FEEDBACK

"TOWARDS INTEGRATED REPORTING Communicating Value in the 21st Century"

RESPONSE TO THE DISCUSSION PAPER PUBLISHED BY THE INTERNATIONAL INTEGRATED REPORTING COMMITTEE IN SEPTEMBER 2011

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(Note this response is the opinion of the author and does not represent acting as a spokesperson for any other organization)

A FRAMEWORK FOR DEVELOPMENT

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Executive summary

Not since the industrial revolution has the world seen as significant economic and social changes as are now impacting us.

The Wall Street crash in 1929 created a realization that the approaches to corporate governance and accountability that existed in the 19th century could not respond effectively to the economic and social realities of the 20th century. Corporations were developing that were required to achieve the economies of scale to undertake large projects such as industrial mass production and infrastructure development such as railways; these corporations had a need for financial resources to undertake this work and increasingly this financing was being sourced from new areas such as the general public.

In the wake of the crash, major changes occurred including the creation of the SEC (Securities and Exchange Commission) as well as certain labor legislation; from this time also came FASB (Financial Accounting Standard Board) and many of the accounting standards that have provided the foundation to financial reporting over the last 75 years. The organizations were created to bring greater rigor to corporate accountability as corporations increasingly became key players within society.

At the time of the Wall Street crash, shareholders prime value was represented by financial capital and it was this financial capital that shareholders, including those in the general public wanted protected. Accountability was all about “what are you doing with my money” and “where did my investment go?” As we start the 21st century we do so at a time when shareholder value has increasingly moved away from a focus on money and financial capital, to one where value is created by intangibles, many of which are not reflected on an organizations balance sheet, even though the outcomes of employing these intangible assets is reflected on the income statement. For the shareholder it’s a new world.

World population has also grown during this time; in 1929 it was about 2.0 billion while today it exceeds 7 billion; this population has gradually learned to harness natural resources such as water and minerals including oil to energize their development. This evolution has brought about significant social changes such urbanization, pollution and concerns about a developing shortage of certain resources.

Corporate accountability is no longer limited to information about financial performance; shareholders are increasingly demanding to know about performance risk in other areas such as the impact of a corporation’s use of natural and social capital. In many of today’s businesses a shareholder’s value can be decimated if it damages its reputation or brand through practices that the general public feels are no longer in line with societal expectations – and these expectations have changed as the public becomes more concerned about the environment and the behavior of public and private institutions.

In addition for many organizations human capital as well as intangible areas such as leadership and process capability have a direct impact on the sustainability and “going concern” capacity of an organization. The west in particular is in a new era as organizations move from the industrial economy to the knowledge economy; as in 1929, today we know that corporate accountability in its current framework does not work. This became evident over 30 years ago as corporate scandals such as “Whitewater” revealed a lack of oversight and corporate accountability. This continues and demands the revitalization of reporting for corporate entities.

Q1 (a) Do you believe that action is needed to help improve how organizations represent their value-creation process? Why/why not?

Yes.
Organizations used to focus on financial capital as a key driver of value creation and capability. Human capital was essentially inter-changeable and reasonably easily replaced. The work of people such as Frederick Taylor (1856 – 1915) had focused on industrial efficiency and focusing on workers as "parts of the system." There was a general lack of awareness of the environmental impact of utilizing "free" resources such as water and the air, and these resources were seen as both available and plentiful.

In 1929 the Wall Street crash created a realization that the consumption of financial capital was not being fully represented to key stakeholders, in particular shareholders. Pressure mounted to improve the system of accountability; while there was much "push back" from certain stakeholders who had vested interests around not disclosing such information, regulations and standards of reporting were gradually introduced that provided significant transparency on the source and use of financial capital.

Since the 1980's this same scenario has been evolving as the world starts to deal with the impact on "externalities" (resources utilized by not priced within the economic system), as well as developing increased focus on human capital as the driving source of value. Scandals have rocked the public's perception of corporate accountability in areas such as pollution caused by environmental spills and emissions; abrogation of accountability through misallocation of organizational resources including fraud committed by senior leaders; loss of resources through unethical employee behavior; violation of societal expectations around integrity and principles through manipulation of financial transactions and many others. Corporate entities and their shareholders have suffered massive losses through fines and elimination of value that have come as surprises.

(b) Do you agree that this action should be international in scope? Why/why not?

Yes.
In particular because of the growing realization of inter-dependency through the utilization of natural capital (i.e. environmental pollution on one continent impacts others around the world); in addition today the world is economically inter-dependent as we have seen as a result of the banking crisis in particular the impact of first the US crisis caused by poor risk management in financing loans in the housing industry and secondly through the impact of the declining Euro based on national actions in European countries and its impact on the global economy.

We are all increasingly connected and we "sink or swim together".

Q2. Do you agree with the above definition of Integrated Reporting? Why/why not?

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

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

Yes – but:
Generally I like the definition above however I think there will be some level of resistance in stating that the report includes "strategy" without a clear understanding of what context that word is being used in. For many organizations this statement will start to encroach on what should be held confidential.

I believe that the statement starting with the second sentence "It provides a clear and practical…." focuses on what the main purpose is, which is the aligning and integrating (and maybe later improving and enhancing) the materials that are being disclosed today by progressive organizations.

Q3. Do you support the development of an International Integrated Reporting Framework? Why/ why not?

Yes – but:
Engagement of the international community is essential for the reasons stated in the earlier summary – i.e. we are inter-dependent today more than ever before. However the challenge will be in how to engage people so that the "intent" which is good is actually moved to "execution" – i.e. where it will actually work.

Thus I believe that while the discussions should be global there should be a clear delineation between the types of entities being included and how reporting should work. I expand on this below.

Q4. (a) Do you agree that the initial focus of Integrated Reporting should be on reporting by larger companies and on the needs of their investors? Why/why not?

Yes and No:

The initial reporting should focus on larger organizations but I have two concerns; the first is focusing on "companies;" because there are different types of corporate structures around the world I think the scale and scope of initial inclusion should be determined not by corporate structure but by impact. As an example I would suggest initial inclusion of organizations of any type – public or private that meet certain key criteria. These could include:

- Organizations that a publicly owned through shareholding or public debt;
- Organizations that are "taxpayer" owned and accountable to the public at large;
- Consumption above a certain threshold of natural resources that are economically priced;
- Consumption above a certain threshold of resources that are "free" – as an example emissions, and use of water;
- Operations that impact outside a certain radius (i.e. those that operate internationally?);
- Scale criteria such as employee size, revenue size or even possibly number of locations?

In this way I think we start with not only what investors should be aware of but also what the general public has a right to know about.

(b) Do you agree that the concepts underlying Integrated Reporting will be equally applicable to small and medium enterprises, the public sector and not-for-profit organizations?

Yes - but;

See above comments; key areas identified in the table "How is Integrated Reporting Different?" supports the need for a broad application – however while applicability might be the same for public, private and not-for-profit and think that more careful scrutiny should be given to small and medium enterprises.

One key issue in assessing applicability around size will be the realization that different countries have differing definitions of what an SME (Small to Medium sized enterprise) actually is. I believe that some of the examples below indicate this issue?

Country	Source	Employees	Revenues
Canada	Industry Canada	< 500	< $50M
China	?	< 220 retail / trade to < 2000 manufacturing) to < 3000 construction	< ¥300M
Italy	?	< 250	< €50M
UK	?	< 250	< €50M

USA	Small Business Administration	Varies by SME - manufacturing from 500 – 1000	Varies by SIC

The EU has created a guideline for standardization of the definitions within the community and it would appear that some linkage back to this type of "collective" definition might be helpful?

The following table looks at the aspects of integrated reporting and attempts to illustrate that certain criteria as stated may be more or less critical in different types of enterprises. Prudence must be applied in asking for increased reporting and accountability; evidence (objective) must be presented to show that there is a need especially in transparency.

Criteria	Large	Medium	Small	Public	Private	NFP
Thinking	Yes	Yes	Less of an issue	Yes	Yes	Yes
Stewardship	Critical	Important	Important	Critical	Critical	Critical
Focus	Important for all enterprises					
Timeframe	Critical	Important	Important	Critical	Critical	Critical
Trust	Critical	Important	Important	Critical	Important	Critical
Adaptive	Needs rules	Need rules	Guidelines	Needs rules	Guidelines	Rules
Concise	Important for all users – "practical"					
Technology enabled	Yes	Yes	No	Yes	Maybe	Maybe

Q5. Are: (a) the organization's business model, and (b) its ability to create and sustain value in the short, medium and long term, appropriate as central themes for the future direction of reporting? Why/why not?

Yes and No:
Overall the business model reflects the various capitals that are employed to develop and organizations capacity to execute; however I believe that IIRC needs to create a "bridge" between the "capital's employed" framework and models that already exist elsewhere. I believe that this will help demonstrate that the concepts of integrated reporting are in fact a logical next step in organizational oversight and management.

There are a number of books and articles that I have written on this subject that I will reference – however here are what I believe to be key points:

1. Models for Excellence

Management models already exist in particular for organizational excellence; research that we did a few years ago into a number of these models indicate that there are common themes involved. I believe that these themes can be mapped to the concepts of the IIRC and make a suggestion of how on the next page.

I do not include all the research but the process was to a) identify a number of key models (European EFQM, Canadian NQI, US Baldrige etc.) and then b) identify key themes that appeared in each. We believe we identified a correlation in excess of 90%. We then developed a composite model which I use as the base for discussion on the following:

Themes of Excellence	Financial	Manufactured	Human	Intellectual	Natural	Social
Leadership			X	X		X
Planning	X	X	X	X	X	X
Client (sales channels)			X	X		X
Human			X	X		X
Process		X	X	X		X
Partners (Supply channels)			X	X		X
Reporting	X			X		X
Learning and Improvement			X	X		X

This representation is not an exact science and requires more in-depth research – however the appeal of an integrated reporting framework will increase if it is seen as holistic with the models through which organizations are managed.

2. Other models

The public sector has developed a number of models that are applied to the planning and execution of organizational activity and should be investigated. One example is the Canadian Federal Government MAF or Management Accountability Framework.

3. Alignment with other reporting models

Kaplan and Norton in their book “The Balanced Scorecard” went some way towards expanding the ideas of corporate reporting relative to the way that strategy is developed and deployed. Some level of accommodation strategy to this work in terms of alignment with IIRC would be a positive way of promoting the concept of integrated reporting.

The above concepts were developed in my book “Governance, Accountability and Sustainable Development: An agenda for the 21st century” that was published in 2005 by Carswell Thomson in Canada. In addition the three publications that I authored for the Institute of Management Accountants in the US are also relevant (these are available as free downloads from my website www.nickshepherd.ca):

- “Values and Ethics: From Inception to Practice” (2008)
- “The evolution of Accountability: Sustainable Development for Accountants” (2008)
- “Unrecognized Intangible Assets: Identification, Management and Reporting” (2010)

4. The language of Sustainability

A problem that I have encountered is that there are two schools of thought on sustainability and the work of the IIRC needs to bring these together. The first is the concept of “planetary sustainability” which in my mind deals with the aspects of CSR that have been developed trough organizations such as GRI. I would suggest these are strong on environmental and the “macro” social aspects of the (corporate) entity within society. However there is another aspect of sustainability that the accounting profession has used for many years which is the concept of a “going concern.”

Accountants (in reporting on public companies and those whom are subject typically to statutory audit) are required to express an opinion as to the ability of the organization to continue to operate in subsequent financial periods as a “going concern.” Typically this has focused in the area of financial capital – but with the emergence of intellectual capital as a core driver of organizational capacity – financial capacity means very little from a long term strategic perspective. In fact from a shareholders perspective damage to intangible assets through ineffective leadership can have a devastating negative impact on an organizations capacity to continue to operate. This the broader concept of sustainability from a shareholders perspective under the framework envisaged by the IIRC can only add value if it takes a broad approach to the identification and reporting of intangibles in the areas such as relationships, process capability and human capital.

Work by authors such as Thomas Stewart[1], Leif Edvinsson[2] and Ken Standfield[3] as well as more recently Mary Adams[4] clearly identifies the importance of these issues, but struggles with the metrics needed to address the issue. Work that we did for example shows that while organizations can build intellectual capital through qualifications, experience and tenure the ability and the quest to energize this capital and thus its ability to be a valuable intangible asset has much more to do with outcomes of effective leadership and motivation.

[1] *"Intellectual Capital – The New Wealth of Organizations" Thomas A. Stewart, (1997) Bantam Doubleday*

[2] *"Intellectual Capital – Realizing your Company's True Value by Finding it's Hidden Brainpower" Leif Edvinsson and Michael S. Malone (1997) Harper Collins*

[3] *"Intangible Management – Tools for Solving the Accounting and Management Crisis" Ken Standfield (2002) Academic Press*

[4] *"Intangible Capital – Putting Knowledge to work in the 21st Century Organization" Mary Adams and Michael Oleksak (2010) Praeger*

Q6. Do you find the concept of multiple capitals helpful in explaining how an organization creates and sustains value? Why/why not?

Yes

See answer to above question; the core of the need for change is driven by the need to recognize more than financial capital as a driver of organizational capability. Some key work that the IIRC is probably aware of is the representation of the 5 capitals contained in the work that the ACCA (Association of Chartered Certified Accountants) in the UK was involved with. For those unaware of this work it can be seen at:

http://projectsigma.co.uk

Q7. Do the Guiding Principles identified in the Discussion Paper provide a sound foundation for preparing an Integrated Report – are they collectively appropriate; is each individually appropriate; and are there other Guiding Principles that should be added? Why/why not?

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

Concerns. This is a profound shift in accountability reporting in that it focuses on the organizations underlying approach to the marketplace which for many organizations might be seen as an intrusion into competitive advantage. I agree that there should be "context" for the reporting but would see that as being "that level necessary to position the current performance in a meaningful and relevant context." I have concerns that this approach may over-step boundaries.

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

Agreed. This is a core aspect of integrated reporting; the areas that I might express concern over relate to the level of public disclosure around strategic aspects of the business operations; in addition public disclosure of remuneration aspects unless dealt with on a "holistic" and aggregated basis may cause problems with privacy concerns in some jurisdictions?

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

Concerns. Requiring disclosure on forward looking aspects will again prove a problem to many organizations; risk assessment and response is typically an internally oriented activity and in many cases will impact strategic approaches that may or may not impact competitive advantage.

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

Agreed. I like this aspect and consider it a key driver to readers of reports understanding the due diligence that the "reporter" has engaged in to determine the areas of focus. In particular I like this aspect because it links in to the approach taken by reporters such as GE (who have won CERES awards for their reports) whereby they avoid obtaining third party assessments of their CSR reports preferring to let the stakeholders themselves comment on the acceptability.

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

Agreed. This is a key aspect to the GRI framework that I have always liked. I believe that this links back to the need to limit broad based discussions in the early principles such as the strategic area.

Overall comment and suggestions

Based on the five guiding principles and the comments above, I believe an approach that takes a higher level view is more appropriate. What might this look like? I have in mind the following

Principle # 1 Clarity of capital dependency; in this statement the reporting entity would define the level to which its activities impact the various "capitals" required to operate. This would be more of a "statement of fact" based on current consumption and impact including a history.

Principle # 2 Clarity of engagement; this would focus on the process through which the reporting entity identified and connected with its stakeholders. This would outline how "those we impact and those whose activities impact us" were identified, engaged and assessed in terms of their relative level of involvement.

Principle # 3 Concept of clarity and relevance; this principle would address what is currently included in "Conciseness, reliability and materiality and would deal with the creation of the reporting framework in terms of meeting the needs of principles one and two above.

Q8. Do the Content Elements identified in the Discussion Paper provide a sound foundation for preparing an Integrated Report – are they collectively appropriate; is each individually appropriate; and are there other Content Elements that should be added? Why/why not?

Overall comments

I have some concerns about the clarity of segregating the "principals" and the "elements" as I believe they overlap and unless clarified might lead reporting entities to confusion and duplication of work.

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

I believe this is important in terms of the discussion earlier around context; it seems to me that this is repetitious with the principle of "strategic focus" and may lead to complexity.

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

I believe that while this is necessary to create context it again conflict with material identified in the principle of "strategic focus."

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

Again I have a fear that this forward looking statement may encroach upon an organizations areas of competitive advantage. I would like to see this aspect dealt with as a more transparent discussion between aspects of the organizations activities (what do we impact today and to what extent) and how the organizations intends to lessen the impact especially in the areas of externalities.

I think in this area of disclosure it is important to link back to stakeholder needs. From what I understand of the driving forces of key stakeholders, the need is to understand where risk exists today and where management actions are headed to change this profile. There needs to be a balance on what is required for disclosure and the ability of the organization to retain key confidential information. As an example, much of the investor concern today in terms of issues that have been crystallized probably relates to areas such as CDER (Carbon Disclosure Reporting).

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

I think this is a positive approach and one that links directly to the concerns raised in my 2005 book[5]; the key aspect here should be ensuring that a) the board has effective oversight on a set of key performance indicators (KPI's) that align with the reporter's capacity to execute. However ensuring this alignment and making information that the Board needs to conduct effective oversight without disclosing it in a way that impacts competitive advantage are two different issues and ones that lay at the heart of how the balance between the goals of IIRC and the public at large are concerned.

In terms of remuneration I have addressed this earlier and while I agree that statements of principles and aggregated impact are important that is as far as it should probably go?

Q9. From your perspective as a reporting organization:

(a) Do you agree with the main benefits as presented in the Discussion Paper? Why/why not?

(b) Do you agree with the main challenges as presented in the Discussion Paper? Why/

I am not a reporting organization.

Q9. From your perspective as an investor:

(a) Do you agree with the main benefits as presented in the Discussion Paper? Why/why not?

(b) Do you agree with the main challenges as presented in the Discussion Paper? Why/why not?

(c) Do you agree that Integrated Reporting will drive the disclosure of information that is useful for integrated analysis? Why/why not?

I am an investor but not one who has a material impact or interest in this activity.

Q9. From your perspective as a policy-maker, regulator or standard-setter:

(a) Do you agree with the main benefits as presented in the Discussion Paper? Why/why not?

(b) Do you agree with the main challenges as presented in the Discussion Paper? Why/why not

I am not a policy maker – purely one who tries to influence such activity!

Q9. From your perspective as a key stakeholder:

(a) Do you agree with the main benefits as presented in the Discussion Paper? Why/why not?
(b) Do you agree with the main challenges as presented in the Discussion Paper? Why/why not?

Yes. In terms of stakeholders, I am currently an Organizational Stakeholder of GRI and am responding in that capacity. My main role is one of management consultancy but more importantly the development and delivery of professional development activities for professional accountants.

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[5] *"Governance, Accountability and Sustainable Development," Nick Shepherd (2005) Carswell Thomson*

In this capacity I have concerns that the profession is "…getting better and better about auditing and reporting what is less and less relevant." I believe strongly, as presented in my opening comments that corporate accountability, transparency and reporting need a major revision as we move into the 21st century economy. So in terms of the man benefits I agree.

In terms of the challenges I agree with what has been outlined in the paper, and also believe that there are a number that have not been (maybe clearly enough) dealt with. These include:

- Issues around community of user engagement OUTSIDE of those who are already engaged as "believers" (which is a minority of reporters at this time);
- The issue of the impact and balance of meeting competitive advantage issues whole achieving an acceptable level of transparency (I would compare this to the impact of SOX - Sarbanes Oxley legislation – that was well intentioned and necessary for the small proportion of unethical leaders and reporting organizations, but has negatively impacted the competitiveness of a whole economy?);
- The impact of transition should the concepts in this proposal achieve readiness after the pilot and guidelines have been developed;
- The legislative impact through which current reporting is mandated by commercial legislation which differs among various jurisdictions;
- The issue of different approaches to a) developed versus developing economies and b) between entities that vary in both size and statutory type.

Overall I believe in the goals of IIRC; however my concerns are that the intents will be seen as "idealistic" and potentially impractical by many traditionalists and also will not be enshrined in legislation in many reporting jurisdictions. Therefore a simpler, more aligned approach with current internal management approaches might allow for a more effective "buy in" from the reporting community.

Q10. (a) Do you agree that the actions listed in the Discussion Paper should be the next steps undertaken by the IIRC? Why/why not? Are there other significant actions that should be added?

(b) What priority should be afforded to each action? Why?

Q11. Do you have any other comments that you would like the IIRC to consider?

Overall I agree that at this time the steps outlined are a practical way forward; one item that I would suggest is that (based on who participates in the pilot) there should be the equivalent of a "partnering pilot. This would mean that as a second round of pilot's a number of organizations who have not to date had exposure in any form, of supplemental reporting (CSR) would be engaged to trial the guidelines developed as a result of the initial pilots.

A key concern that I have in initiates such as this is that as they move forward the gap between those with "no knowledge" and with "some knowledge" and as "advanced adopters" rapidly increases. This will make it harder for later entrants to bridge the gap towards compliance and thus may prove to be a disincentive. Learning is a progressive activity and as such the new guidelines should be viewed from the perspective of an organization with no knowledge moving forward rather than what would appear to be a group of people who have already “bought in to” the concept.

Closing

Thank you for this opportunity to comment on the IIRC discussion paper; this is a timely and critical initiative.

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