INTEGRATED REPORTING

A Chat with the Experts

By Brad J. Monterio

Corporate financial reporting and disclosure are nothing new to management accountants. They have been fixtures for a century in U.S. companies and factor into many internal and external processes such as management actions, risk management, investment allocation, regulatory oversight, reputation management, and more. Yet corporate reporting isn't static. It's always evolving to better meet the needs of those who rely on the information. This evolution involves a widening view beyond financial information to nonfinancial information, including areas like business strategy and models, environmental and social factors (e.g., use of natural resources, impact on local communities), human resources (e.g., labor practices), intangibles (e.g., brand equity, intellectual property), governance models, and risk management, to name a few.

Frameworks, Guidance, and Standards

In the last two decades, this evolution in corporate reporting has morphed to include corporate social responsibility (CSR) and sustainability reporting. Along with them came nonfinancial reporting frameworks, guidance, and standards for disclosing this information to internal and external stakeholders. Two primary framework providers for various aspects of sustainability reporting are the Global Reporting Initiative (GRI, www.globalreporting.org), based in Amsterdam, Netherlands, and the Carbon Disclosure Project (CDP, www.CDP.net), based in London, England. They join the Sustainability Accounting Standards Board (SASB, www.sasb.org), the U.N. Global Compact (www.unglobalcompact.org), the International Organization for Standardization (www.iso.org), Organisation for Economic Co-operation and Development (OECD, www.oecd.org), U.N. Principles for Responsible Investment (www.unpri.org), IRIS (http://iris.thegiin.org), WICI (www.wici-global.com), Dow Jones Sustainability Indices (www.sustainability-indices.com), and a host of other global and local frameworks that each stakes a claim in some part of the nonfinancial reporting ecosystem.

From a report preparer's perspective—the corporate—this can be overwhelming and confusing at times. Selecting the right framework(s) from a patchwork quilt of choices can actually bring the nonfinancial disclosure process to a state of paralysis. Companies don't know which way to proceed. For the user of the information, it's equally challenging to understand how data reported using the various frameworks is comparable and connected.

From a market-demand perspective, we know there's demand among investors, analysts, regulators, nongovernmental organizations (NGOs), and community groups for the nonfinancial disclosure as part of a bigger company "story," as evidenced by Ocean Tomo's 2010 research, *Intangible Asset Market Value Study*. Its findings show that stakeholders found more than 80% of the company's value *outside* the financials. This is a paradigm shift from the 1970s.

Amid the confusion of competing sustainability and CSR-type frameworks, the International Integrated Reporting Council (IIRC) was formed a few years ago to develop a global framework for a newly evolved type of disclosure: integrated reporting (<IR>).

What Is <IR>?

The IIRC defines integrated reporting as "a process founded on integrated thinking that results in a periodic integrated report by an organization about value creation over time and related communications regarding aspects of value creation." One of the outcomes of the <IR> process is a periodic integrated report or series of interlinked reports. According to the IIRC, an integrated report is a "concise communication about how an organization's strategy, governance, performance and prospects…lead to the creation of value over the short, medium and long term." (See www.theiirc.org for more information.)

"Periodic" and "concise" are two important terms here—periodic may mean it's part of an existing communication vehicle such as an annual report, and concise indicates it must be filtered to include material financial and nonfinancial disclosures—a company can't report on everything.

Unlike its sustainability reporting brethren (each of which serves its own very useful disclosure purposes), integrated reporting moves beyond sustainability reporting. <IR> gives companies around the world a consistent, yet flexible, way to tell their own unique stories, linking their business strategy, business model, various "capitals," opportunities, and risks to future economic value over the short, medium, and long term. An integrated report shows interdependencies and connections between these important elements so that users of the information can clearly see how one impacts another and ultimately affects the value of the organization.

Speaking with the Experts

I recently sat down with Paul Druckman, CEO of the IIRC; Robert Eccles, a professor at the Harvard Business School and global integrated reporting expert/author; and Jeffrey Thomson, president and CEO of IMA® (Institute of Management Accountants), to discuss the evolution toward <IR>.

Brad Monterio: As with anything "new," there are always concerns over getting stakeholders to adopt them. What are some of the biggest obstacles/challenges to <IR> in the U.S.?

Robert Eccles: I think there are four: (1) the perception that an integrated report is just another reporting burden that adds no value beyond what is communicated in the company's 10-K, its annual report, and its sustainability report (if it has one); (2) lack of awareness about the IIRC and the International <IR> Framework that it published in December 2013; (3) the mistaken notion that <IR> will increase litigation risk; and (4) the current

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general lack of support for <IR> by large U.S. institutional investors.

Jeff Thomson: From my perspective, the biggest obstacle is one of awareness and keeping the end in mind. U.S. preparers are already facing disclosure overload (investors also face disclosures that are too short term, complex, long, and financially focused) with few remedies in sight other than a multiyear FASB [Financial Accounting Standards Board] project focused on financial footnotes (to 10-Qs and 10-Ks). If an integrated report is the sole end in mind, that could impede awareness of the internal benefits of <IR> concepts (e.g., operational reporting, balanced scorecards focused on people, planets, and profit), as well as the external benefits to help "tell the company story" to investors, analysts, and intermediaries on value creation capacity, capability, and sustainability. The end in mind isn't necessarily a report; rather, it's to create stronger organizations with a more balanced and integrated approach to internal and external enterprise performance management [EPM]. In some, and perhaps many, cases an integrated report is part of the solution, but the approach has to factor in legal, reputational, and competitive issues unique to different jurisdictions and cultures.

Monterio: Where does a company begin its journey toward <IR>?

Paul Druckman: <IR> has been developed by businesses from across the world in order to improve the way they consider and communicate information to explain how they create value. More than 100 businesses, including Deutsche Bank, Microsoft, Coca-Cola, Tata Steel, National Australia Bank, and Unilever, worked with the IIRC to develop the International <IR> Framework, which is now being adopted by many businesses around the world. Our Framework is both ambitious and aspirational. It brings about a new benchmark for how businesses could communicate and is as much about creating an environment for management to think more holistically about the business as it is about the production of "a report." The IIRC's Examples Database gives examples and commentary on emerging practice in <IR>. [Learn more at http://examples.theiirc.org/home.] Our 2014 Yearbook also provides case studies and personal insights from companies on the <IR> journey. [For more details, see www.theiirc.org/yearbook2014/timeline-assets/timeline.html.]

Eccles: I can't think of a single example of a company successfully implementing <IR> without the strong, overt support of the CEO. Often the CEO needs to insist on this over the objections of the CFO (who is uncomfortable talking about nonfinancial information and well aware of the lower quality of this information in most companies compared to financial information) and the General Counsel. But this is only the beginning. Someone has to be put in charge of the process of pulling together all the information across the organization that needs to go into the integrated report. By definition, no such process exists the first time a company compiles an integrated report, and so it must be created. The company must then winnow all this information into what is really "material" for inclusion in the integrated report. Here the company needs to put in place a rigorous process for determining what is *material*. Materiality is entity-specific, depends on the company's significant audiences, and is ultimately based on judgment. There are no simple rules of thumb for determining what information is truly material. The company needs to design a process for doing this, and it needs to explain this process in its integrated report. In order to have an integrated report rather than a merely combined financial and nonfinancial report, the company needs to identify and explain the relationships it believes exist between financial and non-

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financial performance. <IR> is about more than a paper document, so consideration needs to be given to how to most effectively use the company's corporate reporting website.

Monterio: One concern in the U.S. market is the perceived reporting burden among corporate report preparers. How does <IR> fit in with current corporate disclosure practices/processes?

Thomson: The relationship is very strong in that the concepts of <IR> (with its focus on balanced, integrated, and longer-term measures) could help the organization better tell its story on value creation, capacity, and capability. This could result in clearer and more actionable management discussion and analysis (MD&A), interlinked or a single integrated report. The key is that *all* constituents around the world need to directionally agree on the call to action—operational or internal reporting can be improved, and surely external disclosures are overwhelming some preparers and underserving most investors. For example, an Ernst & Young study from two years ago looked at a cohort of large publicly traded companies and found that the number of pages devoted to MD&A and footnotes had quadrupled over the past two decades. If extrapolated forward, there could be an average of 500 pages devoted to MD&A and footnotes! Generally, external disclosures are too long, complex, and financially focused. Targeted research needs to be conducted to determine what investors and other stakeholders really need, relative to the cost (i.e., the value proposition) of producing more balanced, integrated, and longer-term measures with higher levels of variability and lower levels of confidence (i.e., nonfinancial data).

Monterio: As part of the IMA Technology Solutions & Practices Committee, my colleagues and I are tasked with educating and informing IMA members about how technology enhances their day-to-day professional roles and activities. For example, it can help companies digitally connect information and define interdependencies in integrated reports. What role will/can technology play with <IR> for IMA members?

Thomson: Technology plays a *vital* role. By definition, <IR> is more balanced (think financial, people, customer, societal, and other measures), integrative/connected, and longer term. Sourcing, validating, analyzing, and reporting nonfinancial measures in a manner that's effective and efficient to validate the ROI [return on investment] of <IR> concepts is critically important because it's likely that multiple information systems and sources are involved (internal and external).

Monterio: The IIRC recently launched a technology initiative. From your perspective, how important is the role of technology in <IR>?

Druckman: Leading companies around the world are already adopting <IR> in their organizations, and there's a crucial role for technology companies to play in helping make this happen. Through this initiative, technology companies will learn of the challenges and problems faced by organizations practicing next-generation reporting so that tools and technologies can be applied to make corporate reporting faster, more efficient, more accurate, and better integrated into business processes. It will also aim to enhance the experience for users of reports. We're extremely pleased that companies leading the way in providing technology solutions have already joined the initiative to become front-runners in this field, and we encourage others to follow suit. We're also delighted to announce that the European Commission will be the first policy maker to be represented as an observer in the initiative and expect other regulators and policy makers to engage with the program as it progresses.

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Monterio: Robert, you just recently published another book on <IR> that covers many considerations for companies as they begin down the path toward <IR>. What are some of your recommendations in the book? Is there a simple first step a company can take to start the journey toward <IR>?

Eccles: The answer to this is a definite "Yes." The company's board of directors should publish an annual *Statement of Significant Audiences and Materiality*. In this Statement, the board identifies significant audiences (i.e., shareholders, bondholders) and a relatively small number of other stakeholders upon which the company depends to have a sustainable strategy that will enable it to create value over the long term while contributing to a sustainable society. It should also identify the time frames the company uses to evaluate the effects of its decisions on these significant audiences. Companies say they only want to report on the *material* issues. That's fine. But they need to explain *how* these material issues are determined. The Statement lays the foundation for this. Then the company should create a *Sustainable Value Matrix*, which is the management tool that translates the Statement into management actions concerning reporting, stakeholder engagement, resource allocation, and innovation. [See chapters 5 and 6 in *The Integrated Reporting Movement* by Robert Eccles and Michael P. Krzus.]

Monterio: What closing thoughts would you like to leave with our readers about <IR>?

Thomson: IMA, as a global accounting association focused on the mutual dependency of accounting, finance, operations, technology, strategy, and leadership in the value chain, is uniquely positioned to help advance the concepts of <IR> to improve internal/operational reporting and the value of external disclosures. It's a complex challenge, but data and debate with cultural sensitivity are a winning combination to progress on the journey. IMA has a rich history in management accounting innovations, including the balanced scorecard and performance dashboards.

[IMA was recently appointed to the IIRC as a representative for a key stakeholder group in the <IR> process: management accountants. For more information, see the press release: www.imanet.org/about_ima/news/press_release_detail/14-12-09/IMA_Appointed_to_International_Integrated_Reporting_Council.aspx.]

Druckman: <IR> enhances accountability and stewardship for the broad base of capitals that an organization uses and affects and promotes understanding of their interdependencies. These capitals aren't just financial and manufactured, on which traditional financial reporting places undue emphasis, but also intellectual, natural, social and relationship, and human capital. <IR> therefore ensures that businesses are aware of and account for all the resources and relationships that it impacts. The process of <IR> takes into account the relationships between different areas of an organization, its use of capitals, its strategy, its business model, and the way it defines value. An integrated report tells its unique value creation story and benefits all stakeholders interested in its ability to create value over time.

Eccles: <IR> is a journey. Start with small but important steps, and build on them. Don't expect to get everything right the first time. **SF**

Note: Brad, Paul, and Robert will be presenting a webinar on <IR> on March 10 as part of IMA's Inside Talk: Tech Talk Series. To register, visit www.imanet.org/programs-events/ima-webinars/inside-talk.

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