

Blickpunkt: Integrated Reporting

Integrated reporting: if not now, when?

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The core concept underlying the term “integrated reporting” is providing one report that fully integrates a company’s financial and non-financial (including environmental, social, governance, and intangibles) information. However, integrated reporting is far more than simply combining a financial report and a sustainability report into a single document. The article focuses on the benefits of this forthcoming trend in corporate reporting.

1. The idea in brief

An integrated report enables the reader to better understand the cause and effect relationships between, for example, financial and sustainability performance. Integrated reporting serves as a **platform to furnish more detailed data** than what is available only in a paper or PDF report. Integrated reporting also leverages the Internet and Web 2.0 tools and technologies, such as Wikis, blogs, podcasts and forums, in a way that facilitates the readers’ ability not only to perform their own analysis of financial and non-financial information, but also to communicate their thoughts and opinions with other stakeholders.

Business models and corporate decision-making should reflect an inherent understanding of the complex relationships between the economic, governance, environmental, and social issues.

Finally, integrated reporting is a **management tool**. Companies operate in a multi-dimensional world, the global economy, the environment, and the society on which business relies to create value. In the 21st Century, business models and corporate decision-making should reflect an inherent understanding of the complex relationships between the economic, governance, environmental, and social issues. Success, defined in this article as the ability to simultaneously **create value for shareholders and society**, will belong to organizations that

have learned to balance the imperative for long-term viability¹ – of the company and the world it relies on to create economic value – with the demands for short-term competitiveness and profitability.

2. The forces of change

The effects of the 2008 financial crisis and the subsequent global recession directly or indirectly touched people and institutions throughout the world. People lost homes to foreclosure; government deficits and debt reached unprecedented levels; unemployment soared; many businesses filed for bankruptcy; and some governments introduced harsh austerity measures. One residual effect of yet another financial crisis is the shaken public trust in governments, markets, and business, which inhibits recovery. The problems created by the crisis and lingering economic uncertainty are compounded by the potential effects of climate change, water shortages, depletion of natural resources, and human rights violations on businesses and society.

2.1. The economic challenge

Academics, economists, and historians will analyze the causes of **the 2008 financial crisis** for years to come. As demonstrated by the U.S. Financial Cri-

¹ “Viability” is defined as “capable of working successfully; capable of surviving”, New Oxford American Dictionary, April 2005.

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- sustainability
- financial crisis

sis Inquiry Commission², consensus will not be easily achieved. Even though agreement on the primary drivers of the crisis remains elusive, regulatory reforms were initiated around the world. However, an October 2010 report by the IBM Institute for Business Value argues, "... these reforms have yet to fundamentally resolve structural tensions in the system."³

The delicate balance between reform initiatives, financial innovation, and economic growth is beyond the scope of this article. Integrated reporting, because of its focus on transparency, should be considered a critical **element of market reform**. Transparency has been defined as, "accessibility of information to stakeholders of institutions regarding matters that might affect their interests."⁴

Transparency in reporting is an important vehicle for rebuilding public trust. Reporting provides insights into how a company views itself and its role in society. It communicates a company's performance, both good and bad. It creates commitments to improve future performance and establishes accountability for meeting objectives. In addition to the traditional measures of business performance, integrated reporting focuses on the business implications of sustainability issues such as carbon emissions and usage of water and other resources, including human capital and intangible assets. Integrated reporting should be viewed as part of a broader reform agenda to underpin financial stability.

Integrated reporting, because of its focus on transparency, should be considered a critical element of market reform.

In a February 2011 speech, *Hans Hoogervorst*, future Chairman of the International Accounting Standards Board, captured the essence of **the relationship between transparency and stability**.

"The second hotly debated question is whether the purpose of financial reporting should primarily be to provide transparency, or that it should also serve the goal of stability. In this debate, transparency and stability are often juxtaposed as if they were conflicting goals. I think this is essentially a false contradiction. In my view, it is clear that transparency is a necessary

precondition of stability. The current credit crisis has, to a large extent, been caused by a lack of transparency in the financial markets. Huge risks were allowed to build up on and off balance sheet without being noticed. Without proper transparency about risks, stability is bound to collapse in the end. Stability is not the same as transparency, but there can be no durable stability without transparency."⁵

The nascent practice of integrated reporting will enable stakeholders to fully evaluate the economic, environmental, and social performance of a business thereby facilitating a more effective assessment of a company's ability to create value over the long-term. In this way, integrated reporting forms one of the cornerstones of corporate accountability and trustworthy markets.

2.2. The environmental challenge

Environmental challenges pose threats to, among others, business operations, employees, and supply chains.

Example:

Rising sea levels might interrupt the normal flow of materials from suppliers and people may be forced to flee coastal cities. In addition, declining availability of fresh water threatens human population and business operations by decreasing food production and increasing the risk of political instability.

The overarching question is: do business leaders view the environmental challenge as a risk or as an opportunity? The processes required to publish a truly integrated report will provide management and boards of directors with the tools necessary to understand **the dependencies between financial and non-financial performance** and answer the questions around the environmental challenge.

2.2.1. Climate change

Climate change is one of the most complicated issues facing society. Some business executives may see environmental matters in solely terms of risk avoidance. Their focus is on monitoring and mitigating risks that might expose the company to liabilities for bodily injury, property damage, cost of removal,

and punitive damages. Others, such as the executives of Novo Nordisk, a Danish pharmaceutical company, believe that "...taking early and voluntary steps to reduce our carbon footprint is long-term risk mitigation as well as an act of corporate responsibility. Combining the two is sound business. [Climate change] is an unprecedented opportunity to start a virtuous circle of sustainable innovation and value creation for a brighter, more prosperous and healthier future."⁶

Siemens AG, a global electronics and electrical engineering company, also demonstrates a deep understanding of the **benefits resulting from an integrated approach to strategic thinking**. The company's Environmental Portfolio⁷ describes how energy-efficient solutions benefit customers, future generations, and the company. In fact, in fiscal year 2010, the Siemens Environmental Portfolio generated revenue of about €28 billion.

2.2.2. Water scarcity

The **declining availability of fresh water** has broad economic and societal implications. According to the United States Geological Survey, the High Plains aquifer, which underlies parts of eight states, has been overused for irrigation. "Water levels have declined more than 100 feet in some areas and the saturated thickness has been reduced by

² "Financial Crisis Inquiry Commission (FCIC) website hosted by Stanford University's Rock Center for Corporate Governance," accessed April 11, 2011, <http://fcic.law.stanford.edu/>

³ IBM Institute for Business Value, "The yin yang of financial reform: Embracing maxims to enable financial stability and healthy financial innovation", October 2010.

⁴ *Tapscott, Don* and *David Ticoll*, *The Naked Corporation: How the Age of Transparency Will Revolutionize Business*. New York: Free Press, 2003.

⁵ *Hans Hoogervorst*, "The Objectives of Financial Reporting", Conference organized by the European Commission, Financial Reporting and Auditing: A time for change?, Brussels, February 9, 2011. See also IRZ 4/2011, p. 165–169.

⁶ *Blueprint for change: the climate change challenge*, Novo Nordisk, April 2010.

⁷ "The Siemens Environmental Portfolio", Siemens AG, accessed April 11, 2010, <http://www.siemens.com/sustainability/en/environment/portfolio/index.htm>

more than half in others.”⁸ Also, a 2009 World Bank report states that China, as a whole, will join the group of water-stressed countries. “The combined impact of the widening gap between water demand and limited supplies and the deteriorating water quality caused by widespread pollution suggests that a severe water scarcity crisis is emerging.”⁹ Diminished availability of water threatens the operations of many businesses ranging from food and beverage companies to automobile manufacturers and chemical companies.

2.3. The societal challenge

The interests of shareholders and other stakeholders are neither completely aligned, nor in total opposition. Companies realize that the value of their brand and reputation can be effected by the working conditions of both employees and workers in their supply chain; relationships with the communities where plants and other facilities are located; and the structure of compensation plans.

2.3.1. Human rights

Approximately 270 companies¹⁰ have published policy statements with explicit linkage to **human rights**. Pfizer, a pharmaceutical company, makes a promise “to advance human rights by working to improve the health of people around the world through access to medicines and strengthening health care systems for underserved people.” The chemical company BASF publishes their responsibilities as a global employer on their website.¹¹ The company expresses a commitment to

(1) comply with effective law and in countries where either resources or political will are lacking, to implement and enforce applicable law;

(2) strictly uphold the ILO core labor standards and – when those principles are prohibited by national law – to develop approaches that adhere to the principles underlying the internationally recognized standards; and

(3) implement the internationally recognized labor and social standards to the fullest extent, with a goal of reconciling the economic and social dimension of sustainability.

Human rights issues take on another dimension in the context of the Internet and a digital world. Human Rights

Watch said Google’s “decision to stop censoring its Chinese search engine is a strong step in favor of freedom of expression and information, and an indictment of the Chinese government’s insistence on censorship of the internet.”¹²

2.3.2. Governance

If companies are to rebuild public trust, then it will be necessary to not only acknowledge the inseparable bond between governance, appetite for risk, and compensation, but also to leverage those relationships **to drive behavior**. The linkages within this “behavioral triangle”¹³ go beyond the abstract ‘tone at the top.’ In other words, compensation structures within an organization must balance the imperative for long-term viability – of both the entity itself and the world it relies on to create economic value – with the demands for short-term competitiveness and profitability.

2.4. Relevant legislation and regulation

Government legislative and regulatory bodies are actively addressing concerns about various aspects of corporate responsibility. Businesses that fail to see opportunities in environmental and social issues may find that changing regulations threaten their competitive position and capacity to efficiently conduct business. Legislative and regulatory mandates for **corporate social responsibility reporting** include:¹⁴

- Argentina – the Buenos Aires City Council passed Law 2598 in 2008, requiring all companies with at least 300 employees to prepare annual sustainability reports, complying at a minimum with the Ethos Principles, but encouraging companies to use the Global Reporting Initiative’s G3 Guidelines when preparing their reports;
- Denmark – The Danish Commerce and Companies Agency acted in 2009 to require the country’s 1000 largest businesses, as well as state-owned companies and institutional investors, to state in their annual reviews whether they have corporate responsibility policies, and if they do, what they are and how they implement them;
- Malaysia – In 2007, the Prime Minister of Malaysia announced that all companies listed on Bursa Malaysia

(the Malaysian stock exchange) would be required to disclose information on corporate social responsibility activities in their annual financial reports;

- South Africa – Based on the King Code of Governance for South Africa 2009, the Johannesburg Stock Exchange listing requirements were amended to require listed companies to issue an integrated report for financial years starting on or after March 1, 2010, or to explain why they are not doing so;
- Sweden – The Swedish government announced in late 2007 that all 55 fully or partially state-owned companies must produce annual sustainability reports in accordance with the Global Reporting Initiative’s G3 Guidelines.

There have also been **recent actions by G20 countries**. In 2008, the China State-Owned Assets Supervision and Administration Commission published a directive that strongly encourages state-owned enterprises to follow sound CSR practices and report on their CSR activities. In 2010, the United States Securities and Exchange Commission published an interpretive release, *Commission Guidance Regarding Disclosure Related to Climate Change*, which provides guidance on how to apply existing regulations regarding climate change and greenhouse gas emissions disclosures. Finally, the Grenelles II legislation in

⁸ “Groundwater depletion”, United States Geological Survey, accessed April 11, 2011, <http://ga.water.usgs.gov/edu/gwdepletion.html>

⁹ Addressing China’s Water Scarcity: Recommendations for Selected Water Resource Management Issues. World Bank, 2009.

¹⁰ “Company policy statements on human rights”, Business & Human Rights Resource Center, accessed April 11, 2011, <http://www.business-humanrights.org/Documents/Policies>.

¹¹ “Human Rights and Labor and Social Standards in the BASF Group”, BASF, accessed April 11, 2011, <http://www.basf.com/group/corporate/en/sustainability/employees/human-rights/index>

¹² “China: Google decision Shows Government Intransigence”, Human Rights Watch, accessed April 11, 2011, <http://www.hrw.org/en/news/2010/03/22/china-google-withdrawal-shows-government-intransigence>

¹³ What does your reporting say about you? PricewaterhouseCoopers, March 2010.

¹⁴ Lydenberg, Steve and Katie Grace, Innovations in Social and Environmental Disclosure Outside the United States. Prepared for Domini Social Investments, November 2008.

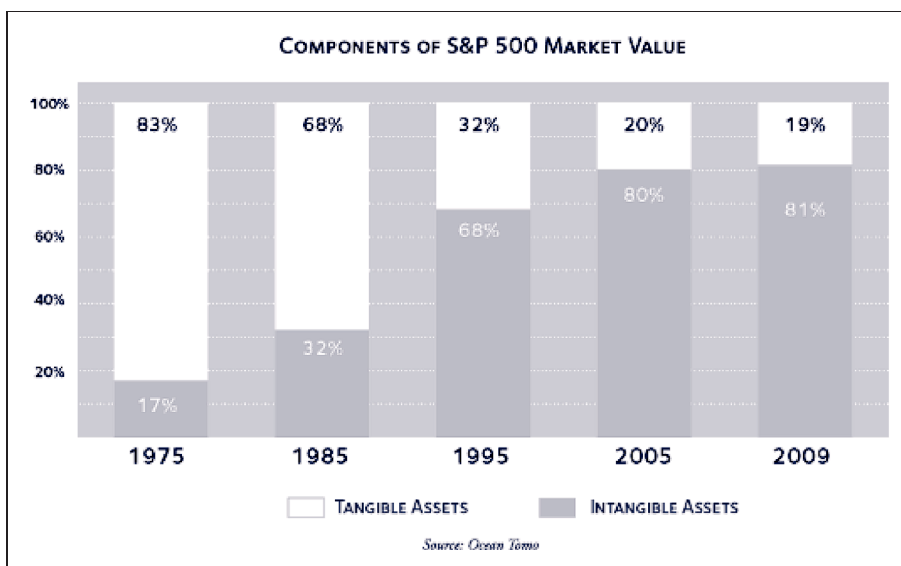


Chart 1: Components of S&P 500 Market Value

France requires all companies, listed and private, with more than 500 employees to provide non-financial information (to be covered by an assurance report) in their annual report beginning in 2012.

Companies that have already started their journey towards integrated reporting in anticipation of regulatory requirements will have a robust platform on which they can build and meet new or changing environmental or even integrated reporting requirements. Those companies that have done nothing to prepare for integrated reporting will have to rush to meet any requirements, resulting in higher costs, lower quality, and fewer benefits.

3. Why integrated reporting matters

Increasing use of the expression “integrated reporting” is a mixed blessing. The term accurately describes a core concept – the integration of a traditional annual report and a sustainability report into a single document. However, the words “integrated reporting” completely fail to convey the reality that integrated strategic thinking is fundamental to a company’s ability to publish a truly integrated report. Companies operate in a multi-dimensional world, the global economy, the environment, and the society on which business relies to create value. Corporate reporting and, more importantly, decision-making, must reflect this reality.

Notwithstanding current economic uncertainty, a recent study by the MIT Sloan

Management Review and The Boston Consulting Group finds many companies consider economic, environmental, and societal factors to be inextricably linked.

“While the survey revealed that most companies view sustainability as eventually becoming ‘core,’ what’s more interesting is the revelation that one camp of businesses – the embracers – is acting on the belief that it is core already. Whereas cautious adopters see the sustainability business case in terms of risk management and efficiency gains, embracer companies see the payoff of sustainability-driven management largely in intangible advantages, process improvements, the ability to innovate and, critically, in the opportunity to grow. And the embracers, it turns out, are the highest performing businesses in the study.”¹⁵

3.1. Corporate reporting today

The current financial reporting model was developed in the 1930’s for an industrial world. In general, the model provides a backwards-looking review of performance and does not provide enough **relevant information for decision-making today**. There is not enough focus on the needs of investors, analysts, and the wider community of stakeholders. In many corporate annual reports, there is little substantive disclosure about strategy, innovation, people, customer loyalty and the business risks related to climate change, water scarcity, and evolving public policy and regulatory issues. Stand-alone sustainability re-

ports suffer their own weaknesses. They fail to connect environmental, social, and governance issues to business strategy and financial performance. As a result, mainstream analysts and investors tend not to use sustainability reports in their evaluation of corporate performance.¹⁶

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3.1.1. Information relevance

To make successful decisions, management, investors, and other stakeholders need **information about value drivers** – the elements of a company’s business that are the sources of its value. These can be measured numerically through key performance indicators or may be qualitative factors such as business opportunities, risks, strategies and plans – all of which permit assessment of the quality and variability of its cash flows and earnings. Research shows that the percentage of an entity’s market value that can be attributed to tangible assets is diminishing. Ocean Tomo, a firm specializing in Intellectual Capital Equity® prepared the two charts, which depict the percentage of **market value attributable to tangible and intangible assets** for the S&P 500 and three non-U.S. markets.¹⁷

3.1.2. Information complexity

Decades of adding ever-increasing and more complex disclosure requirements have produced complex disclosures that are often hard for even the most sophisticated users to understand. Some older requirements may no longer be useful and

¹⁵ Sustainability: The ‘Embracers’ Seize Advantage, MIT Sloan Management Review and The Boston Consulting Group, Winter 2011.

¹⁶ See PricewaterhouseCoopers, Measuring assets and liabilities: Investment professionals’ views, February 2007; Corporate reporting – a time for reflection: A survey of the Fortune Global 500 companies’ narrative reporting, April 2007; Corporate reporting: Is it what investment professionals expect? November 2007; Performance statement: Coming together to shape the future, December 2007.

¹⁷ “Intellectual Capital Equity®”, Ocean Tomo, accessed April 11, 2011, <http://www.oceantomo.com/about/intellectualcapitalequity>

actually obscure with needless and irrelevant detail the important current information a company may be attempting to disclose. In addition, companies are faced with multiple reporting requirements under U.S. GAAP, International Financial Reporting Standards, and national securities regulations. These **redundancies create confusion** and waste both company and investor resources. Integrated reporting per se does not address the issue of complexity. However, integrated reporting should be part of broader regulatory initiatives to rethink the objectives of business reporting and make required disclosures more relevant and useful.

3.1.3. The challenge

The current reporting model does not focus on critical 21st Century issues and lacks an orientation towards the future. Although many people recognize the shortcomings of current financial and sustainability reporting models, this has not translated into wide spread demand for change. Given the cumulative societal cost of past scandals, market bubbles, business failures, and the 2008 financial crisis; can anyone afford to ignore the possibility that a new, more transparent corporate reporting model just might contribute to restoring trust and confidence in business and financial markets?

3.2. The benefits of integrated reporting

Four critical benefits of integrated reporting that correct fundamental problems with today's reporting model follow.

3.2.1. Greater clarity

Very often, companies make sweeping statements about how sustainability is good for shareholders and other stakeholders with little, if any, explanation of why such a statement is true. Implementing a sustainable strategy is not easy – it requires evaluating trade-offs and making difficult decisions that can leave one or more stakeholder groups disappointed, angry, or both. For example, investments in renewal energy or to reduce carbon emissions can ultimately show positive investment returns, but hurt cash flows and dividends in the short term.

At the heart of integrated reporting is **management's ability to coherently describe** the relationships between financial and non-financial information. It

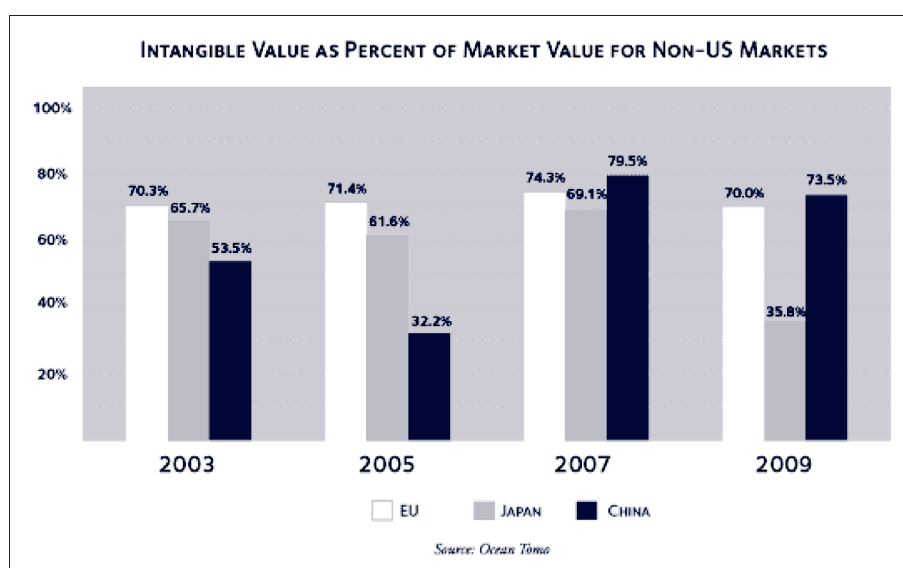


Chart 2: Intangible Value as Percent of Market Value for non-US Markets

may be helpful to think about the relationship between sustainability risks and opportunities in terms of the financial statement line items. Will perceptions about “greener” or more energy efficient products create more customer demand and therefore increase revenues? Will taxes or other regulatory mechanisms to value carbon depress sales? What will be the effect of increasing scarcity of water and other finite resources on cost of goods sold? How much should research and development expenses increase to remain competitive in a given sector? Could a so-called “black swan” event severely damage an otherwise impeccable reputation and depress earnings?

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As a company achieves a better understanding about the relationships between financial and non-financial performance, monitoring and review controls will be improved and systems and business processes will likely see increased efficiencies and effectiveness. These improvements are the foundation for modeling and analysis to reevaluate categories of risks, opportunities, and choices. As management achieves this, its capability to develop and implement sustainable strategies will improve.

3.2.2. Better decisions

Robert Kaplan's and *David Norton's* body of work on the Balanced Scorecard provides rich evidence and thoughtful arguments demonstrating how better information and measurement leads to better decisions. Better-informed decisions about the relationships between financial and non-financial performance will improve the efficient and effective use of capital and other resources.

Management will find, however, that determining the relationship between financial and non-financial outcomes is easier said than done. Just as there is no globally accepted standard for integrated reporting today, companies find that all too often good metrics either do not exist, or are very hard to develop. This difficulty can serve as an **excuse for not doing the hard analytical work** necessary to specify and validate the relationships that are believed to exist. *Christopher Ittner* and *David Larcker* found that less than 25 % of the companies they surveyed¹⁸ actually built and verified cause-and-effect diagrams to identify relationships between for example, corporate governance, tolerance for risk, and executive compensation. However, the better response is to improve poor measurement methodologies and invent new ones for those useful metrics that do not yet exist.

¹⁸ *Ittner, Christopher, and Larcker, David.* “Coming Up Short on Nonfinancial Performance Measurement”, *Harvard Business Review*, v.81, is.11, 2003, p. 91, 89.

It is not easy to implement a sustainable strategy – to eventually demonstrate management’s understanding that business survival demands full consideration of environmental and social issues as much as of economic and financial matters. This **involves significant cultural change** to drive collaboration between accounting, finance, communications, investor relations, public policy, legal and regulatory affairs, sustainability, safety, marketing, and line operations teams. One benefit of this improved collaboration is a better appreciation by each function or unit of the consequences its decisions have on other parts of an organization.

3.2.3. Deeper engagement

Integrated reporting discloses and explains the relationship between the financial, social, environment and governance issues a company faces. Unfortunately, there are severe limitations to presentation when it is communicated only in paper form, making the **use of the Internet central** to this process. In using the Internet, a company supplies stakeholders with more detailed information regarding financial and non-financial outcomes and the relationships between them.

Just as a reader should not think of an integrated report as solely a paper document or PDF file, meaningful engagement is not a focus group or a presentation to analysts. Moreover, the Internet and its associated Web 2.0 tools and technologies make it possible to shift from a one-way push of information to an ongoing dialogue between a company and all of its stakeholders. This means a company’s website should be simple and easy to navigate and permit visitors to perform their own analysis of information provided by the company. In addition, **social media platforms**, discussion forums, blogs, and podcasts are likely to lead to richer stakeholder engagement, including user generated content, comments, and suggestions.

As management develops this deeper engagement process, shareholders will gain a more holistic perspective of a company; realizing that an organization’s ability to earn profits over the long term will

require investments that come at short-term costs. Conversely, NGOs and other stakeholders will learn that companies must make a profit in order to survive and grow, thereby making responsible business initiatives possible.

The Internet, in addition, social media platforms, discussion forums, blogs, and podcasts are likely to lead to richer stakeholder engagement, including user generated content, comments, and suggestions.

3.2.4. Lower reputational risk

Not only integrated reporting is the catalyst for incorporating economic, environmental, financial, and social issues into business strategy, but integrated reporting can also push a company towards more integrated risk management processes.

For example, as corporate social responsibility and sustainability have increased in importance, so has the focus on reputational risk. It is important to be clear about what integrated reporting can, and cannot do. The 2010 oil drilling rig explosion and fire in the Gulf of Mexico was a harsh reminder of the inextricable linkage of governance, strategy, and sustainability. However, it would be absurd to claim that integrated reporting alone could have prevented that disaster. What integrated reporting does is drive a chain of events that can help companies **more effectively focus on risk**. Integrated reporting helps a company understand the effect of its strategic and tactical choices on society because internal and external dialogue ensures that a company’s strategy is attuned to society’s needs as a whole.

A 2010 report by Accenture¹⁹ appears to validate the foregoing assertions about the benefits of integrated reporting. The report finds “that companies that adopt sustainable business strategies and practices drive value by:

- Growing revenue through new products and services
- Reducing costs through efficiency gains

- Managing operational and regulatory risk more effectively
- Building intangible assets such as their brand, reputation and collaborative networks”

4. What’s next?

To be clear, integrated reporting is not about incremental change or tweaking existing reporting requirements – ultimately, it requires a complete revamp of the reporting model and new regulatory requirements. Integrated reporting will accelerate the process of learning how to measure business success in new ways, which is a positive development in the evolution of a more accountable form of capitalism.

The challenge to develop and promote a globally accepted framework for integrated reporting has been accepted by the International Integrated Reporting Committee (the “IIRC”) (www.theiirc.org). This diverse global organization includes “leaders from the corporate, investment, accounting, securities, regulatory, academic and standard-setting sectors as well as civil society”.²⁰ The IIRC is expected to publish a Discussion Paper seeking comments on integrated reporting and their approach to developing a framework in June 2011.

Integrated reporting will be judged on whether its principles and framework drive the development of sustainable business strategies and integrated thinking and decision-making. If successfully implemented around the world, integrated reporting will advance the urgent vision for business to create value for both the company and society, thereby contributing to lasting prosperity on a healthy planet.

IRZ

¹⁹ Accenture, Driving Value from Integrated Sustainability: High Performance Lessons from the Leaders, 2010.

²⁰ “The IIRC, Mission Statement”, International Integrated Reporting Committee, accessed April 15, 2011, <http://www.theiirc.org/theiirc/>