles and content elements for preparing an integrated report.

The elements of an integrated report as suggested by the IIRC in the discussion paper are:

Organizational overview and business model: What does the organization do, and how does it create and sustain value in the short, medium and long term?

Operating context, including risks and opportunities: What are the circumstances under which the organization operates, including the key resources and relationships on which it depends and the key risks and opportunities that it faces?

Strategic objectives and strategies to achieve those objectives: Where does the organization want to go, and how is it going to get there?

Governance and remuneration: What is the organization's governance structure, and how does governance support the strategic objectives of the organization and relate to the organization's approach to remuneration?

Performance: How has the organization performed against its strategic objectives and related strategies?

Future outlook: What opportunities, challenges and uncertainties is the organization likely to encounter in achieving its strategic objectives, and what are the resulting implications for its strategies and future performance?⁹

While many of these components should be familiar, the business model element deserves some discussion as it introduces the concept of how the business creates and sustains value in the short, medium and long term and the businesses' interaction with external factors, its relationships and use of resources. In doing so this element considers six capitals that the business may use: financial, manufactured, human, intellectual, natural and social.

These are defined thus:

Financial capital: the pool of funds available to the organization

Manufactured capital: manufactured physical objects, as distinct from natural physical objects

Human capital: people's skills and experience, and their motivations to innovate

Intellectual capital: intangibles that provide competitive advantage

Natural capital: includes water, land, minerals and forests; and biodiversity and ecosystem health

Social capital: the institutions and relationships established within and between each community, group of stakeholders and other networks to enhance individual and collective well-being; includes an organization's social license to operate¹⁰

Integrated reporting, then, will include a lot more information about how the entity fits within the environment and society and how it creates long-term value. The focus will move from being merely concerned with reporting the past in financial terms to considering the past and short-, medium- and long-term futures in a connected strategic manner. It will be tailored to the reporting entity's specific circumstances and likely have a greater degree of transparency.

The IIRC has issued a set of guiding principles underpinning the preparation of an integrated report:

Strategic focus: An Integrated Report provides insight into the organization's strategic objectives, and how those objectives relate to its ability to create and sustain value over time and the resources and relationships on which the organization depends.

Connectivity of information: An Integrated Report shows the connections between the different components of the organization's business model, external factors that affect the organization, and the various resources and relationships on which the organization and its performance depend.

Future orientation: An Integrated Report includes management’s expectations about the future, as well as other information to help report users understand and assess the organization’s prospects and the uncertainties it faces.

Responsiveness and stakeholder inclusiveness: An Integrated Report provides insight into the organization’s relationships with its key stakeholders and how and to what extent the organization understands, takes into account and responds to their needs.

Conciseness, reliability and materiality: An Integrated Report provides concise, reliable information that is material to assessing the organization’s ability to create and sustain value in the short, medium and long term.¹¹

Given the numerous elements that integrated reporting includes one can’t help thinking that conciseness may be one of the biggest challenges.

THE DEVIL WILL BE IN THE DETAIL

Many issues may arise as the integrated reporting framework is developed. The IIRC is starting a number of pilots with businesses to support them as they go about producing integrated reports. These pilots are expected to identify areas where more work is needed.

Some likely issues that we see will need to be addressed are:

Ecosystem and natural capital: As pointed out earlier there are no standards for evaluating the value of natural capital or ecosystem services consumed by a business. While valuing an ecosystem may be possible at a macro level, allocating between consuming entities is much harder. For many of these natural capital



assets and services there is no market price. The value of many is context-specific. For example, the value of water use in a water-stressed area is higher than in an area of water abundance. And that true value may not be reflected in any market price—if such a price exists.

Future orientation: One of the key changes that will be effected by integrated reporting is a move from merely reporting historic financial results to a focus on the longer-term viability of the entity. However any material purporting to provide information about the future prospects and profitability of the entity is normally regulated and risky for directors and others involved. No one can predict the future—forecasts are inevitably wrong at some level of detail and are dependent on assumptions about the future. Management is likely to have the best information available to make such predictions but needs to be protected from the consequences of undue reliance by investors.

Safe harbor provisions may be needed to allow future-oriented disclosures to happen.

Materiality: Another principle is that material information should be made available. There are frameworks for determining what materiality means for financial data—both on a quantitative and a qualitative basis. But what does it mean for nonfinancial data?

Stakeholders: And material for whom? For what stakeholders are the data being produced? Who has a legitimate claim for access to this information?

Confidentiality: The information in an integrated report is likely of far greater strategic significance than that in a set of standard historic financial statements. What is the right balance between disclosure and loss of competitive edge?

KPIs: Failing to focus on the material aspects of performance, or choosing the wrong key performance indicators (KPIs) and key risk indicators (KRIs), can lead to wasted efforts and loss of credibility. If an organization focuses on metrics that are immaterial to its business model, if excessive or superfluous data predominates, the report may be confusing and—if it proves irrelevant to the majority of stakeholders' needs—ultimately useless. The threshold for reporting on a particular metric will vary for each company, including factors such as its industry, stakeholder demands, regulatory mandates, profitability, the markets it operates in and its brand and product strategy.

Fortunately, many organizations will not need to start the process from scratch. A variety of KPIs and KRIs are already available and can be drawn upon for integrated reporting. Existing functions, including risk management, internal audit, compliance and legal can be tapped for their expertise. Some combination of these groups will exist in many organizations, and they will likely have identified,

catalogued, measured, monitored and mitigated a host of relevant performance and risk indicators that can form the basis for integrated reporting.

Audit: Clearly auditing integrated reports is consistent with the need for greater reliability as well as encouraging consistency. However, there is less experience in the provision of external assurance for users of nonfinancial data than there is for the audit of financial data, which has decades of development behind it. The business processes producing this information are likely to be less sophisticated and robust than those producing financial data. What about forward looking or strategic data? What, if any, assurance reporting will be needed or could be provided there?

LEADING PRACTICES

While a growing number of companies do engage in some form of integrated reporting (as they have defined it), virtually all do so on a voluntary basis that yields variances in format and scope, thereby limiting comparability and usefulness.

Only one country has mandated comprehensive, fully integrated reporting to date: South Africa, where listed companies must abide by the King III Code on Corporate Governance by providing an annual integrated report in addition to audited financial and sustainability reports (or explain why they are not providing the report).

In line with the expectation that integrated reporting should be a journey that South African companies have been encouraged to embark on from March 2011 onwards, analysis of the South African experience to date has not revealed any comprehensive examples of an integrated report. Deloitte South Africa recently carried out a high-level analysis of listed company reporting practices and concluded that, on average, companies are less than half way along the journey toward integrated reporting. Those companies that had embraced the concept of integrated reporting are, however, well progressed and scored between 60 and 75 percent against the Deloitte South Africa criteria.¹²

WHAT DOES THE FUTURE HOLD?

Just as most of the world has moved steadily toward the adoption of International Financial Reporting Standards, the progression toward a single, global, common framework for integrated reporting seems all but inevitable. Less clear, however, is the timing of adoption, which may be affected by a variety of economic, political, social and other factors.

Regardless of how the timing plays out, many companies are putting integrated reporting on their agendas now, as the benefits of being ahead of the curve

may be significant. One such benefit may be marketplace advantage, where organizations that report on the full spectrum of issues may be seen as more advanced than those that restrict their reporting to traditional financial information and limited mandated disclosures. The information disclosed through integrated reporting may provide additional input to sway investors, influence customers and attract business partners. Additionally, uniform integrated reporting of an entity's financial and nonfinancial performance would likely yield comparable information for global companies, allowing benchmarking and evaluation activities that are not currently possible.

Additional potential benefits of a strong engagement with integrated reporting include:

- Improved ability to identify and respond successfully to opportunities, risks and changes in the business environment through a focus on longer-term business impacts
- More readily apparent linkage between environmental, social and governance performance and financial performance
- Better linkage of overall performance and executive compensation
- Competitive advantage through cost savings, operational efficiencies, brand differentiation and innovation (e.g., new product development)
- Improved stakeholder relations by better addressing their needs and managing their expectations
- Improved compliance with existing and pending regulations and corporate governance requirements
- Improved credibility with key stakeholders through transparent and independently assured integrated reporting
- Alignment and simplification of internal and external reporting for consistency and efficiency

ACT NOW ... OR NOT?

This is an early stage in what is likely to be a far-reaching process, and becoming engaged now may pay dividends not just in preparedness but also in influencing the outcome. At a minimum, keeping up to date with developments at the IIRC could serve a company well as integrated reporting becomes more fully defined in the years to come. In addition there is an opportunity to engage in the debate and help shape how integrated reporting evolves.

Of course engagement at this level entails some costs, and companies may elect to observe from the sidelines as the standards and frameworks are developed. But there can be another reason to become engaged. Evolution of this reporting framework is responding to the changing expectations not just of disclosure but also of businesses’ wider responsibilities in society. Participating in the exercise may lead businesses to re-examine the risks and opportunities in this new environment and the metrics used to manage the business. In short, it may end up being transformational not just for reporting but for the entire business strategy. **DR**

***Nick Main** the chief sustainability officer for Deloitte Touche Tohmatsu Limited (DTTL) and the global leader of DTTL’s Sustainability and Climate Change group. He is a member of the supervisory board of the Prince’s Accounting for Sustainability Project and the Advisory Board for the Cambridge Programme for Sustainability Leadership.*

***Eric Hespenbeide** is a partner with Deloitte & Touche LLP and serves as a global leader in DTTL’s Sustainability and Climate Change group within Audit and Enterprise Risk Services. He represents DTTL in various forums such as the Liaison Delegate to the World Business Council for Sustainable Development and is DTTL’s organizational stakeholder at the Global Reporting Initiative. In addition, he is a member of the Working Group of the International Integrated Reporting Committee.*

Endnotes

1. International Integrated Reporting Committee, <www.theiirc.org/about>

2. Ocean Tomo (2010), “Ocean Tomo’s Intangible Asset Market Value Study”

3. <http://novonordisk.com/sustainability/news/2011-09-Novo-Nordisk-supports-global-dialogue-on-integrated-reporting.asp>

4. Discussion Paper by the Integrated Reporting Committee (IRC) of South Africa. <www.sustainabilitysa.org>

5. <http://www.theiirc.org/the-integrated-reporting-discussion-paper>

6. <http://www.globalreporting.org/AboutGRI/WhatIsGRI/>

7. According to a source at Bloomberg LP (which provides news on publicly traded companies to the financial sector), there are about 63,000 publicly traded companies.
<http://wiki.answers.com/Q/How_many_publicly_traded_companies_are_in_the_US_and_the_world#ixzz1c1T4XniC>

8. <http://www.corporateregister.com>

9. <http://www.theiirc.org/the-integrated-reporting-discussion-paper>

10. IIRC discussion paper <http://www.theiirc.org/the-integrated-reporting-discussion-paper>

11. Ibid.

12. The analysis covered seven subjects, 58 principles and 160 questions seeking to measure actual performance against best practice. <deloittesa.wordpress.com/tag/integrated-reporting/>