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Integrated Reporting: It's Streamlined, But Will the Benefits Outstrip the Costs?

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A brave attempt is underway to get companies' annual reports to tell investors, workers and society what they really want to know. Not just the short term, financial bottom line of its performance, but the big picture. The aim is to cut through to an outline of where the company is headed, by considering such salient factors as: whether its operations are environmentally sustainable and ethical; what are the big risks in implementing its strategy and, how the board rates its chances of getting there.

Integrated reporting promises clear answers to the questions that analysts and journalists sometimes have to drag out of chief executives in briefings after a traditional annual report is released. These are the same answers that investors, who often prefer a long-term focus, also want before they decide to chance their money.

With global competition for scarce capital, the capital markets also want the whole story so they can properly evaluate different investment opportunities. "The integrated reporting framework is designed to bring reporting closer to the information that management uses to run business day-to-day," says Jane Diplock, a director of the Singapore Exchange and formerly chairman of the New Zealand Securities Commission.

The Big Four accounting firms have been aware of the underlying problem for a decade and are on board to devise a solution that replaces the current 200-year-old system. "The accounting profession – supported by leading corporations, investors, industry groups, legislators and regulators – has been pushing for the development of better business reporting," says Michael Bray, a partner at KPMG in Melbourne.

Bray argues the current regulatory reporting model is a result of layers of new information gradually being added to the foundation historical cost information. "Such reporting drives capital markets and other stakeholder decision-making, (and) it is clear it has reached breaking point. No amount of analyst and investor relations activity can make up for an impure historical cost reporting model," he says.

There's a collective desire to end the trend for annual reports to become longer and more complex, according to Roger Simnett, an accounting professor and associate dean of research at the Australian School of Business and this is a major benefit to come from integrated reporting. He confirms that over time, reporting requirements have accumulated through a patchwork of laws, regulations, standards, codes, guidance and stock exchange listing requirements, which can mean lots of additional reporting to bodies outside the annual report, with lots of overlap.

Selling the Benefits

Simnett is on the content taskforce of the International Integrated Reporting Committee (IIRC), which was set up in 2010 to develop a globally accepted framework that brings together environmental, social and governance (ESG) information with financial reporting in a clear, concise, consistent and comparable format. He describes the IIRC as "a powerful network of interested parties that has come together to do something about a reporting system that's not achieving what it is supposed to achieve".

One pressing reason to bring on integrated reporting is that some organisations have to meet multiple – up to 100 – reporting requirements, Simnett highlights. "We want to see if we can bring the multiple sources of information together and report them in a simple format that addresses what people want," he says. "People are setting up corporate structures and reporting silos according to all these different requirements and it is not necessarily the most beneficial approach."

More work is required on selling the concept to companies, according to Simnett. "People are saying they can see the costs of integrated reporting (IR), but they are wondering what the benefits are. Yet many companies in Australia are a fair way down the track in voluntarily adopting aspects of the vision. The benefits they are discovering from the enhanced business reporting include improvements in both internal decision-making and processes. They are also finding external benefits, such as capital cost reduction and improvements in analyst decision-making.

The IIRC is trying to come up with an agreed international solution to producing a corporate report that investors can readily digest, notes Simnett. "Developing a framework can be difficult at an international level and a lot of impetus might have to come from a bottom up approach – individuals and companies adopting the approach. South Africa and France are showing the way – and proving it can be done, as are many progressive companies."

Integrated reporting is the way investors want to see things happen, confirms Nick Edgerton, a senior investment analyst at Colonial First State Global Asset Management, a division of the Commonwealth Bank of Australia. "I think the consensus view is that it will eventually be the way things are done. The question is how long it will take to come about. Some companies are leading the way, such as PUMA in its recent annual report."

Sports and leisure company PUMA took a step towards integrated reporting with the release of a combined financial and sustainability annual report in April 2011, saying it believed public reporting is not only a venue to demonstrate accountability, "but also a means for us to celebrate success, openly address challenges, and elicit feedback on what we do and how we do it". It has published an economic valuation of the environmental impacts caused by greenhouse gas emissions and water consumption along its value chain.

Ultimately, PUMA will include further environmental key performance indicators, followed later by social and economic impacts. The company cooperated with the Global Reporting Initiative (GRI) by supporting the call for supplier factories to report on their social and environmental initiatives. The company agreed with 20 key suppliers in South-East Asia and other major sourcing regions to issue their own sustainability reports in 2012. It found the biggest environmental impacts in the value chain occur not through PUMA's core operations but at the level of its Tier 4 suppliers, where raw materials are derived from natural resources, such as the cultivation and harvesting of cotton, cattle ranching for leather, and natural rubber production. This part of the supply chain accounts for 36% of the total greenhouse gas emissions and 52% of water consumption. It seems the most water-intensive activity in the production of a T-shirt occurs at the initial step – the cultivation of cotton.

"Through this project, PUMA endeavors to enhance transparency as well as social and working conditions in its supply chain by advising factory management regarding weak points in their operations and enabling them to make improvements independently," said the company.

NAB, one of Australia's Big Four banks, and mining giant BHP Billiton are among the Australian company trendsetters earning kudos for leading the way. Hundreds of other companies worldwide, particularly in Europe, are starting to file integrated reports. In South Africa, the Johannesburg stock exchange is asking companies to comply with requests to submit integrated reporting or explain why they have not done so in place of traditional annual reports. And this year, France has enacted the Grenelle II legislation, requiring large companies to embed social and environmental consequences of their actions in their annual reports. Denmark and Sweden also encourage voluntary reporting on non-financial performance.

In 2010 the European Commission engaged in public consultation over the disclosure of non-financial information by companies, including social, environmental, human rights and sustainable development issues. The European Union also has a report modernisation directive. The UK Department for Business Innovation & Skills found a low level of satisfaction with the quality of corporate reporting, with disclosures lacking in relevance and coherence. "Good narrative reporting should tell the company's story effectively and in a balanced way that puts financial information into context," it said. "The statutory reporting framework is intended to help boards consider material issues facing the business so they can determine the right strategy for long-term company success in the interests of company members. Social and environmental issues should be central to these discussions."

Capital Inclusions

IR may add five other types of capital to the current financial reporting of a business.

1. Manufactured capital accounts for physical objects such as machines available to the organisation to produce goods or services.

2. Natural capital includes air, water, land, biodiversity, eco-system health and energy.

3. Human capital involves people's skills and experience, and their motivations or rewards to innovate.

4. Intellectual capital takes in the intangibles that provide competitive advantage.

5. And, social capital is defined as the institutions and relationships that exist in a community, group of stakeholders and other networks to enhance individual and collective wellbeing, which support the business model.

The aim of integrated reporting would be to chart the levels of the various capitals held by a company at the beginning of a year, and how these capitals are built up or depleted over a particular period. At the same time, the integrated report would tell a company's value proposition – why an investor should invest in the company in the short, medium and long term. It would also integrate the information in the financial and the sustainability reports to allow the reader to understand the company's broader performance. As currently reported, for example, information on strategy (if disclosed) is not well tied to identified risks, which is also not well tied to disclosures of governance structures and remuneration strategies – as such, a company's value proposition is not clearly communicated.

Traditional reporting has become more compliance-oriented and detailed, but the collection of data for reporting on the many components, as currently required, is "siloed" within companies and commonly not integrated with other related activities.

One reason for such add-ons is the changing business context. Factors that drive value creation have moved rapidly in recent times – such as a shift from the tangible to the intangible, from manufacturing to service industries. ESG reporting has gathered momentum over the past few decades, but has not yet been well integrated with financial reports. Simnett foresees a single integrated report being concise and material. Another guiding principle is a move from paper-based reports to versions leveraging new technology and online formats so that information can be up to date and relevant to business development, with interaction from stakeholders.

Testing Time

In 2011 companies around the world were recruited for a pilot program to test proposals for an agreed international integrated reporting framework by the end of 2013. One member of the pilot group, CLP Holdings an investment holding company with subsidiaries engaged in the generation and supply of electricity in Hong Kong, Australia (TRUEnergy), and India – has found that integrated reporting changes the way the company operates by, among other things, increasing the focus of the board on sustainability, reports its environmental affairs manager Jeanne Ng.

There was support for integrated reporting at the United Nations Conference on Sustainable Development (Rio+20) in June attended by government delegates from 196 countries. IIRC chief executive Paul Druckman told delegates: "We are actually a breath of fresh air which brings sustainability reporting into a meaningful integrated picture so that investors and other stakeholders truly understand where a business is and how it is going to create and preserve value long term for the shareholders and the planet."

There are still issues to be worked through. While the costs can be concentrated, the benefits can be more intangible and diverse. To gain widespread acceptance, companies need to see that the benefits outweigh the costs.

Simnett also asks how auditors, who verify statements in traditional annual reports, will handle forecasts and other future-orientated material in integrated reports. New standards, techniques, reporting mechanisms and liability considerations for auditors might be required. "If there is information to be provided that is not assurable, is there some form of assurance that can be provided, for example, that at least the process is reasonable? Report preparers are concerned about disclosures of strategic advantage, and [any] potential greater risks they are facing. There will need to be engagement with the regulators, and this should include what needs to change from the assurance profession's perspective," he says.

The Society for Knowledge Economics is coordinating the Australian effort. It established The Australian Business Reporting Leaders Forum as a multi-stakeholder group in late 2010 to collaborate with the IIRC and global initiatives to promote integrated reporting. It aims to contribute an Australian perspective to international proposals and influence the Australian government, regulators, standards setters and industry bodies to endorse integrated reporting proposals and raise awareness of the issue. Diplock, who is leading the forum, told its April 2011 meeting that the lessons from the global financial crisis were that financial markets matter and regulating banks alone was not enough. Markets are vitally interconnected and national borders cannot stop capital flows or the spread of contagion. It was sound governance that checked destructive behaviours. "[The global financial crisis] was a crisis of ethic proportions – sound governance is good for business and good reporting tells investors ESG is being practised," Diplock outlined, concluding that the IIRC represents awareness that the financial crisis masks an imminent socio-ecological crisis.