IFA
Institut Français des Administrateurs

The Board of Directors and integrated reporting

IFA publications

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One of the key functions of the Board of Directors is to define a value creation strategy for the company's shareholders.

For the French Institute of Directors (IFA), «integrated thinking» and «integrated reporting» are an inherent part of this function. The former is used to establish the company's long-term vision, while the second aims to communicate this vision clearly to the market participants.

Initial experiments have produced interesting and promising results. However, the content of the resulting reports is still far from perfect, particularly from the investor's perspective, bearing in mind that an additional compliance exercise must be avoided at all costs.

Since there is still no consensus on the exact definition of "integrated reporting", IFA has decided to convene a working group to identify its advantages, analyse ongoing experiments, and issue recommendations to its members on the involvement of directors and the Board of Directors in this approach.

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«Integrated reporting» is gradually gaining a foothold in France. Most of the major listed companies have started to explore its potential, and around 20 of them have already published a report called “integrated”. Some 20 additional companies are planning to do so in 2017. Countries like South Africa, Australia and Great Britain, and certain Asian countries, have also adopted this approach (some of them sooner than France); promoted by the International Integrated Reporting Council (IIRC), it is supported by a growing number of issuers, regulators, and investors.

In the latest version of its Governance Principles, the International Corporate Governance Network (ICGN) encourages integrated reporting that puts historical performance into context and presents the risks, opportunities and prospects for the company in the future, to help investors and stakeholders understand its strategic objectives and the progress made in their execution.

The French Financial Markets Authority (AMF) itself has recently invited listed French companies to consider coordinating financial and non-financial information, and recognises the innovative nature of an integrated presentation of a company’s performance and its value creation strategy. It believes that this approach should be “encouraged and supported”.

Directors represent the interests of shareholders and have a duty to act in the company’s social interest. As a professional association for directors, IFA also finds this approach interesting because it enables the Board to clearly communicate its long-term vision, and improves the dialogue with investors and stakeholders.

1. Supplementing regulated information...

For many years, regulators have sought to supplement the regulated information given to investors, in order to:

- Put annual results back into a more operational, indeed strategic, context. This is the purpose of the management report in France, the Management Discussion and Analysis (MD&A) in the United States, or the Strategic Report in United Kingdom.

- Clarify corporate risk management processes. The Sarbanes-Oxley Act in the United States and the Financial Security Act in France require companies to provide information on their internal control and risk management system.

- Demonstrate good corporate governance. In France, the Chairman of the Board of Directors must produce a yearly report about the company's governance system.

- Explain the company's approach to social responsibility (CSR). Several framework have been set up, such as the GRI and the SASB . In France, the issue has been addressed through a range of legal obligations under the Grenelle II Act and its implementing decree. The European Union has also begun discussions on how non-financial information could improve the quality of information

- Adopt more appropriate performance measures than the aggregates strictly defined in accounting regulations ("Non-GAAP" indicators). In December 2015, ESMA published guidelines on the APM introduced on 3/7/2016 to promote transparency and the reconciliation of Non-GAAP and GAAP measures.

- Inform shareholders about executive compensation policy by establishing a clear link between strategy, key value drivers and remuneration structure, the goal being to ensure that compensation is fair and commensurate with performance (European Directive on Shareholder Rights).

2. ...does not fully meet the expectations of investors

However, regulated information is simply not enough for investors because, even where supplemented, it is essentially historical. The decision to invest is based on a comparison between the intrinsic financial value of a company share and the price at which it can be bought on the market. The value is estimated based on the company's future economic profitability.

The valuation assessment consists in adding the value of the assets in place to the present value of future growth opportunities.

The value of the assets in place is estimated by analysing historical results and traditional financial indicators. The value of future growth opportunities is more difficult to establish, since the company does not provide the investor with its business plan.

However, investors must form an opinion on the company's strategic plan, its ability to build and maintain competitive advantages, its ability to overcome the risks associated with its business and its environment, and the way it intends to use its financial resources.

The strategic narrative («business case») therefore becomes a key factor in the formation of investor expectations. This narrative can be reinforced by the regular dissemination of operational indicators that make the company's strategy tangible and enable investors to monitor its progress.

However, it is clear that the information disseminated by companies is insufficient or only partially meets investors' needs. A recent international study on the information communicated to investors shows that, missing information aside, there are few reports that manage to give an integrated, logical and holistic view of the business model and its contribution to value creation:

- The content of belatedly disseminated annual reports remains primarily financial and retrospective: Far more space is allocated to the presentation of results than to strategic or operational information.

- Important aspects of the business model are not addressed. In particular, key intangible assets, such as brand or human capital, are neglected in corporate communication. More than 50% of companies do not provide any quantified information on research and development, brand assets or human capital.

- The indicators used are still largely historical and financial. Only a minority of companies (11%) use at least 5 or 6 operational indicators. Some investors are heavily criticised for their short-term approach, but the information given to them makes it difficult to analyse the company's future potential.

- The operational indicators provided rarely shed any light on the future. Most of them are lagging indicators, meaning that they provide information that is useful for understanding the present situation but does not really reflect the current trend. They are chosen because they are available, and not because they are relevant to understanding the value creation strategy.

The profusion of publications (annual report, financial report, sustainable development report, Chairman's report on internal control, and the soon-to-be-introduced report on the principles and criteria for determining, distributing and allocating executive compensation) is a complexity factor not only for volume reasons, but especially because of the disjointed nature of the information they contain.

Investors do not have the overall vision needed to understand a company's logic and to value that company more effectively.

3. The integrated report: Explaining the value creation strategy

Integrated reporting is based on a different approach than those listed above. This is the first time that a truly holistic and integrated vision of the company has been promoted. It is not about adding but rather linking information to give it the meaning, relevance and consistency that are missing when separate pieces of information are simply juxtaposed.

By identifying the link between objectives, resources implemented, and the outcome or progress of actions undertaken, the integrated report constitutes a new stage in the development and 'integrated' presentation of information disseminated to investors.

The basic objective is to improve the quality of information distributed to capital providers to help them better value the company and therefore achieve a more efficient allocation of financial resources. In the longer term, the aim is to implement integrated management and encourage decision-making that focuses on creating value in the short, medium and long term.

The approach has two facets that IFA considers inseparable:

- «integrated reporting» itself, which encompasses all of the measures taken by the company to better communicate its value creation strategy; and
- «integrated thinking», which should logically precede communication because its aim is to build the value creation strategy. The company's senior management must be clear about its strategy so that it can explain it correctly in its communications.

The IIRC framework presents a detailed approach that provides an interesting starting point. However, IFA considers that this document should not under any circumstances be used as a benchmark or standard. Moreover, it has neither the ambition nor the means to be used as such: It is part of an "apply or explain" approach and could be described as a market initiative inspired by principles, not rules. Discussions are taking place about implementing a process to certify the quality of the approach. However, IFA wishes to maintain a flexible approach that is not distorted by a logic of verification.

The IIRC framework should above all be a source of inspiration for Boards of Directors. Indeed, by definition, creating value only makes sense if unique competitive advantages have been implemented and are maintained over time. Therefore, the communication of a value creation strategy is necessarily specific to each company.

Even if it contains concepts that require further explanation or greater adjustment, this document has the merit of providing a reasonably comprehensive view of the factors that contribute to value creation, and of putting forward common sense principles to create it.

Value creation mechanisms can be explained through numerous dimensions, such as:

- The strategic vision,
- The organisation structure and how the company interacts with its environment,
- Governance,
- Strategic resources,
- The business model,
- Competitive advantages,

- Risks and opportunities,
- Strategy and capital allocation ,
- Financial and non-financial performance,
- Future prospects.

Companies must be free to present these themes in the way that seems most relevant to them, and to add any others that they feel may be worth bringing to the attention of investors. The objective is to present and promote the "engine" that will drive virtuous, sustainable and profitable growth and, as a result, will provide shareholders with a financial return commensurate with the risks they take.

The guidelines for drafting the report also play a role in improving the information distributed to the market:

- the document must be strategic and forward-looking;
- connections must be made between different information sources, and particularly between financial results and non-financial indicators;
- the relationships between the company, its stakeholders and the ecosystem in which it operates must be clearly explained;
- the content must be relevant, concise, reliable and complete, and the data must be comparable over time.

IFA stresses that the integrated report is aimed primarily at investors. This does not mean that other stakeholders or business partners may not be interested in it. However, it is difficult to achieve the concise and coherent style required while, at the same time, satisfying the information needs of all the other stakeholders. The integrated report is not intended to reproduce all the information contained in the social responsibility report; neither should it be devoted primarily to social responsibility. The only CSR initiatives that should be included are those that contribute directly and clearly to the long-term value creation for shareholders.

Likewise, the integrated report should not be the only working document consulted by financial analysts and professional investors. The latter base their recommendations on financial publications, meetings with managers, and any information provided by or regarding the company and its competitors.

4. The expected benefits of the approach

Although the approach is still new and experimental, it has many advantages for companies.

Internally, it enables them to enhance their strategic thinking and to involve a majority of employees from all levels and functions in the strategy development process.

The development of an integrated report must indeed be preceded by an "integrated thinking" process, the aim of which is to formalise the strategic vision, present it in a concise manner, and establish it firmly as part of a drive to create shareholder value .

It is an opportunity for operational managers — who are often trapped in their silo logic — to develop a common language and to fully understand their contribution to and their complementary roles in the company's value creation process. Integrated thinking allows them to place their activities into a long-term perspective, which is too often overshadowed by economic and competitive uncertainty. It facilitates the development of a clear strategic overview, which is essential for keeping staff motivated.

It is also an excellent opportunity to get directors fully involved in strategy definition. The process is highly unifying because it creates a consensus around the company's objectives and vision at all levels of the company. It increases the consistency of strategic execution across the company, and makes it more competitive as a result.

Beyond these internal benefits, the integrated report is also a means of fostering dialogue with shareholders. As explained above, it contains the key information that investors need to correctly value a business. High quality information prevents opacity or distrust discounts.

However, one of the major benefits of relevant and useful communication on value is the impact it may have on the very nature of the shareholder base. Studies show that companies with the largest number of long-term fundamental investors are those that communicate most about their strategy and their strategic execution. Conversely, companies that focus their communication on financial matters have far fewer fundamental investors.

The integrated report should therefore become a special tool for attracting and retaining shareholders primarily interested in the fundamentals of the company, and excluding more opportunistic shareholders. This is an excellent exercise to prepare for attacks by activist investors.

5. The preliminary lessons learned from ongoing experiments

First of all, it is important to highlight the extraordinary diversity of approaches adopted by the pilot companies and by those that were the first to publish an integrated report. The sample reports published on the IIRC website are a clear illustration of this. This diversity is found in the content, graphics, volume and the type of media used. It confirms that the approach is flexible and depends primarily on the company's choices.

The investors and managers surveyed readily acknowledged the intellectual proximity between the IIRC framework and their conception of long-term value, as well as the relevance of the aspects to be considered in order to understand value creation.

However, in their opinion, so-called «integrated» reports are still far from perfect:

- They are still very often inspired by sustainability considerations. Too often, the social responsibility report is merged with the financial report without any consideration or explanation of the company's CSR strategy and its financial implications for the shareholder. Of course, sustainable development is central to the strategy of the most responsible companies; however, reports that focus too much on this aspect without clearly explaining the impact on financial value are worthless to investors.

- While they are often aesthetically very pleasing thanks to creative illustrations, the text is too insufficiently insightful to give investors a clear picture of how the company plans to improve its long-term value. The central concept itself (value) is not clearly explained. Attaching diverse meanings to the concept creates ambiguity, which is unlikely to reassure investors.

- The majority of the indicators presented are financial. The links between strategy, key value drivers and key performance indicators are not highlighted.

- When an integrated report is aimed exclusively at the stakeholders and the latter are legitimately consulted, the content is very general and cannot fully meet the specific needs of investors. In this case, the integrated report is more a communication document than a coherent, technical analysis aimed at informing an audience of financial professionals. Socially responsible investors — and other stakeholders who welcome measures to give financial credibility to Environmental, Social, Governance (ESG) initiatives — can benefit from current integrated reporting practices, but they are not the main target of this initiative.

All in all, mainstream investors do not yet view integrated reporting as an essential new development that will improve their analysis and decision-making. At present, integrated reports are neither accurate nor relevant enough to replace the powerful means of investigation that already exist (such as direct discussions with business leaders), or to provide additional useful information.

6. Best practices for Boards of Directors

The Board of Directors must play a central role:

- in the integrated thinking phase: As clearly stated in the Corporate Governance Code for Listed Companies, the primary mission of a Board of Directors is to provide strategic direction.

- in drafting the integrated report: The code specifies that the Board ensures that shareholders and investors receive "relevant, balanced and instructive information on the strategy, development model, non-financial policy and long-term prospects of the company". This definition is very similar to that of the integrated report.

Naturally, it is up to the Board to decide how involved it should be in the integrated reporting process. At the very least, it should deliver an opinion on the content of the report, and give its formal approval. But, given the importance of this document, it is desirable that the Board be more involved in the drafting process. Several options are possible:

- direct involvement in the process alongside the general management;

- regular monitoring of the process through an ad-hoc committee composed of the representatives of several committees;

- participation in a seminar to define basic strategic guidelines.

Whatever the terms of this involvement, the Board must pay attention to the following points:

6.1. Clear objectives

- Dialogue with shareholders: Current and potential shareholders must clearly be the prime target of the integrated report. It is particularly useful to investors who do not have access to the company management. The Board must ensure that the current expectations of such investors have been correctly identified: Roadshow reports, specific survey of significant shareholders, etc. Direct information gathering (for example, targeted interviews with investors) is preferable to indirect information gathering (through analysts' notes, for instance).

- The objectives of integrated reporting should go beyond improving thedialogue with investors: it should enhance internal strategic thinking and lay the foundations for better strategic execution. The quality of internal thoughts and discussions is more important than the appearance of the final report. Investors are primarily interested in the credibility of the management team, the company's strategy, its competitive position, and the flexibility and resilience of its business model.

6.2. Rich and meaningful content

- An objective analysis must be performed on the company's current position in regard to value creation. The aim is to form an internal opinion on whether the company is over- or under-valued, by analysing the differences between the intrinsic value (as it emerges from the current business plan) and the stock market price. This analysis, which involves developing genuine empathy towards the shareholders, is necessary to understand how the value creation of is perceived by the market.

- Special attention should be paid to identifying the company's competitive advantages, which are instrumental in value creation. Their duration, protection and regeneration, their impact on margins and the return on investments (both tangible and intangible) are central to integrated thinking. These issues are important enough for the Board to also be involved in this identification process.

- The shareholder value strategy must be clearly envisioned: The general management must clearly establish how the strategy it intends to pursue and the resulting capital allocation will increase the financial value of the company at a rate at least equal to the cost of capital (representative of the shareholders' expected return). This requires a financial valuation of the business plan, the conclusions of which must remain confidential but are an essential factor in the Board's thinking.

- The business model, the role of — and interaction between — the different assets or resources that contribute to value creation, and the exchanges of value between the company and its ecosystem are complex factors to understand and clarify. In many cases, current disruptions make this exercise fragile, as any explanation is in danger of quickly becoming obsolete. An alternative approach is to be upfront about the risks to the current model, and describe the measures taken to adjust it and make it more flexible and resilient.

- Risk management and, more generally speaking, risk appetite is an area on which investors want to have relevant information. The Board must ensure that only the most significant risks in terms of shareholder value are mentioned (in particular, any risks that impact on competitive advantages and the business model), and that the measures taken to mitigate these risks are explained. The risk mapping that is drawn up annually and generally discussed by the Board is a good starting point. The Board must ensure that it covers the major risks to the company's long-term shareholder value.

- CSR must be addressed from the point of view of shareholder value. Not all of the information in the sustainability report is of interest to investors, especially that which is published to meet regulatory requirements. The integrated report should include only that information which has an impact on shareholder value — i.e. on profitability and risk — and which can be clearly established. Integrated thinking enables the Board to verify that the CSR strategy really does create financial value.

- The selection of indicators is a particularly important and delicate process. The goal is to select a small number of indicators that are representative of the key value drivers. They may be financial or operational and should, where possible, enable investors to anticipate the future by giving them an indication of the progress of the company's strategy. They are known as "leading indicators» as opposed to «lagging indicators", which refer more to past performance. Ultimately, their objective is to give substance to the strategic narrative presented to investors, and to reassure them that the company's strategy is being executed as planned. It would be logical if these critical indicators were validated and monitored by the Board, which could also use them to evaluate the performance and set compensation of executives.

- Governance and executive compensation policy must be clearly presented. The aim is to convince investors that the corporate governance policy is designed to make a real contribution to strategic decision-making and the company's long-term vision. Investors also want to understand the links between compensation, key performance indicators and company strategy. By promoting a structured approach around value creation, the Board will be able to base its compensation policy on specific elements and thus avoid the usual criticism about the gap between management performance and pay.

6.3. A collaborative and controlled process

- The process of integrated thinking must be organised such that a maximum number of departments or functions are involved. The objective is to ensure that everyone understands the common goal of creating value, their respective roles in the value creation process, and the importance of working together to maximise the value created. It is an opportunity to develop a common language and to stimulate collective intelligence.

- The process must be driven by a cross-functional team that is as close as possible to the Board and the investment community. Therefore, the finance department, investor relations management and strategy management play a key role. Sustainability or CSR department must be closely involved, but foreign experience shows that finance departments are effective in managing the process insofar as they are generally responsible for investor relations.

6.4. An educational report

- The final document must be both relevant and short. Special attention should be paid to the text and the illustrations. It should not be a set of separate topics that are dealt with one after the other, but rather an integrated whole that aims to present the company business case in a convincing and honest manner.

- In addition, the report should not resemble a promotional document. The substance is just as important as the form, as the report is aimed primarily at investment professionals. It must be updated regularly.

- All media can be used to present the integrated report. A digital format fits well with the size constraints: The use of hyperlinks helps keep the main text to a reasonable size, while allowing readers access to more detailed information should they require it.

- Drafting the integrated report should also be an opportunity to simplify and clarify other financial documents intended for public release. It is possible, indeed desirable, to integrate it into the annual report or the official prospectus. The latter can thus be clarified, and any redundant information that has accumulated over time can be removed. But we will have to wait for new laws and regulations before we can replace mandatory documents with the integrated report. However, given the strategic nature of the integrated report, an offprint should always be made.

- The IFA recommends merging the management report, the Chairman's report on corporate governance, internal control and risk management, the report on executive compensation principles and criteria, and the integrated report into one and the same document, which could be entitled "Board of Directors Strategic Report". This report would be distributed to shareholders at the General Meeting and would be a statement, as it were, of the Board's long-term general policy.

IFA recommendations for directors

1 Formally adopt an integrated thinking and integrated reporting approach.

2 Take part in the integrated thinking process conducted by the various functions and business units within the company.

3 Define the company's strategy in terms of value creation for shareholders.

4 Formalize the company's vision and long-term strategy by clearly identifying its competitive advantages, the characteristics of its business model, and its appetite for risk.

5 Identify, validate and monitor the key indicators representative of the company's strategy.

6 Develop and approve a "Board of Directors Strategic Report", a key tool for engaging with investors.

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The French Institute of Directors (IFA) is an association of corporate directors, with nearly 4,000 members exercising their functions in companies of all sizes, across all sectors.

The IFA is tasked with disseminating information on governance matters, professionalising the members of its network, organising experience sharing, participating in the public debate and informing it of the benefits of governance practices that promote business competitiveness.

The IFA acts in partnership with all those who, through their activities, contribute to the development of good governance practices.

The IFA operates all over France, with 8 regional delegations in Paris, Lille, Strasbourg/Nancy/Metz, Lyon, Marseilles, Toulouse, Bordeaux and Nantes.

The IFA is also a founding member of the European Confederation of Directors' Associations (ecoDa).

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