

INTEGRATED REPORTING <IR>

THE PILOT PROGRAMME  
2012 YEARBOOK

# Capturing the experiences of global businesses and investors



# About the IIRC



For more information visit:  
[www.theiirc.org](http://www.theiirc.org)

The International Integrated Reporting Council (the IIRC) is a powerful international cross-section of leaders from the corporate, investment, accounting, securities, regulatory, academic and standard-setting communities, as well as civil society.

The IIRC is chaired by Professor Mervyn King, and Paul Druckman is Chief Executive Officer.

The IIRC's mission is to create the globally accepted Integrated Reporting (<IR>) Framework (the Framework) that elicits from organisations material information about their strategy, governance, performance and prospects in a clear, concise and comparable format. The Framework will underpin and accelerate the evolution of corporate reporting, reflecting developments in financial, governance, management commentary and sustainability reporting. The IIRC will seek to secure the adoption of <IR> by report preparers and gain the recognition of standard setters and investors.

[www.theiirc.org](http://www.theiirc.org)

INTEGRATED REPORTING <IR>

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### About this Yearbook

This document is extensive in its content and is intended to be used for reference purposes, not as a report. Readers can refer to individual sections for further information, quotes and case studies from the businesses in our Pilot Programme.

All Pilot Programme participants were given the opportunity to contribute to this Yearbook. Some businesses provided written submissions, some were interviewed (to supplement or clarify information in their contributions), and other businesses and investors provided information via interview. Businesses' Annual Reports or Annual Reviews and IIRC documents were also used to supplement information.

### Statement from the CEO

This Yearbook profiles the journey many businesses have embarked upon towards communicating more coherent, value-relevant information to investors and other stakeholders. It also showcases the development that has taken place in the first year of the IIRC's Pilot Programme.

The Pilot Programme is the IIRC's innovation hub, where creativity meets the reality of today's corporate reporting challenges. At its core is the commitment of over 75 businesses and 25 investor organisations to contribute to the development of a technical framework for <IR>. A consultation draft of the Framework will be published during the first half of 2013.

Many stakeholders have an interest in high-quality corporate reporting and a sustainable economy depends on relevant and accurate information flowing to investors, to enable efficient and productive capital allocation. As the world wrestles with the challenges afflicting the economy and environment, internationally-recognised businesses and investors have come together to make sure the reporting environment becomes fit for the 21st century.

While it is reasonably straightforward to achieve consensus on the need for change, a harder challenge is to address the many legal, regulatory, technical and practical issues that arise from this attempt to be the catalyst in the evolution of corporate reporting. The Pilot Programme seeks to bring these issues to the fore, and provide real-time insights that inform technical papers and detailed consultations with market participants.

Their transparency in sharing the challenges, practices, and the highs and lows of putting the concepts underlying <IR> into practice, provides a window of possibilities to strengthen the credibility of corporate reporting.

This Yearbook shows the progress being made through shared experiences, lessons learned and best practice. It is extensive in its content and I expect that readers will want to use it as a resource as corporate reporting evolves towards <IR>. The Yearbook also identifies emerging themes and practices, focusing on the technical topics that are currently being examined, including; business model, capitals, connectivity, materiality, users and their information needs and value. As many of the companies and investors featured in this report demonstrate, <IR> is an idea whose time has come.

I would like to thank Trucost and Research Editor Liesel van Ast for helping us bring the stories in this report to life.

Paul Druckman



# EXECUTIVE SUMMARY

The IIRC Pilot Programme was established to enable businesses and investors to share experiences and to create the conditions for widespread adoption of <IR> in the years to come. A critical part of enabling global acceptance is the creation of the Framework which will set out the concepts and principles from which businesses will produce their Integrated Report. The Pilot Programme plays a large part in testing the robustness of the Framework.

Since October 2011, more than 75 businesses from a variety of sectors and 23 countries – the Pilot Programme Business Network – began to put the concepts and principles underlying <IR> into practice. In addition, the Pilot Programme Investor Network, with a membership of 25 institutional investors, helps to ensure that the information that businesses communicate in their Integrated Reports is value-relevant and supports capital market decision-making.

The first year of the Pilot Programme has set an important benchmark for future activity. The Pilot Programme Yearbook demonstrates that businesses are starting to see extensive changes in thought processes across their organisations. Businesses are starting to use the <IR> concepts and principles to drive their focus on integrated thinking and strategic decision-making.

This first Yearbook shows that businesses are at different stages in their evolution towards <IR>. Some organisations have produced non-public integrated reports, which have

enabled them to test systems and processes internally. Others are combining information as a first step towards integration, while another group have incorporated the concepts and principles of <IR> in their Annual Reports and accounts. For many businesses at the first stage of experimenting with <IR>, it will take more than one reporting cycle to implement <IR>.

The Pilot Programme continues to gain momentum and the fact that so many multinational businesses are actively taking part in this initiative is testimony that <IR> not only benefits investors, but is also a valuable tool for businesses.

Our challenge to Pilot Programme members is to provide insights and perspectives that ensure the evolution towards <IR> is informed by business and market experience, and not necessarily to produce an Integrated Report immediately. The Pilot Programme has therefore been extended into a third year, 2014, enabling participants to trial version '1.0' of the Framework.

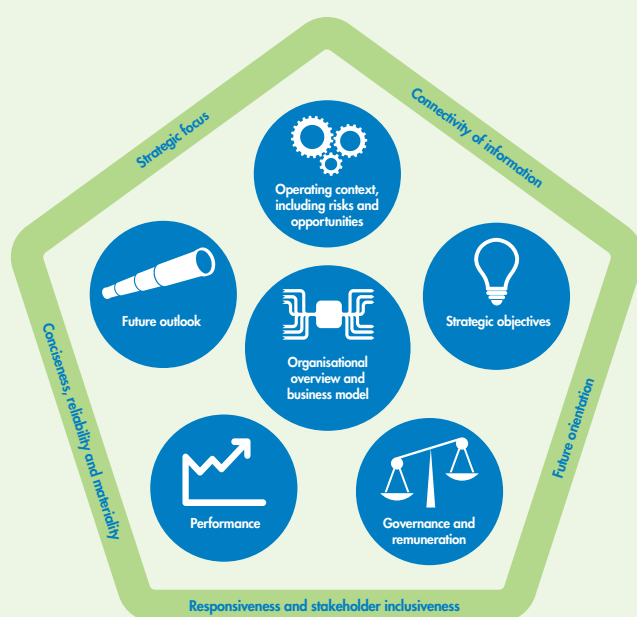
The Investor Network is critical to the success of the Pilot Programme and will review and comment on innovations made by businesses within the Pilot Programme, as well as providing detailed input into the development of the Framework. This network is exploring how <IR> can be a route for investors to obtain better quality and more relevant information from businesses, enabling them to allocate capital more efficiently. Investors need Integrated Reports to reveal how companies take account of the capitals in business models and strategies.

## What is integrated reporting?

<IR> brings together material information about an organisation's business model, strategy, governance, performance and prospects in a way that reflects the commercial, social and environmental context within which it operates. It aims to communicate the 'integrated thinking' through which management applies a collective understanding of the full complexity of value creation to investors and other stakeholders.

The IIRC aims to create the globally accepted <IR> Framework. The IIRC's Discussion Paper, *Towards Integrated Reporting – Communicating Value in the 21st Century*, released in September 2011, outlined initial proposals for the development of the Framework, which included the following building blocks:

## Guiding principles and content elements



## Pilot Programme businesses comment on key technical topics

The IIRC asked the Pilot Programme participants to share their latest thinking on the five areas that are the focus of technical papers being developed by the IIRC Secretariat. Our main findings are as follows:

### 1 Business model

- Some companies are identifying new business models in terms of operating structures, brands and product or service offerings.
- Investors need to understand a company's strategic focus and how its business model supports its ability to create value.
- Business models can describe capitals on which an organisation relies, strategic objectives to add value to these capitals, and delivery of products or services to achieve these objectives.
- Reporting on the business model in an integrated way can provide insight into how external factors drive risks and opportunities that define markets and influence value creation.

[More information on page 17](#)

### 2 Value

- Businesses are demonstrating ways to create and preserve value through their business models and values.
- There is growing recognition that a wide range of factors create value in the short, medium and long term.
- Some companies are using innovative ways to communicate value creation and preservation through the capitals.
- Recognising value creation more comprehensively can help identify value at risk.

[More information on page 21](#)

### 3 The capitals

- The capitals evaluated in <IR> are financial capital, manufactured capital, human capital, intellectual capital, natural capital and social capital.
- Many companies in the Pilot Programme are initially strengthening measurements of corporate key performance indicators (KPIs) in relation to the capitals, as part of understanding their strategic significance to businesses.
- Finance departments within Pilot Programme businesses are becoming accountable for more than financial information.
- Many companies seek independent verification and assurance of more than just financial information to ensure data quality is adequate for decision-making.
- Industry-specific and local issues can drive the KPIs selected to assess dependence and impacts on capitals.
- More insight into links between capitals could help address the challenge of demonstrating their relevance to strategic decision-making.
- Companies are strengthening accountability for capitals to meet investors' needs for more comparable, meaningful information.

[More information on page 26](#)

“Pension funds cannot avoid corporate externalities because they are internalised over long term investment horizons”

Piet Klop, PGGM

#### 4 Connectivity

- Working across departments to connect information in order to develop <IR> can help break down ‘silos’ and lead to stronger cross-functional communications.
- Connecting information can facilitate more productive dialogue between employees at all levels across business activities, and a more cohesive approach to reporting.
- Company management that connects information can develop more integrated thinking and cohesive reporting.
- Integrated decision-making can contribute to more meaningful dialogue with external stakeholders.
- IT applications can provide a starting point to improve capabilities to link information and provide access to it. New IT tools can be useful to connect data and narrative.

[More information on page 33](#)

#### 5 Materiality

- Several investors have called for Annual Reports to clearly identify material risks and the financial and strategic implications of all the capitals.
- Many businesses in the Pilot Programme are engaging with stakeholders to help determine issues material to stakeholders.
- Materiality assessments can be useful to identify and prioritise issues that could be material to the organisation’s value in the short, medium or long term.
- Scenario analyses can help address uncertainties surrounding the probability, timing and magnitude of potentially material factors.
- Companies can connect internal and external information on all of the capitals to identify material issues that are relevant to strategy development.

[More information on page 38](#)



**INTEGRATED  
REPORTING &  
YEAR ONE  
OF THE  
PILOT  
PROGRAMME**





## Integrated Reporting

<IR> is an evolution in corporate reporting that supports business and investor decision-making, by helping to reveal how value has been created over the short, medium and long term. The combined effects of a series of economic, business and environmental crises underlines the need for <IR>. The economic repercussions of the global financial crisis that started in 2007 demonstrate the interdependence between society and business. Economic difficulties in many parts of the world are causing businesses and policymakers to question capital market orthodoxy and challenge traditional accounting practices, business models and value creation methods. One concern is whether capital is being allocated in the most effective way to achieve sustainable returns over the short, medium and long term. The quality of the information businesses communicate to the market is a significant factor in determining investors' capital allocation decisions.

The power and influence of the world's largest corporations is considerable and deserves to be better understood. It is tempting to think of this power purely in terms of financial impact. Yet it is the decisions companies make that have the greatest impact, both positive and negative, for the economy, people and the environment. More relevant disclosures by companies can help investors and other stakeholders to gain a better insight into the quality of the decisions companies make, and the degree to which they are securing the businesses' long term future. A lack of adequate reporting on risk factors and strategic information in many compliance-driven Annual Reports creates a vacuum in information available to investors. There is a gap between what companies disclose and what investors need to consider, particularly regarding how they are equipped to respond to changing operating contexts and how they balance short and long term interests.

Investors need reliable and relevant information – the lifeblood of capital markets. Businesses, investors and standard-setters are collaborating to improve corporate reporting and help address the need for companies to create and preserve value, and contribute to sustainable and stable economies.

The IIRC aims to develop a Framework that helps companies and investors make more informed decisions and helps organisations communicate clearly how they create value. <IR> is not the only or final answer. It is one route to help address current challenges by spurring more rounded strategic thinking and integrated risk management. It aims to help companies and investors allocate scarce resources, including financial capital, more efficiently. Responses to the IIRC's Discussion Paper in 2011 showed overwhelming support for the development of a flexible principles-based Framework.

## Building on existing reporting practices

<IR> aims to elicit a more coherent and concise representation of links between an organisation's business model, value creation strategy, and capitals, putting them into the context of the whole business. It aims to build on recent reporting developments to communicate more clearly how material factors contribute to creating and preserving value. The Framework will be used alongside existing standards and guidelines, including those for financial and sustainability reporting. <IR> is not about selecting disconnected KPIs and performance data. Instead, it is about establishing a conceptual market-led framework in response to investor demand and changing stakeholder expectations. "We are now taking the critical first steps towards a new way of reporting globally. Being at the helm of an organisation concerned with business and sustainability, I am excited by the huge potential this gives business to make positive changes to our world," said Peter Bakker, President, World Business Council for Sustainable Development (WBCSD).

## Year one of the Pilot Programme

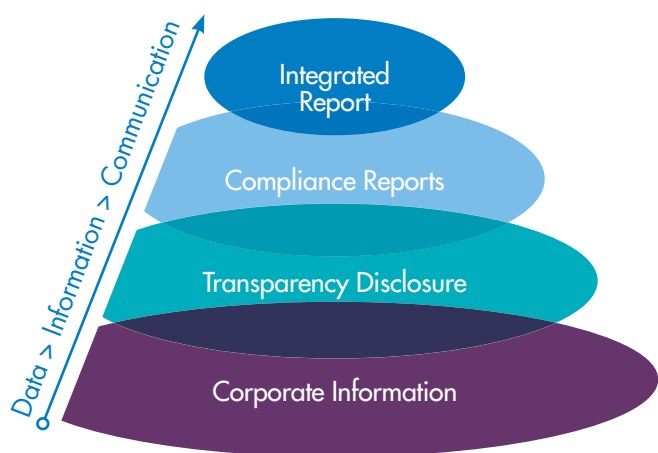
The IIRC's Pilot Programme is a major contributor to the development of <IR>. More than 75 businesses from a variety of sectors and 23 countries began to put the concepts underlying <IR> into practice during the first year of the Programme. Their feedback on the application of the guiding principles and content elements outlined in the 2011 Discussion Paper is invaluable to inform the development of a practical Framework.

The Framework is being developed with the information needs of investors as the primary focus. The Pilot Programme Investor Network, established in March 2012 engages investors actively in this process (see page 12

– The Investor View). As <IR> evolves, more consideration will be given to how the Framework can be tailored to address broader stakeholder information needs.

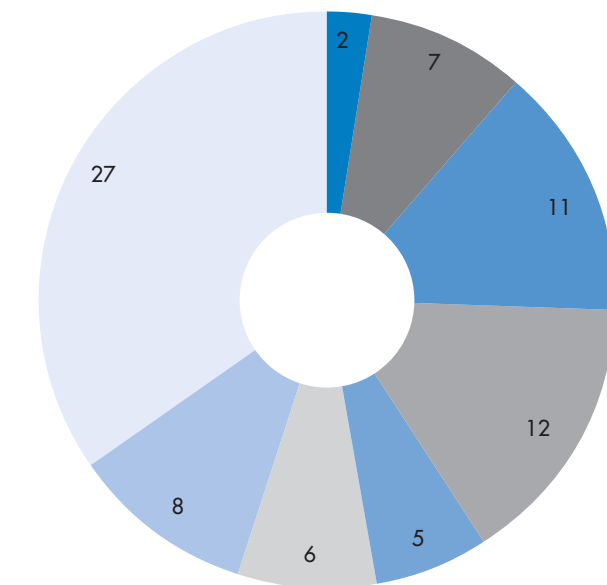
The IIRC has hosted meetings and webinars to enable businesses and investors in the Pilot Programme to share learning and experiences (see page 9 – Activity box). During the first year, businesses have also participated in regional networks, conferences, surveys and a dedicated community website. This wide-ranging interaction provides the opportunity to discuss and challenge the technical material being developed by the IIRC and to test its application. Participants are helping to raise awareness of <IR> among business leaders worldwide.

## <IR> provides a strategic focus



<IR> draws on different aspects of reporting to enable the business to communicate how its strategy and business model create and preserve value.

## Pilot Programme business participants by sector



- Oil & gas
- Basic materials
- Industrials
- Consumer goods and services
- Healthcare
- Telecommunications and technology
- Utilities
- Financials
- Total: 78

## Activity

This year members of the Pilot Programme have...

...contributed to the development of the Framework by:

- Completing a survey to explore <IR> in their organisation
- Participating in an investor critique of current corporate reporting
- Contributing to webinars on
  - the practical guide
  - Discussion Paper feedback
  - materiality
  - the current corporate reporting landscape
  - value
  - reliability and assurance
- Establishing PP regional networks for
  - the Americas
  - United Kingdom
  - Netherlands
  - Germany
  - South Africa
  - Japan
  - Eastern cluster (Australasia and SE Asia)

and further networks are being developed

...built momentum towards <IR> by speaking to:

- regulators at Federation of European Accountants (FEE) conference on <IR>
- policy makers at a university in the Netherlands
- business and finance peers in Germany at SAP-hosted roundtable
- United Nations Global Compact (UNGC) members at Rio+20
- International Corporate Governance Network (ICGN) members at their annual conference in Rio
- 250 global investors at Principles for Responsible Investment (PRI) annual conference in Rio
- over 100 FTSE100 peers in London
- 1,000 global finance professionals in Las Vegas at the Institute of Management Accountants (IMA) annual conference
- 200 investors in Madrid with European Federation of Financial Analysts Societies (EFFAS)
- businesses, investors and regulators in Sydney at the Integrated Reporting in Action conference
- 300 governance leaders in Vancouver at the Canadian Society of Corporate Secretaries (CSCS) annual corporate governance conference

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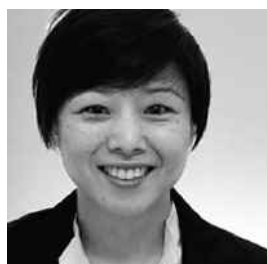
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## Participating business by country

### Australia

mecu Limited  
National Australia Bank Limited  
Stockland

### Belgium

Solvay

### Brazil

AES Brasil  
BNDES  
Natura  
Via Gutenberg

### Canada

Vancity

### Chile

MASISA S.A.

### China

CLP Holdings Limited

### Denmark

Novo Nordisk  
Vestas Wind Systems

### France

Danone

### Germany

EnBW Energie Baden-Württemberg AG  
Flughafen München GmbH  
SAP

### India

Tata Steel

### Italy

Atlantia S.p.A.  
CNDCEC  
Enel S.p.A.  
eni S.p.A.  
Generali Group  
PricewaterhouseCoopers Advisory  
Terna S.p.A.

### Japan

Ernst & Young ShinNihon LLC  
Showa Denki Co. Ltd.  
Takeda Pharmaceutical Company Limited

### Netherlands

AEGON N.V.  
AkzoNobel N.V.  
BAM Group  
B Wise B.V.  
Deloitte Netherlands  
Ernst & Young Nederland LLP  
Eureko (Achmea)  
LeasePlan Corporation N.V.  
N.V. Luchthaven Schiphol  
PriceWaterhouseCoopers N.V.  
Rabobank  
Randstad Holding N.V.

### New Zealand

New Zealand Post

### Russian Federation

Rosneft  
State Atomic Energy Corporation  
ROSATOM

### South Africa

Eskom Holdings SOC Limited  
Gold Fields  
SASOL  
STRATE  
Transnet

### South Korea

Hyundai Engineering & Construction  
SK Telecom

### Spain

BBVA  
ENAGAS S.A  
Indra  
Industria de Diseño Textil S.A. (Inditex)  
Telefónica S.A.

### Sri Lanka

Diesel & Motor Engineering PLC

### Sweden

AB Volvo - Volvo Group

### Switzerland

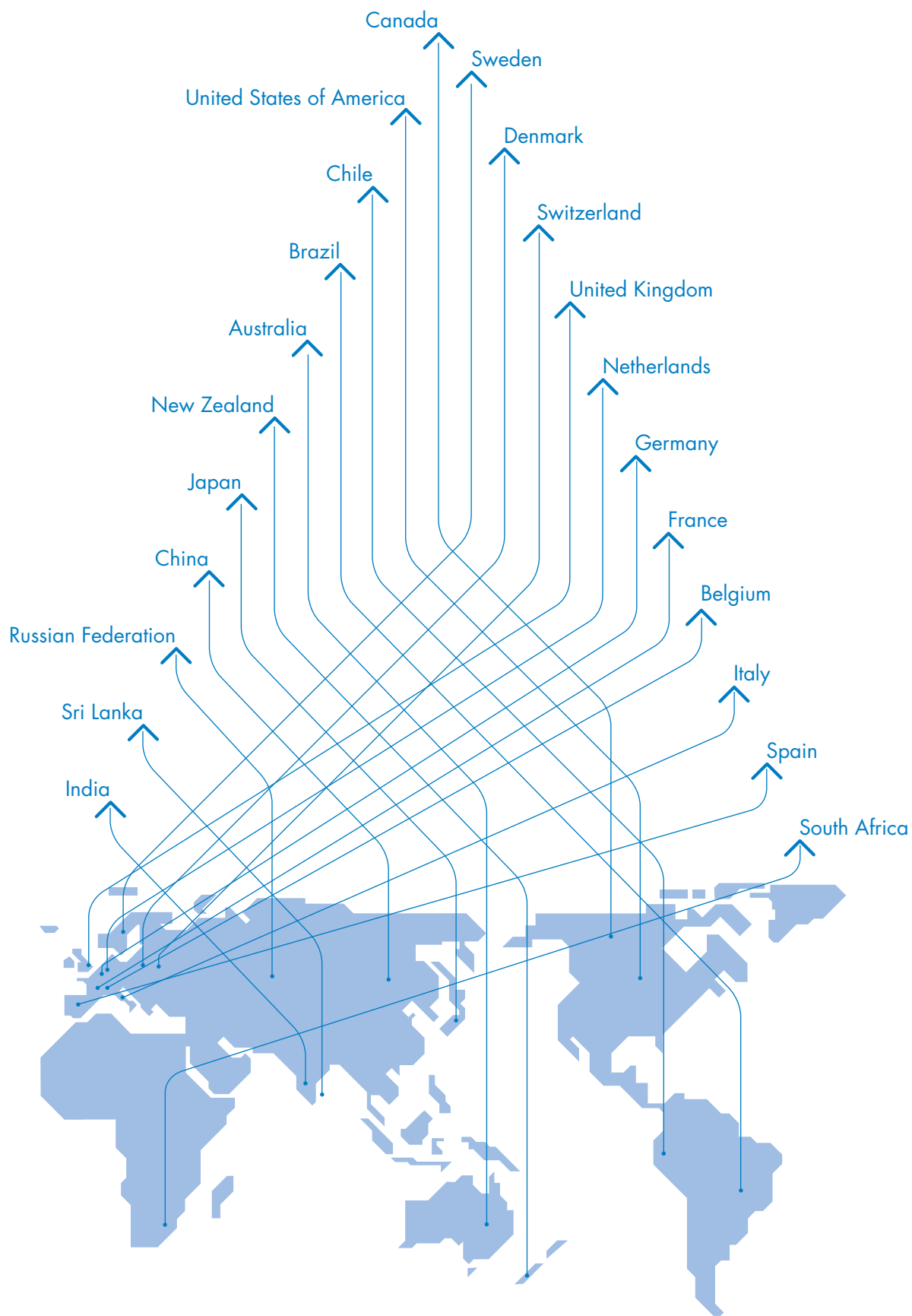
KPMG International

### United Kingdom

ARM Holdings plc  
Association of Chartered Certified Accountants  
The Chartered Institute of Building  
The Chartered Institute of Management Accountants  
Deloitte LLP  
Grant Thornton UK LLP  
HSBC Holdings plc  
Marks and Spencer Group plc  
NHS London  
Sainsbury's  
The Crown Estate  
Unilever

### United States of America

Cliffs Natural Resources  
Edelman  
Microsoft Corporation  
Prudential Financial, Inc.  
The Clorox Company  
The Coca-Cola Company



## The Investor View

The IIRC's Pilot Programme Investor Network is contributing to the development of the International <IR> Framework to ensure it meets investors' needs.

One of the Investor Network's first tasks was to critique 13 primary reports from reporting organisations in the Pilot Programme. Several asset owners and investment managers provided feedback on shortfalls in reporting to date, to gauge how <IR> can address these, and to clarify what they need to see in companies' reports for the purposes of investment analysis. Piet Klop, Senior Advisor, Responsible Investment at Dutch pension administrator PGGM Investments, highlighted one example of good reporting: "The report begins with its strategy, determines related indicators to track progress, explains objectives and links these to external impacts and hard financial metrics. It also explains how the business is positioning itself for major external trends."

### Demand for <IR> set to grow

Deep and liquid capital markets are essential for the effective functioning of the global economy. Capital is allocated largely on the basis of information provided to institutional investors by businesses. The investor community is far from homogenous and is made up of short and long

term investors, as well as traders. Overall, in recent years, institutional investors have held equities for much shorter periods, a phenomenon that may have exacerbated market volatility and contributed to a culture of short termism. In 1940 the mean duration of U.S. equity holdings by investors was approximately seven years. By 2007, this had fallen to just seven months.

Many investors' information needs as well as their perspectives and their expectations of businesses, are changing. There is a growing realisation that they need better quality information from businesses to enable a more efficient allocation of capital. <IR> will accelerate this process by encapsulating more of the intangible value of businesses.

There is also a growing body of research which shows that greater transparency can improve a company's access to capital. For example, a study by Beiting Cheng and George Serafim from Harvard Business School, and London Business School's Ioannis Ioannou, showed that greater corporate transparency reduces information asymmetries between businesses and investors, reducing perceptions of risk, which in turn can reduce agency costs – the operating expense caused in a business when managers and shareholders disagree about decisions – this can enhance a company's ability to obtain capital through lower interest rates and/or a larger amount of funds.

Demand for change is coming from various sources. Investor initiatives such as the International Corporate Governance Network (ICGN) are calling for change in the way investors relate to the assets they invest in. The IIRC's Investor Network is raising awareness of ways in which investors can address short termism, driving change towards a longer term view for investment decision-making.

Bob Laux, Director of Accounting and Reporting at Microsoft Corporation, believes that many investors have short term views of financial and business reporting. He said, "Investors need to put more stock on long term sustainability – not from an environmental angle, but for the long term good of the company. This doesn't resonate much in the fragmented shareholder community.

Underlying asset owners – such as pension funds and insurance companies – often hold investments in companies for a long period. Piet Klop said that long term investors need to make decent returns over the short term and be accountable to clients, but not at the cost of the long run.

### The IIRC Pilot Programme Investor Network

AMP Capital Investors	Government Employees Pension Fund of South Africa
APG	Hermes EOS
Arisaig Partners	Interamerican Development Bank
ATP	Natixis Asset Management
Australian Council of Superannuation Investors (ACSI) (on behalf of StatewideSuper + AustralianSuper)	Newton Investment Management Ltd
Calvert	Norges Bank Investment Management (NBIM)
CFA Institute	Pax World
Colonial First State Global Asset Management (including First State Investments)	PGGM
DWS Investment GmbH (DB Advisors of Deutsche Bank Group)	Railways Pension Trustee Company Limited
European Society of Financial Analysts Societies (EFFAS)	Rathbone Brothers Plc
Element	Rockefeller Financial
Ethos Foundation	Skandinaviska Enskilda Banken (SEB)
	Victorian Funds Management Corporation

# Q&A with Colin Melvin

## CEO Hermes Equity Ownership Services and Chair of the Investor Network

### What do companies stand to gain from <IR>

Integrated Reporting provides an interesting change in perspective on companies. Many people see sustainability as separate to company behaviour and success.

However, it is about how companies are run and their longer term viability, resilience and ability to deliver value. Behind <IR> is a desire to combine sustainability with more mainstream financial aspects. In the long run, companies that behave well, do well.

### What are the barriers to the development of <IR>

A fundamental problem within the investment industry is a short term orientation. In general, the investment industry focuses on decisions around buying and selling rather than ownership of companies. Fund managers often just want information about the next quarter, but should find out about corporate strategies, risk and governance in the longer term.

Part of the difficulty is that investment mandates can be terminated at any time and fund managers are often measured over cycles. This needs to change. Responsible ownership of companies is important to society.

### How can these barriers be addressed

Through stronger governance, stewardship and accountability. Addressing short termism will probably require policy and regulatory measures. Within the financial industry, we need to empower and encourage asset owners to exercise more control to drive better performance by fund managers over the longer term. This involves reassessing the relationship with fund managers on a longer term basis, where appropriate for clients. Fund managers will require a change in contractual relationships to provide incentives that align their activities with clients' interests.

We need to reassure pension fund trustees that they can interpret fiduciary duty with a long term perspective. Stronger funds can demand better returns and drive better behaviour. Integrating ESG issues into strategies is in the interests of the public at large. The capital deployed through fund managers is the money of workers and savers.

### What is the Investor Network doing to support this

Promoting Integrated Reporting <IR> is a step in the right direction, but it won't be sufficient unless there is investor demand. The Investor Network will be important to establish dialogue between investors. We need to work with leaders in the investment industry who are driving change in the traditional approaches and behaviours of fund managers.

We plan to mobilise portfolio managers' involvement. We aim to find out what they want and need, while encouraging the investment industry to take a long term perspective. We will raise awareness of how they can help ensure <IR> supports investment decision-making. Investors with a longer term perspective will find information disclosed through <IR> useful if it looks at issues that are material, or could become so.

**“The discipline of producing Integrated Reports should benefit companies themselves. Integrating information from a management perspective can help to recognise how material issues link to business strategy and purpose.”**

Colin Melvin, Hermes Equity Ownership Services  
and Chair of the Investor Network

# PILOT PROGRAMME BUSINESSES COMMENT ON TECHNICAL TOPICS

The IIRC asked the Pilot Programme Business Network to share their latest thinking on the five areas that are the focus of technical papers being developed by the IIRC Secretariat:

1. Business model
2. Value
3. The capitals
4. Connectivity
5. Materiality



## Getting started

Businesses in the Pilot Programme are at different stages of working towards <IR>. Some are creating non-public reports to test the application of <IR> concepts internally and strengthen information management systems. Many are performing gap analysis to help identify information required to develop Integrated Reports, initially focusing on certain components of <IR>. Some companies are working towards more strategic and concise reporting in Annual Reports or Annual Reviews. Businesses in the Pilot Programme are working on a variety of approaches to start developing <IR> and working towards producing Integrated Reports, reflecting differences in organisations, business environments, regulatory regimes and stakeholder information needs. Some of these approaches are summarised in this section.

## Shadow Integrated Reports

Microsoft is among the companies that are initially consulting internal stakeholders on fledgling Integrated Reports. Their first Integrated Report is mainly aimed at demonstrating the value of <IR> within the company itself. Microsoft's Bob Laux explained, "We are concerned that financial reports have become compliance documents with disclosure overload. Evidence shows that people are not reading them to make investment decisions. We are passionate about helping an initiative that may change the financial discussion and improve business reporting.

To comply with fair disclosure regulations in the U.S., the team extracted information that was already publicly available. Microsoft's draft report follows the format outlined in the IIRC's 2011 discussion paper to provide an overview of the business and its strategy, explain how the company depends on capitals and manages key resources and relationships. It also discloses financial statements and integrates the Annual Reports' management commentary and key footnotes.

Managers within Microsoft who have seen the draft report view it as the start of a change process to think differently about the business. Laux said, "So far, we've had favourable feedback, but Integrated Reporting is going to take a lot of small, evolutionary steps to change people's mindsets."

Food and beverage company Danone is also creating a shadow Integrated Report during 2012. It will not be public, but internal stakeholders will be asked for feedback. The team producing the report will measure success through their ability to transform the shadow report into an official Danone report, and to close any gaps identified.

Developing its information management systems, OJSC Oil Company Rosneft is initially focusing on strengthening financial reporting across business activities, before broadening the scope to incorporate environmental and social factors in an Integrated Report. Different departments currently have their own goals and different financial reports, with a variety of financial indicators and data.

The Coca-Cola Company, the beverages producer, is currently analysing its internal reporting landscape to perform a gap analysis and understand data or content needs, overlapping needs, and variations in the scopes and quality of data. Corporate External Affairs Senior Manager Cassandra Garber explained, "We are assessing the information we currently have, or have the ability to gather, using existing financial and sustainability reporting systems. We are identifying our most critical reporting needs, taking account of voluntary and mandatory reporting commitments as well as stakeholder information requests. This will help us to define the elements we require for Integrated Reporting."

## Accounting for more than financial capital

Coca-Cola is formulating KPIs and measurements to strengthen reporting efforts in the future. Allyson Park, Vice-President, Corporate External Affairs, said that challenges in developing <IR> include the costs of collecting and assuring non-financial data in the same timeframe as financial data; quantifying human, social and intellectual capitals; understanding potential Securities and Exchange Commission requirements; and working towards full implementation of <IR>. Park explained, "We embed content from our Sustainability Report into our Annual Report, and vice versa. However, we do not feel that this is Integrated Reporting. Like many companies, we currently produce a combined report."

**"...so we took a "clean sheet of paper" approach to identify what's most important to investors and demonstrate our vision of how an Integrated Report could look."**

Bob Laux, Microsoft

### <IR> in Annual Reviews and Annual Reports

HSBC's involvement in <IR> is currently restricted to its Finance and Sustainability departments. Head of Group Finance Operations Richard Scurr said, "We will need to show the benefit of reporting in an integrated fashion to HSBC, and expect this will entail producing a 'straw man' version of the new document to demonstrate the implications of making the change."

Financial reporting rules present a barrier to HSBC. "As a financial institution, we are encased in a straightjacket of reporting rules, regulations and best practice guidelines which provide little room for manoeuvre when it comes to radically changing our reporting," explained Scurr. "Unless the restrictions can be eased and international inconsistencies ironed out, it is unlikely that we will be able to convert our full Annual Report and accounts to an integrated document. We may have to consider producing a separate report which integrates our Annual Review and our Sustainability Report."

Life insurance and pensions company, AEGON N.V. integrated elements of both its Annual Report and Sustainability Report in its 2011 review. The Review provides a concise overview of AEGON's strategic objectives, business model, risk factors, governance, operating environment and financial performance. For the first time, AEGON presents financial performance alongside environmental, social and governance performance. On AEGON's website, Chief Financial Officer Jan Nooitgedagt says that this approach provides a more comprehensive view of the company and its businesses: "I don't believe companies should be seen solely through their profit and loss statement – vital though that is. It's not just about financial performance. It's also about how a company is managed and governed and about how changes to the business environment bring new challenges and new opportunities. And it's about how effectively we are able to deal with those changes."

Mike Mansfield, AEGON's Sustainability Officer, says that endorsement of <IR> from the top of the company has increased awareness of the interconnection between financial and non-financial information in running the business. "It has helped us to start developing a set of key performance indicators that better reflect our business drivers," he said.

**"Endorsement of Integrated Reporting from the top... has helped us to develop key performance indicators that better reflect our business drivers."**

Mike Mansfield, AEGON

# 1 Business model

**An Integrated Report aims to provide an overview of the organisation and its business model.**

## Pilot Programme businesses comment on technical topics

### Business model

The starting point for AEGON was to take the two most significant lines of business – life insurance and pensions, and describe the business model as clearly as possible. Products are designed with the goal of helping people to secure their financial futures. AEGON's Mike Mansfield said, "We have attempted to address this in our Integrated Report by focusing on global trends to show how our business model is designed to meet the consequent risks and opportunities."

#### Strategic value creation

Investors need to understand a company's strategic focus and how strategic objectives relate to the organisation's ability to create and sustain value over time.

Danone is one of several participants in the Pilot Programme that defines its business model in terms of its ability to create value. Its core value proposition is to "Bring health to the largest number of people through food". The company plans to link more than financial issues to internal performance and risk management through the <IR> project, formalising the existing connection between economic and social issues in its business model.

Business models can outline capitals on which the organisation relies, activities that add value to these capitals and the outputs of these efforts, whether product or service offerings. Since 2008 Munich Airport operator Flughafen München GmbH (FMG) has reported on how its business model is geared towards sustainability, and since 2010 FMG has merged the sustainability and

Annual Reports into one. The company developed its business model by identifying its competitive advantage and customer proposition, focusing on opportunities and sustainability.

Some businesses that have not previously published Sustainability Reports are instead working to develop <IR> for their primary reports. The UK-based Chartered Institute of Building (CIOB), a professional body, reported on sustainability issues for the first time in its 2011 Annual Review. Relationships with members are at the heart of CIOB's business model, to create value to current and prospective members. This is supported by goals to offer a more rigorous and assured route to membership and to improve the qualifications that contribute to an effective and sustainably-built environment.

Reporting on the business model in an integrated way aims to provide insight into how risks and opportunities arising from a range of external factors influence value creation. Such factors might include a change in economic conditions, emerging societal and environmental issues, technological change and competitive forces; each contributes to the organisation's operating context and can affect its ability to create and preserve value. SAP bases its business model around strategies to develop opportunities in response to emerging trends such as changing demographics, shifting consumer preferences and the introduction of technology-enabled possibilities (see case study). The company connects its business model and strategy to create value with its five major growth opportunities, including core enterprise applications and data analytics tools.

**"Delivering material results to society will ultimately deliver value to investors. This can apply to any company that provides solutions to real problems. Integrated Reporting can give long term investors a better understanding of a company's capacity to understand the value it creates and how it manages its contribution to society in the long run."**

Sérgio Serapião, Via Gutenberg

SAP identifies factors that could undermine its ability to deliver its strategy as material management concerns. These include risks to the security and privacy of data now managed beyond the firewall and delivered via the cloud and mobile devices, the ability of human capital to drive intellectual and financial capital, greater demand driving up energy use, and maintaining standards of governance, conduct and values to anchor the company during fast-paced changes in technologies and markets.

<IR> prompted the private company to review its relationships with primary stakeholders, from clients to suppliers, to identify ways to strengthen the company's positioning and capabilities for long term success. Via Gutenberg considers clients and employees as part of the community, and does not distinguish between internal and external stakeholders. The company found that linking financial and CSR objectives strengthened relationships with clients, suppliers and potential investors.

Via Gutenberg's business model is based around Dr Michael Porter's concept of shared value, which involves creating economic value in a way that also creates value for society by addressing its needs and challenges (see box).

Via Gutenberg refers to value creation through sustainable development themes such as education and healthcare. It has developed a management system to measure project results. Serapião added, "Delivering material results to society will ultimately deliver value to investors. This can apply to any company that provides solutions to real problems. Integrated Reporting can give long term investors a better understanding of a company's capacity to understand the value it creates and how it manages its contribution to society in the long run."

Via Gutenberg has commenced a project to define the value it wants to generate for society, and particularly to stakeholders. The company's main challenge in 2012 is to review business processes in order to identify tangible results in meeting society's demands as a starting point to monetise intangible capitals. Serapião said, "Understanding what is unique about the way we do business helps us to give different weights to social variables. In other words, it helps to assess what difference we make."

### Porter hypothesis: Creating shared value

Dr Michael Porter, a Professor at Harvard Business School, states that realising shared value involves a greater understanding of the link between corporate productivity and meeting social needs, which define markets. It involves putting corporate social responsibility or sustainability at the centre of what companies do, rather than on the margin.

Dr Porter believes that learning how to create shared value will drive innovation through new technologies, operating methods, and management approaches, which in turn could increase productivity and expand their markets. This approach could also reshape capitalism and its relationship to society.

## Case studies

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### SAP links business model to global trends

SAP's Sustainability Vice-President James Farrar said that progress on <IR> has been useful to underline the need to improve the way companies communicate value. SAP's 2011 Annual Report outlines how its strategy has shifted to both adapt to and drive the technology trend towards mobility, "big data" management and cloud capabilities, which are based on a complex system of data centres that store, process and deliver information on demand over the internet. SAP's business model reflects an extension of software from consumption via a premise license sale to a service to be consumed from the cloud, and its expansion to serve mobile device users.

In the future, SAP plans to develop processes to align its long term growth strategy with the company's vision for innovative software technology to make the digitised world more sustainable. The company aims to refine metrics for, and improve production-related reporting, by automating data collection across SAP and its value chain, disclosing all forms of capital and extending the use of eXtensible Business Reporting Language (XBRL). This open standard provides a language to communicate business and financial data electronically.

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### Ernst & Young ShinNihon and modelling business value

Ernst & Young ShinNihon LLC (EY ShinNihon), a member of Ernst & Young Global Limited, is one of the largest professional services companies in Japan and generates 80% of its revenues from financial audits. Executive managers see <IR> as a good opportunity to redefine its medium and long term corporate strategies, strategic objectives, business model and key activities.

EY ShinNihon are trying to capture the organisation's value to help develop a company-wide business model and strategy. They are using a variety of approaches, including

explaining value creation by describing a "value chain process". The value chain process entails assessing how the business is changing inputs into outputs in ways that generate greater value than the original cost of creating those outputs.

The company is also exploring a 'strategic management decision' approach based on a 'business model canvas'. This defines an organisation's business model in nine building blocks: customer segments, value proposition, customer relationships, channels, revenue streams, key activities, resources required to create value, partners and cost structure.

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### Via Gutenberg is innovating in communicating its business model in the context of external trends

Brazil-based consultancy Via Gutenberg is among companies developing innovative approaches to communicating its business model in the context of external trends. The company focused on applying strategic <IR> concepts in its first Annual Report. Team member Sergio C. Serapião said,

"Our experience of Integrated Reporting showed us the importance of linking social and environmental objectives and explaining the value in what we do. Our services are intangible to most people, but an Integrated Report provides a new way of creating and presenting shared value."

# 2 Value

Businesses can create value through their business models and culture. There is growing recognition that a wide range of tangible and intangible factors create value in the short, medium and long term. Some companies are using innovative ways to communicate value creation and preservation through the capitals. Recognising value creation and preservation more comprehensively can also help identify value at risk.

## Pilot Programme businesses comment on technical topics

### Value

The reporting of value creation and preservation lies at the heart of <IR>. Value reflects the way in which an organisation's business model affects the various resources and relationships that it depends on. An organisation's assessment of how its business model creates value depends on its understanding of the connectivity between a range of internal and external financial and non-financial factors that affect it. Businesses can assess value creation through the capitals, focusing on material issues.

In its 2012 Annual Report, UK-based retailer Marks and Spencer Group Plc (M&S) explains how its business model and culture create value. In particular, the report includes a new section entitled, "How M&S creates value for its shareholders", outlining initiatives such as continuous improvement across operations. M&S explains how 'Plan A' – a commitment to become the world's most sustainable retailer – puts an environmental and ethical program at the heart of how it does business and illustrates how "improved efficiency will deliver a net benefit of £105 million in 2011/12".

The report presents business performance in the context of the external marketplace, which is linked to a strategic review. This provides a context for the retailer's product focus in relation to consumer trends, such as online retail. The report also outlines how the company's values of "quality, value, service, innovation and trust" contribute to how the business creates value for stakeholders, including customers.

Investors are the primary audience for Novo Nordisk A/S's Annual Report 2011, which outlines how the healthcare company's mission, values and guiding principles contribute to value creation. 'The Novo Nordisk Way' states that the company will 'never compromise on quality and business ethics'. Novo Nordisk promotes values to balance financial, social and environmental responsibility for the benefit of patients, employees, healthcare professionals, shareholders and society at large.

There is growing recognition that a wide range of tangible and intangible factors create value in the short, medium and long term. <IR> encourages companies to communicate both tangible and intangible value, even where value is not currently captured by financial statements, but could affect financial performance. Some companies are reporting on value generated by economic contributions, as well accounting for more intangible factors such as social and environmental costs and benefits of products and services, reputation, positioning in the marketplace, and the talents, skills and innovation of employees.

In its 2011 Annual Report, IT company Indra Sistemas, S.A. (Indra) explains how it creates economic, social and environmental value to different stakeholders. This includes an overview of economic value generated from customers, alongside figures on economic value retained and distributed to shareholders and other capital providers, employees, suppliers and society.

The report provides forward-looking strategic information and targets that reflect external factors. Indra outlines its strategy to deliver information and communication technologies (ICTs) to support greater resource efficiency and mobility, in response to external technology and societal changes such as a shift to renewable energy sources; more efficient transport systems that shorten distances and lessen environmental impacts; opportunities due to urbanisation and the need for analytics and sustainable mobility; and the changing use of IT to deliver healthcare services.

Indra's Corporate Responsibility Manager Alberto Muelas Plaza said, "In the end, it is all about how you become transparent for investors and other stakeholders and how you generate confidence by doing so. Stakeholders need to know that you have a long term plan for value creation that they can rely on. And that means understanding the context of operations and the impacts of activities."

State-owned, ROSATOM, has seen a positive change in the way their Annual Report is being used internally, as they move in the direction of <IR>. Marina Galushkina, Manager of ROSATOM's Public Reporting System said, "Senior management and employees were provided with one document that reflected all ROSATOM activities so individual business units were able to see how they fit in the bigger picture of the organisation. One of the aspects this has most benefited is stakeholder engagement."

Japan-based Takeda Pharmaceutical Company Ltd reports on goals to contribute to both economic and social development through business activities and products, as well as through its role as a responsible corporate citizen. This involves seeking to use healthcare to benefit society in the long term, based around global initiatives such as the UN Millennium Development Goals, which include objectives to address health problems such as HIV/AIDS. Assessments of value delivered to local communities inform the group's estimates of timeframes and programmes to address health problems and deliver improvements over periods of up to 10 years (see case study).



Some companies are developing innovative ways to communicate value creation through the capitals. The creation of financial or tangible value such as property and cash can be accounted for in financial statements using existing standards and approaches. However, fewer generally-accepted approaches exist to communicate other, more intangible, ways in which businesses create value, such as providing employment, protecting natural resources or energy security, creating intellectual capital and supporting public policymaking that promotes sustainable development.

Some companies are developing new ways to express value creation through different types of capitals (see page 26 – The Capitals). This reflects growing recognition of connections between resources and relationships on which an organisation depends to generate value, as well as related risks and opportunities. By explaining, and where possible measuring, interactions between the material components of value creation, <IR> provides a broader understanding of performance than traditional financial and sustainability reporting.

Novo Nordisk has started to assess the value it creates by delivering products and services to people in different treatment settings globally. For instance, by measuring the effectiveness of systems to diagnose diabetes and distribute insulin in sub-Saharan Africa, it aims to help ensure treatments benefit people across income levels. For the first time, the company included metrics on social performance in a statement of financial performance highlights in its 2011 Annual Report. Novo Nordisk has started to conduct social accounting to measure the value that it creates to society. It uses nascent methodologies to monetise social issues for internal decision-making.

Colin Melvin, CEO of Hermes Equity Ownership Services and Chair of the Investor Network said, “Excluding environmental and social costs from the way the industry makes money is nonsensical. The question is not whether or not we should in isolation improve approaches to poor governance, social issues and the environment in silos, it is about the sustainability of the capitalist system itself. The fund management community does not understand this yet.”

“In the end, it is all about how you become transparent for investors and other stakeholders and how you generate confidence by doing so. Stakeholders need to know that you have a long term plan for value creation that they can rely on. And that means understanding the context of operations and the impacts of activities.”

## Recognising value creation more comprehensively can also help identify value at risk

Understanding value drivers can help identify material risks. For instance, M&S recognises brand value as financial capital, and reports on risks and uncertainties associated with being one of the UK’s most trusted brands in its Annual Report. It identifies operational and reputational risk management activities, considering current and emerging internal and external factors that could affect value.

Disclosure of value could be constrained by commercial sensitivity, such as concerns that competitors may use information disclosed to their advantage or forecasts of expected value could expose directors to liabilities. SAP highlighted the possibility of ‘safe harbour’ or ‘reduced liability exposure’ initiatives to help address potential risks from forward-looking statements. Other companies are managing exposure by limiting disclosures, noting uncertainties and assumptions, and applying broader risk controls. Among them is ARM Holdings Plc, which avoids disclosing pricing information or contract information that is not already publicly available to manage risks to competitiveness. The company connects past, present and future information with five to ten-year forecasts on value creation where possible, and manages risks from uncertainties by including caveats and third-party market research and analysis and strategic risk management (see case study). Reports on forecasts, projections and sensitivity analysis can distinguish between evidence, estimates and assumptions to help demonstrate a reasonable basis for disclosures, despite uncertainties.

Value at risk can be examined more fully through materiality assessments (see page 39 – Materiality). Connecting factors that contribute to value creation over different time periods and across capitals can reveal trade-offs between activities that create financial capital in the short term, but damage environmental and social capitals in the longer term. For instance, quantifying the environmental impacts of projects has helped Danone consider trade-offs between measures to reduce carbon that can increase impacts on water (see page 26 – The Capitals). Danone is yet to decide on how to report on such challenges.

Alberto Muelas Plaza, Indra

## Case studies

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### Takeda accounts for social value chain

Takeda took an integrated approach to its Annual Report in 2011 to strengthen relationships with shareholders and investors. The company sees transparency as part of building trust with stakeholders, whose interests are central to its initiatives to create value in the short, medium and long term. In practice, this means delivering pharmaceutical goods and services to customers, providing managerial resources and behaving ethically in order to deliver value to society.

Takeda reports both qualitatively and quantitatively on past achievements and future expectations on developing products and maximising their value in order to deliver sustainable growth. One of the company's strategies to achieve this is through sales growth in emerging markets, including developing countries.

Value creation is embedded in corporate citizenship initiatives that aim to support communities. The company takes account of the views of stakeholders including non-governmental organisations and citizens' groups that have a frontline understanding of social issues, to find out whether health and medicine business activities reflect the needs of communities. This entails assessing whether an activity benefits recipients (outcome) and has positive spin-offs across society as a whole (impacts).

Takeda's Annual Report explains how value creation is supported by the group's Global Code of Conduct, which includes principles to conduct business with integrity and fairness and to protect assets/information. Corporate governance and procurement structures help ensure activities comply with the code, as well as with policies and rules on human rights.

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### bankmecu uses value to define business model

Australia-based cooperative bank, bankmecu, aims to use <IR> to communicate value creation. The bank is owned by customers, and expects that working towards producing an Integrated Report will enable the company to demonstrate more clearly how it generates long term value for them. The United Nations General Assembly has declared 2012 as the International Year of Cooperatives, highlighting the contribution they make to socio-economic development, particularly through poverty reduction, employment generation and social integration. However, lack of awareness in Australia makes it challenging to

communicate how bankmecu provides value as an alternative to listed banks. The bank hopes to use <IR> to demonstrate the broader value it delivers to society through the cooperative business model, which enables resources to be pooled for the benefit of communities. bankmecu returns profits to customers through better rates and fees and retained earnings. The bank captures more than just financial data, including benefit dividend comparison against other banks and the provision of no-cost-to-customer social and environmental banking features.

## ARM Holdings forecasts market value

Joining the Pilot Programme has made ARM Holdings Plc, which designs and licenses microprocessors for applications such as mobile phones and consumer electronics, more aware of the need to create a clearer description of the company. "As a technology company developing something pretty obscure, our number one challenge is explaining our business to someone who has no knowledge of the sector," said Ian Thornton, Vice-President of Investor Relations.

ARM defines value creation as a combination of designing interesting technology that also contributes to its engineers' personal development; solving customers' problems and helping them succeed; and gaining market share and generating revenues, profits and cash.

Thornton said: "Defining value is challenging because the way we think about products is slightly different to how we think about our markets. We report on the number of technology licences that enable a customer to access our design. That company will then manufacture computer chips based on our design and pay a royalty for each chip sold. Lots of our market value is based on the future growth of the company."

Thornton said that the company's share price was trading at 40 to 50 times its price-to-earnings ratio last year. This illustrates that current earnings are not related to the current valuation, but are based on expected earnings growth over the next five or more years.

Thornton explained, "We're fortunate in that customers provide us with detailed market information. This enables us to give five-year forecasts on how the end markets are going to grow and how our market share will grow within them, without providing financial forecasts. My goal is to provide the context to enable analysts to calculate approximately what ARM's business will look like in five years' time. Most companies don't have that visibility."

"However, there is always a balance that needs to be achieved when presenting a five-year view. We want to give analysts and investors a framework to build their models of ARM, but we do not have a perfect crystal ball, and there are uncertainties around any long term forecasts. We explain how we come up with forecasts and why they are reasonable, including independent analysis, and outline risks and uncertainties. We try to be conservative in managing analysts' expectations."

ARM's business model and relationships with key stakeholders help mitigate the risk of unexpected technological development undermining growth.

# 3 The Capitals

Greater clarity on links between the capitals could help address the challenge of demonstrating their relevance to strategic decision-making. Some companies are developing innovative approaches to strengthen accountability for capitals and meet investors' needs for more comparable, meaningful information. <IR> brings visibility to a variety of resources and relationships – or 'capitals' – on which an organisation depends, or which it affects.

- Financial
- Manufactured
- Human
- Intellectual
- Natural
- Social

Many businesses in the Pilot Programme are initially strengthening measurements of corporate KPIs in relation to the capitals, as part of understanding their significance to businesses. Independent verification of information is helping to ensure the quality of data is adequate for decision-making. Industry-specific and local issues can drive the KPIs selected to assess dependence and impacts on capitals. Greater clarity on links between the capitals could help address the challenge of demonstrating their relevance to strategic decision-making. Some companies are developing innovative approaches to strengthen accountability for capitals and meet investors' need for more comparable, meaningful information.

More than 70% of the respondents to the 2011 Discussion Paper thought that the concept of multiple capitals was helpful to explain how an organisation creates and sustains value. Many respondents supported the general concepts, but questioned the categories and definitions of the various capitals. Several respondents questioned how to measure, monetise and report on the capitals. An IIRC work stream is currently exploring how best to include reporting on the capitals in an Integrated Report. Reporting on the capitals is critical to:

- clarify an organisation's access to and impact on them,
- enable a meaningful assessment of the long term viability of the organisation's business model and strategy,
- meet the information needs of investors and other stakeholders, and
- enable the effective allocation of scarce resources.

The capitals act as pillars that contribute to the execution of an organisation's strategy. Valuable innovation is taking place to communicate about the capitals in a meaningful way to investors and stakeholders.

More insight into links between capitals could help address the challenge of demonstrating their relevance to strategic decision-making. IT companies such as Microsoft recognise intellectual and human capitals as their lifeblood. Microsoft's draft Integrated Report describes the importance of these capitals to the company's prospects. Bob Laux, Director, Accounting and Reporting, explained that Microsoft has thousands of patents likely to be worth more than its US\$50-60 billion in financial capital. However, accounting rules such as U.S. GAAP veer on the conservative side in terms of the amount of intellectual capital that can be capitalised rather than expensed.

Quantitative metrics and detailed reporting are more widely available for financial capitals, where performance is measured against goals and indices, and controls and disciplined analyses are in place. Intellectual capital needs to be measured more rigorously. Laux said, "We need to link intellectual and human capitals with financial capital. It would be good to have more interconnection between challenges and opportunities and quantitative data on performance in these areas."

Microsoft's balance sheet currently accounts for less than half of the company's market value. Its financial statements show virtually none of its intangible assets. Laux suggested that the focus of companies that largely depend on human and intellectual capital is actually more on financial and manufactured capital in reporting. This reflects a legacy of resistance to change in U.S. businesses that have implemented reporting infrastructure designed for a manufacturing economy. Laux explained, "Financial reporting hasn't kept up with the shift to an IT-based economy. When scandals emerge, such as the dot-com bubble in 1995-2000 and the financial crisis in 2007-2012, Band-Aid's are put on problems."

One barrier to change may be the principal-agent problem in economics – the separation between agents' (ie directors or management) interests and those of the principal (ie investors or owners) they are supposed to represent. Greater transparency would require managers to report information that they will be judged on. "We need to consider things like Integrated Reporting to change that," said Laux.

Limited reporting on non-financial material risks and strategies for managing them can undermine the value of disclosures as an input into investment analysis. Investors said it would be useful if reports provided more context for KPIs. Dutch pension administrator PGGM's Piet Klop believes that one reason for the failure of markets to identify the link between 'soft' non-financial issues and hard financial information is because information is reported separately. Klop explained, "Meaning is a whole lot stronger when you relate non-financial and financial information. Furthermore, there is an absence of disclosures on how corporate externalities could affect businesses. The environmental and social context in which companies operate could have a potential impact on operations, such as the loss of social license to operate, which can endanger profitability or continuity of operations. Environmental and social events can have a direct financial bearing on companies in the near term, so it's worth explaining wider trends that could have material consequences, despite uncertainties."

## Pilot Programme businesses comment on technical topics

### The Capitals

#### Robust information to support decision-making

Many companies in the Pilot Programme are initially focusing on strengthening measurements of KPIs in relation to the capitals, as part of understanding their strategic significance to businesses. One of the initial challenges is to create or strengthen internal systems to capture data on issues such as carbon emissions and employee turnover, and to establish who is responsible for data management. Several companies in the Pilot Programme are shifting responsibility for collecting more than financial data for reporting purposes to finance functions in order to improve integration of information. For instance, Randstad Holding N.V., which provides recruitment and HR services, shifted responsibility for non-financial data to Chief Financial Officers (CFOs) in September 2012.

HSBC's finance function acts as a filter for data collection and processing, making it easier to identify the financial implications of environmental, social and human capital issues. HSBC's 2011 Annual Report and Accounts provides detailed descriptions of its risks, values, opportunities and resources – both financial and human.

HSBC's Sustainability Report provides detailed information on its business strategy, how it serves customers, its response to climate change, sustainability risk management – such as lending guidelines, the measures it takes to meet internal environmental efficiency targets, and employee and community investment programmes, along with relevant key data. A senior management committee reviews the report, bringing together views from all major functions, businesses and legal entities. HSBC is currently simplifying its management information and plans to continue increasing the rigour it has applied to measuring environmental and social activities. Many companies seek independent verification and assurance of more than financial information to ensure the quality of data is adequate for decision-making. HSBC believes assurance supports the integrity of reporting, and Danone says that the benefits of assurance outweigh the costs. bankmecu includes externally-verified non-financial capitals in its Annual Report to provide stakeholders, including the company itself, with confidence that the report is reliable. External assurance can identify potential errors and present

opportunities to improve the quality and expand the scope of data. The assurance process also provides greater weight for requesting and collecting timely, accurate data across organisations.

Hong Kong-based power company, China Light and Power Holdings Ltd's desire to achieve higher reliability standards as part of <IR> propelled it to strengthen internal information management systems and increase the scrutiny of performance data. In order to give stakeholders greater confidence in performance results, CLP sought independent verification and assurance for this year's Annual Report. For CLP, the combination of the increased importance of non-financial capitals and the discipline of reporting on them has raised their prominence at board level. In particular, a board-level Sustainability Committee reviews the organisation's Sustainability Report with similar care and scrutiny to that applied by the Audit Committee to financial statements.

Industry-specific and local issues can drive the KPIs selected to assess dependence and impacts on capitals and inform decision-making. South African mining company Gold Fields recognises its dependence on human capital in its Integrated Annual Report 2011, which is comprised of three parts – an Integrated Annual Review that integrates operational and sustainability performance, an Annual Financial Report to comply with statutory financial reporting requirements, and a Mineral Resources and Mineral Reserves Overview. The Review discloses the company's annual performance on a variety of KPIs to assess issues including impacts on and risks to employees. Some health-related metrics, such as chronic obstructive airways disease, are specific to high-impact industries such as mining, while a measure of the proportion of employees on highly-active anti-retroviral treatment reflects the prevalence of HIV/AIDS in South Africa.

Gold Fields plans to put a central database of all types of data in place by 2015, to help it comply with mandatory and voluntary reporting requirements. Gold Field's integrated approach aims to enable investors and other stakeholders – including host governments, local communities and employees – to make a more informed assessment of the company's value and prospects.

**“It's important for CFOs to be responsible for non-financial as well as financial KPIs because they are well-placed to see links between them and can implement company-wide processes to gather data.”**

Patrick Heinig, Randstad

Apparel retailer Industria de Diseño Textil S.A. (Inditex) is engaging with stakeholders including local communities, sector peers and external environmental experts to design its reporting structure and strengthen management of quantitative data. It is also working with other companies through initiatives such as an Ethical Trading Initiative (ETI), Sustainable Apparel Coalition and Textile Exchange to create ways to measure environmental and social performance in order to provide comparable information. In its latest report, the company highlights figures on strategic issues to show that non-financial indicators are important. Inditex's Annual Report 2011 shows that <IR> provides an opportunity to give shareholders information about the company's performance, so they designed a sustainability 'balance sheet' to try to link non-financial and financial information. It shows quantitative indicators in the structure of financials to make it easier for shareholders to understand. They have created sustainability accounts that show social and environmental flows, like financial statements.

Technology company ARM Holdings has tried to report on the role of employees and partners in creating value in its 2011 Annual Report. Ian Thornton, Vice-President, Investor Relations, said, "Despite being a people-based company with engineers designing technology, I was, until recently, neglecting their role in the value creation process. We have focused on bringing the company 'to life' by having more operational managers write about their areas of the business."

One of ARM's important capitals is collectively owned through a network of partnerships. ARM is part of a community of technology companies, and communicating risks and opportunities within this community, and the value of partnerships, has proved challenging. "Along with brand equity and goodwill, this is an intangible that is difficult to value," said Thornton. "We have started giving partners more space to explain how they use our technology and the value it brings to them. These areas are relatively tangible for investors."

A survey of readers of the company's Annual Report found that most are investors looking at ARM for the first time, whose biggest wish was to have a clear explanation of

what ARM is and how it makes money. The company is using <IR> as a tool to link CSR reporting to financial and strategic reporting. ARM links strategy and KPIs to show consistent progress against strategic objectives over the previous five years. It is currently developing new metrics for environmental reporting, taking a cautious approach by trialling them internally before making them public. Thornton believes that consistency is important to established metrics. "Investors do not like to see familiar metrics demoted without a clear explanation," he said. "They are always concerned that something has gone wrong, and there is a cover-up afoot. So 'improvements' need to be introduced with care, and only when a track record can be established."

<IR> involves reporting on capitals that are strategically important, so commentary outlining why metrics are selected can be useful to understand their business implications. For example, data on water use can be combined with information on water security to identify risks to manufactured capital in operations or supply chains. Gold Fields links safety metrics with its corporate objectives, risk management and economic factors. Companies could link the capitals to provide a fuller understanding of significant interactions between them. SAP highlighted the need to harmonise standards and consolidate multiple non-financial accounting standards and methodologies.

**Companies are innovating to strengthen accountability for capitals and to meet investors' need for more comparable, strategic and meaningful information.**

Fund managers rely on corporate financial and non-financial disclosures to make informed investment decisions. Investors want comparable data and indicators that approximate risk. However, the scope and quality of corporate disclosures on financial, governance and sustainability performance varies across companies, sectors, and geographic markets. Christopher Wright of the Norwegian Government Pension Fund Global said, "We need companies to identify material non-financial information and communicate it in a comparable format

**"With Integrated Reporting, we're including other information to present a consistent view of the company and extend the readership to other stakeholders, such as socially responsible investors, suppliers and customers looking at ARM from different points of view."**

Ian Thornton, ARM Holdings

## Pilot Programme businesses comment on technical topics

### The Capitals

in a way that enables investors to understand the relationship with strategy, risk, performance and targets.” Colin Melvin, CEO of Hermes Equity Ownership Services and Chair of the Pilot Programme Investor Network said, “there should be a balance between making numbers comparable and using metrics that are meaningful for companies, and that enables fund managers to take note of disclosures on relevant KPIs.”

PGGM’s Piet Klop sees the main barriers to disclosures on capitals as difficulties in assessing material non-financial risks, and lack of willingness to disclose them. He highlighted the important role of market regulators, exchange authorities, investor lobby groups and dominant data platforms such as Bloomberg, Reuters and FactSet to encourage companies to disclose meaningful and relevant information on all risks.

Using a handful of the most important indicators and proxies to capture risk can minimise complexity. Danone believes that more than financial data can be integrated within a business, and uses a carbon software tool to ensure issues such as carbon dioxide emissions are taken into account in internal decision-making on business activities such as new products, packaging and productivity. Danone takes an ‘extended responsibility’ approach, to look at its business through a life cycle analysis (LCA) lens. Its carbon accounting tool, for example, takes account of impacts from cradle to grave.

Danone is extending environmental accounting to water impacts. Danone recognises water as a natural capital stock that is being depleted and measures of its water footprint take account of the scarcity of supplies. The company tries to be proactive in developing ways to measure the different capitals reliably, but otherwise relies on narratives, for instance for biodiversity. The company is considering expanding the use of its Enterprise Resource Planning system to social reporting.

bankmecu is also taking innovative approaches to improve the way it communicates the organisation’s performance across environmental, social and financial capitals. Initiatives include a project to try to quantify social return on investment (SROI) made through community housing investment. However, the bank has found quantifying the secondary environmental and social impacts of providing products and services to be complex and difficult. During the past year, AEGON has focused on social and human capital by improving its measurement and reporting around employees and customers. The company tries to show its product lifecycle and at what stages of people’s lives customers bought and used its products.

National Australia Bank Ltd (NAB) has been investigating how natural capital is valued – specifically by looking at how traditional business frameworks account for the impact and dependency of biodiversity and ecosystem services. Understanding these related risks and opportunities is, in our view, critical to the sustainability of business and the broader economy.

Investors want companies to put capitals into a strategic context. Many investors would like disclosures on capitals to be supplemented by qualitative information that explains their material relevance to the valuation of the company and outlines the company’s strategy and action plan for improving performance over time.

AEGON endeavours to do this in its 2011 Review which focuses on the company’s role in society. It attempts to tell a concise story about what it is doing to address global trends such as aging populations, changing customer behaviour, rising stakeholder expectations and economic uncertainty. The company reveals how it is adapting to a changing world and addressing related risks and opportunities, using the capitals as inputs and outputs to provide details and examples. As a knowledge-based company, it devotes attention to human capital and reveals how the company attracts, develops and retains talent. It also addresses intellectual capital in relation to products and services, as well as social capital in terms of corporate values and ethical behaviour.

**“We need companies to identify material non-financial information and communicate it in a comparable format in a way that enables investors to understand the relationship with strategy, risk, performance and targets.”**

Christopher Wright, Norges Bank Investment Management (NBIM)



## Case study

### M&S reports on capitals

M&S has appraised how capitals are communicated to investors in its 2012 Annual Report.

**Financial capital:** A financial review and the financial statements detail the cash flow, net debt and borrowings position of the Group and how it manages financial risk.

**Manufactured capital:** The report documents the Group's capital investment in stores, multi-channel, supply chain and technology to support future business growth, and Return on Capital Employed is now an externally reported KPI.

**Human capital:** The strategic review includes details of the management committee, as well as a section about the Group's employees, its people plan, learning and development and employee engagement.

**Intellectual capital:** The core M&S brand is a key non-financial capital of the organisation, as are the sub-brands. The Group recognises two brands in its financials –

Per Una and M&S Mode. The section of the Annual Report that focuses on brand ensures that investors know how the company invests in campaigns to reassure customers that the company is meeting their needs and encouraging potential new shoppers to take a fresh look at M&S.

**Natural capital:** Progress against Plan A is reported in every narrative section of the Report. A section specifically on Plan A provides more detail about how M&S has worked with its customers and suppliers in relation to climate change, waste reduction, and natural resources, and being a fair partner.

**Social capital:** The founding values and how M&S creates value for its shareholders through its relationship with customers, its employees and suppliers are communicated in the 'How M&S creates value for its shareholders' section of the Report. The M&S reputation is based on these brand values.

### Dimo takes strategic view of capitals

Diesel & Motor Engineering PLC., also known as 'Dimo', worked towards its second integrated Annual Report in the financial year 2011/12. Dimo, which is listed on the Colombo Bourse in Sri Lanka, links financial and non-financial value drivers to customers, employees, business partners, regulatory authorities, community and concern for the environment. The report is structured around the company's eight strategic imperatives, including earning customers' trust and nurturing employees.

The report outlines activities and processes in place to achieve strategic objectives and links these to sustainability objectives and metrics that track performance over the past year. The performance review links all types of key data to strategic objectives. The report focuses on environmental impacts, and reports air pollution emissions against regulatory limits at different locations, providing context.

The company's governance framework is based on trusteeship, stewardship and accountability, and Dimo is transparent in providing reasons where goals are not achieved. The company links risk management to strategies, identifying actions to mitigate risks, early warning indicators and the likelihood of occurrence.

Dimo director Suresh Gooneratne said, "Pilot Programme discussions on materiality helped us to refine the aspect of materiality from the last year's Integrated Report. Processes to identify stakeholders and manage stakeholder issues provide a guideline for determining materiality, although we seek further improvements. The programme also led us to describe our 'state of play' to provide a holistic picture or status of the organisation."

Going forward, Dimo plans to review its information management system to strengthen non-financial information. It also plans to consider broader measurement of non-financial capital and its ownership.

## Case studies

### Indra is preserving capitals to support growth

In its 2011 Annual Report, Indra highlights intellectual and human capitals as key to competitiveness in the ICT industry. Indra applies its know-how to create new ways of working – such as methodologies, tools, architectures and measurements – in order to improve processes. Indra's approach to intellectual capital is based on a model that aims to capitalise on both internal and external knowledge and innovation through the organisation's technology and services. The company has distanced itself from classical models of innovation management and has created its own model of open innovation, in which collaboration and knowledge generation are not limited by the company's borders, but instead are open to input from clients, technological allies, universities, research institutes and society in general. This innovation model is decentralised with the participation of the whole organisation, is open and networked, and aligned with the business strategy.

The cornerstone of Indra's growth and development is allocating significant resources to research and development (R&D). Indra recognises that people drive innovation and that "the only lasting competitive advantage that companies can secure is in the talent of its professionals". As management of human capital is crucial to the business, capturing, developing and retaining talent is a strategic priority. Policies, performance appraisals and career management systems are designed to develop human capital effectively.

Indra identifies economic, social and environmental impacts of the business to different stakeholders, from shareholders and employees to clients and suppliers.

Indra reports on its response to investor trends that could affect access to financial capital, such as market uncertainty, high volatility, greater weightings of intangible assets in valuations, an increase in ethical funds and investment and growing demand for good governance practices. Indra's Annual Report provides an overview of governance structures, internal controls and risk management systems, and processes for establishing remuneration. The Board reports on measures to strengthen corporate governance criteria on compensation in 2011.

Indra also outlines strategies to respond to non-financial trends that could be business critical, such as clients concentrating the number of suppliers that they use. With external factors such as the potential for credit shortages to cause financial, solvency and liquidity problems for suppliers, the proliferation of environmental legislation, water scarcity and growing expectations for companies to measure social impacts, Indra's pre-selection and assessment processes for suppliers include criteria to manage financial, environmental and social risk.

Indra identifies economic, social and environmental impacts of the business to different stakeholders, from shareholders and employees to clients and suppliers, helping to make its Annual Report a 'single point of access' for all relevant information for stakeholders. However, some financial KPIs, risk management and corporate governance information are repeated in a separate financial report, required by law in Spain. "So far, legal requirements on financial reporting are an obstacle for Integrated Reporting," said Indra's Alberto Muelas Plaza. "They make it difficult to integrate social and environmental information and often contradict integrated reporting principles."

# 4 Connectivity

Connecting information can create more productive dialogue between employees at all levels across business activities. This integrated thinking contributes to more meaningful communications with external stakeholders such as investors. IT applications can provide a starting point to improve capabilities to link information and provide access to it.

## Pilot Programme businesses comment on technical topics

### Connectivity

The IIRC's 2011 Discussion Paper on <IR> included a Guiding Principle on the connectivity of information. <IR> aims to provide a broader analysis than traditional reporting to tell a more complete story about how business models and value creation connect with relevant capitals, and how this relates to material risks, strategies and performance. This can reveal how impacts on capitals influence current and anticipated Key Risk Indicators (KRIs) and opportunities, which will shape future strategic objectives.

<IR> aims to connect areas of the business together which might include:

- the six capitals,
- financial and non-financial information,
- risks, strategies, governance and key performance indicators,
- management information, board information and information reported externally,
- the external context in which the organisation operates,
- the opportunities and risks faced by the organisation and how it manages them, and
- activities, results and performance, past, present and prospective.

Connecting information on business models and significant internal and external factors is critical to understand an organisation's prospects for long term success.

Connecting information can break down silos and create a virtuous circle of more productive dialogue between employees at all levels across business activities and a more cohesive and strategic approach to reporting. Business leaders that cooperate more closely to share knowledge can collectively map, monitor, manage and communicate the full complexity of the value-creation process. For many preparers of Integrated Reports in the Pilot Programme, the starting point to connect information is to connect people across a variety of internal functions.

This can enable organisations to understand better the relationship between interdependent operating units, helping to break down internal barriers to more effective decision-making. For Coca-Cola, engaging with internal stakeholders helped to develop a strategic approach to reporting. Coca-Cola organised a cross-functional team to develop a working plan to develop <IR>, and an executive-level committee to advise on key milestones.

National Australia Banks' (NAB) Corporate Responsibility Performance Manager Lauren Owens said, "For us the exciting new development has been making connections with different business areas. For the first time, we're trying to incorporate key CR information in the strategic section of our Annual Review to explain links to the delivery of strategic objectives such as strengthening our Australian business and enhancing our reputation. Different parts of the business now have an ongoing dialogue to achieve a mutual understanding of how information connects and what the most material extra-financial risks are, such as reputation and customer retention, or environmental impacts in lending and financing activities.

"Teams are currently identifying the financial performance and corporate responsibility indicators that will be used to provide our key stakeholders with information that represents the whole business and provides a meaningful assessment of our performance. A key message is that this has enabled integration across silos", said Owens. "A collaborative approach is helping us to determine what goes into the next report and how to present a better picture of our total business performance. To a certain extent, we're sticking our neck out and need the support of other organisations to build confidence in what we're trying to do."

ARM Holdings is using <IR> as a framework around which to think about linking broader non-financial factors with corporate strategy. "We are looking to bring more focus and cohesion to our corporate communications," said Ian Thornton, Vice-President of Investor Relations.

**"The development of a cross-functional committee has enabled us to gather with a broad group of experts to work on a common goal. This has caused us to look at Integrated Reporting as just one element of a bigger initiative – clearly defining WHAT we report, to WHOM we report it, and WHY we report it, as a whole. We see great value in this exercise and appreciate the role Integrated Reporting will play in helping us develop our long term reporting strategy."**

Mark Preisinger, Coca-Cola

He continued, “Integrated Reporting is not an end goal. Rather it is a tool which can help both by improving communications to external stakeholders and by highlighting where aspects such as the business strategy, goals and drivers are not aligned. Integrated Reporting is only useful in the extent to which it plays a role in achieving our goal to improve both areas.”

### Integrated thinking

Company management can connect information to develop more integrated thinking and decision-making. Connecting relevant information involves integrated thinking, where management develops a more cohesive understanding of the connectivity and interdependencies between the full range of factors that have a material effect on an organisation’s ability to create and preserve value in the short, medium and long term.

Connecting information can enhance clarity on links between operating contexts, governance and performance indicators used to judge results and determine rewards for internal and external stakeholders in the past, present and future. HSBC’s reporting applies connectivity between the business model, values, strategy, performance, financial information, risks, governance and regulatory information. The bank also adopts a structured approach which ensures consistency of reporting between different elements of its reports, such as in demonstrating the connectivity between strategy, KPIs and performance. However, with only the Finance and Sustainability teams currently involved in <IR>, HSBC is currently facing the challenge of demonstrating connectivity where it clearly contributes to the generation of value and the sustainability of the organisation. Head of Group Finance Operations Richard Scurr explained, “No activities occur in isolation, but determining which are of sufficient significance to have a material impact on performance and sustainability, and how they are connected to each other and to these outcomes, is not always straightforward. This particularly applies to non-financial activities.”

Understanding how interconnected decision-making affects value creation is important to address the realities that an organisation faces and to review strategies, activities, processes and attitudes. CLP Holdings used the <IR> concepts including connectivity as the basis for revisiting its corporate reporting over the past year. This has helped the team to think in a more structured, future-oriented way. Peter Greenwood, Group Executive Director – Strategy, explained, “The discipline of reporting economic, social and environmental performance is contributing to our assessment of the fit and inter-relationship between elements of our business. Integrated Reporting doesn’t merely improve the way we report on past performance, it is also influencing the way we look ahead and the decisions that we make.”

Breaking down barriers between departments has led to stronger cross-functional communications and more integrated thinking for NAB. More strategic dialogue between departments has led to stronger relationships between financial and non-financial teams, and a better understanding of different perspectives on material issues to the business and its stakeholders. Regular meetings of an Annual Review Steering Committee of senior executives from finance, strategy, compliance, shareholder communications, corporate responsibility and legal and governance teams has assisted in shaping the strategic direction of the report and ensuring it talks to the issues most important to realising our business strategy.

Integrated decision-making contributes to more meaningful communications with external stakeholders. Some companies are engaging with external stakeholders to inform integrated thinking. Indra’s 2011 Annual Report was a “major milestone”, according to Corporate Responsibility Manager Alberto Muelas Plaza. He explained, “Learning what is really important for investors and stakeholders through the Pilot Programme has helped to focus on relevant information.”

**“This is about more than just reporting numbers, it’s about retaining our employees and enabling them to reach their potential, enabling customers to thrive, and really adopting an integrated thinking approach to how we go about things. Integrated Reporting is an opportunity for thought leadership, and Integrated Reports are just the outcome of how this discussion is evolving.”**

Lauren Owens, NAB

As a result, Indra has changed the structure of contents to integrate information about its business model, the six capitals and corporate governance. It includes narrative chapters focusing on the connectivity between context and strategy, business model and activity impacts, strategy and performance.

South Africa's Central Securities Depository, Strate, which must produce an Integrated Report under King Code III (see page 42 – Next steps) has worked towards <IR> over the past two years. Strate's report is circulated on the company website and goes to its board, shareholders – mainly JSE Ltd and four major South African banks – and various international bodies that need to know that deposits are secure.

Feedback has generally been positive, but Hannes van Eeden, CFO and Company Secretary, said that the biggest challenge was knowing what to include to meet people's expectations. He explained, "We started carte blanche, with no real guidelines to decide what was important. It is a trial and error process, and we're not sure whether our narrow stakeholders want the level of detail that we provide. However, we believe in disclosing both positive and negative information to stakeholders. There are no real barriers to reporting on things that have gone wrong, such as impairments or failed implementation. I think stakeholders appreciate that we disclose mistakes and want to learn from them. We understand the value of Integrated Reporting and hope it improves transparency."

Van Eeden has learned that the <IR> process towards disclosing information is more important than the report itself. "Integrated Reports are just an end product," he explained. "The way we do business on a daily basis – processes and behaviour – is more important. If you identify unacceptable risk, this should drive activities and performance measurements. I believe we could improve processes to link risks, performance measurement

and targets by integrating them and working towards common goals."

<IR> is likely to lead to fundamental changes in corporate behaviour and thinking as organisations adjust to new ways of measuring, managing and disclosing information. Strategic, marketing and communications agency Black Sun Plc is currently conducting research to track changes in behaviour at companies in the Pilot Programme as they move to towards <IR> (see page 42 – Next steps). The IIRC will use the findings to examine the impacts of applying the <IR> concepts outlined in the Discussion Paper on a company's internal and external value.

IT applications can provide a starting point to improve capabilities to link information and provide access to it. Some companies are using innovative IT tools to strengthen and connect non-financial and financial information and enable users to interact with data. Among them is Financial Services provider BBVA S.A., which published information on a central scoreboard of CSR (see case study) to reinforce the integration of all types of data. BBVA's Corporate Responsibility Manager Beatriz Alonso Aznar said, "Connections between the Group's strategy, and financial, environmental, social and governance performance have been reinforced to enable investors and other stakeholders to understand how BBVA is performing. "Close collaboration between BBVA's finance and corporate responsibility divisions since has led to the gradual integration of information on the capitals for the Group's Annual Report. Technological initiatives that have been crucial to achieve higher connectivity for BBVA include Bancaparatodos – a benchmark in global online CR communications through open consultation and discussion with stakeholders. BBVA is also among companies using web-based reporting to connect information and make it more interactive and accessible to report users.

## Case studies

### EnBW takes steps towards Integrated Thinking

As a first step towards <IR>, Energie Baden-Württemberg AG (EnBW) will publish a combined report comprising financial and sustainability information for the financial year 2012. A sustainability strategy adopted at the start of 2012 forms a basis for the project. EnBW plans to enhance the combined report by incorporating their strategy and improving connectivity between the elements, taking into account a broader variety of stakeholder interests and concentrating on material issues. During this process, non-financial indicators were systematically collected, which will be used to facilitate integrated thinking through the organisation as they work towards developing an Integrated Report by 2015. The EnBW Integrated Report will be used as a communication, steering and governance tool.

To promote Integrated Thinking, the <IR> project is led by a team with members of the finance and sustainability departments. It sees commitments from the Board and a variety of departments as crucial to the project's success. Benefits to date include a growing understanding of the current challenges and breaking down established 'silos' within the company through discussions and new ways of exchanging information. The future benefit is transparent, comprehensive and meaningful reporting for stakeholders. EnBW and other German Pilot Programme businesses established a German IIRC Roundtable to enhance the common understanding of the development of <IR> and for a constant information exchange with other Programme Participants and interested companies.

## Case studies

### ESKOM connects materiality issues to inform management decisions

South Africa's state-owned power utility Eskom Holdings SOC Ltd developed a standard reporting template to help connect material content from various parts of the business. The template was structured to include:

- performance highlights,
- performance lowlights,
- forward-looking commitments,
- benchmarking information, and
- a case study and/or stakeholder commentary.

The template is designed to standardise content and make it easier to integrate large amounts of information. This improves the visibility of the connectivity between material issues reported on by several business units, according to Ian Jameson, Chief Advisor, Climate Change and Sustainable Development, Group Sustainability. "Going forward, the Integrated Reporting process has highlighted an opportunity to streamline our reporting processes into one integrated process," he said.

The Steering Committee is chaired by the Finance Director and includes other members of Eskom's Executive Committee (Exco) and is an official sub-committee of Eskom's Exco. The Committee will ensure that reporting processes and resources deliver the range of information necessary to support Eskom's primary report – its Integrated Report.

Jameson explained: "This will also ensure the connectivity of information throughout the company's reports and demonstrate tangibly that the way we manage our business is the way in which we report on it to our stakeholders."

He added that the committee aims to raise awareness of the principles of <IR> at a site level, to help "empower information providers to bring to bear the material issues and pre-empt their connectivity to other issues within the business". This will support a better bottom-up view of the business and better integration with corporate reporting.

### Spanish companies use technology to connect information

A group of Spanish companies in the Pilot Programme – Financial Services company BBVA, Enagás, Inditex, Indra and Telefónica – have joined a research project led by the Spanish Association of Accounting and Business Administration (AECA) to standardise and disseminate more than just financial data using the latest information software. AECA has developed a central scoreboard of Corporate Social Responsibility (CSR) in eXtensible Business Reporting Language (XBRL) as a repository of financial and non-financial information. AECA's website provides guidance on corporate reporting on 27 economic, environmental and social KPIs. Indicators are only quantitative in order to enhance the comparability and dissemination of information.

The study group includes academics, auditors, and representatives from the Bank of Spain and the National Share Market Commission. Together with AECA, BBVA presented project findings on research into standardising more than financial information and proposals to move towards integrated information from theoretical, technological and application perspectives. The project includes an Integrated Scorecard with Financial, Environmental, Social and Governance indicators – the IS-FESG, which provides a framework to connect KPIs and KRLs in a clear, concise, consistent and comparable format to develop a retrospective and forward-looking understanding of an organisation's performance. The IS-FESG includes indicators linked to strategic objectives and relevant risks, linking indicators to provide insight into interconnections between different business areas.

# 5 Materiality

Several investors have called for Annual Reports to clearly identify material risks and the financial and strategic implications of a variety of capitals. Many organisations in the Pilot Programme are engaging with stakeholders to help determine material issues. Several companies are using a materiality analysis to identify risks. Some companies are connecting internal and external information to identify material issues that are relevant to strategy development.



Materiality defines what is important to an organisation's ability to create and preserve value in the short, medium and long term. In the IIRC's 2011 Discussion Paper, conciseness, reliability and materiality are among the Guiding Principles that underpin <IR> and determine the content of an Integrated Report. Many respondents to the Discussion Paper called for further guidance on how to define materiality and identify, assess, prioritise and report on potentially material issues. Companies and investors need a better understanding of both qualitative and quantitative aspects of materiality.

The definition of materiality in financial reporting is: "Material omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor."

However, the application of materiality in an Integrated Report is likely to be different to that in financial or Sustainability Reports, reflecting differences in stakeholder views of what is material.

Several investors have called for Annual Reports to clearly identify material risks and the financial and strategic implications of non-financial issues. NBIM, CalPERS and APG said in their response to the Discussion Paper that, given that environmental and social risks may be material to the financial performance of companies, poor reporting standards and practices compromise their ability to accurately value companies and their assets, and ultimately, generate long term financial returns. "We expect boards to communicate strategy and material risks and rewards to investors in an adequate and timely manner that permits the strategy and performance to be understood. This includes the material risks and rewards that are associated with non-financial risk factors," they said.

"We expect corporate reporting to explain how companies generate value through their business models and the material risks they are exposed to. Under current reporting standards and practices, material information is oftentimes omitted or under-communicated."

Christopher Wright, Senior Analyst, Climate Change/ Environment, Ownership Policies, NBIM, has seen some companies disclose significant risks in places such as Environment Reports, Carbon Disclosure Project responses, and U.S. SEC Form 10-K filings, where they are legally obliged to disclose risk factors. "Material risks should be elevated to a strategic level in Annual Reports," said Wright.

Colin Melvin, Chair of the Pilot Programme Investor Network, said that investors with a longer term perspective will find information disclosed through <IR> useful if it looks at issues that are material, or could become so. Melvin explained, "Integrating information from a management perspective can help to recognise how the material issues link to its strategy and purpose."

Many organisations in the Pilot Programme are engaging with stakeholders to take account of their needs, interests and expectations in determining material issues. Engagement can shed light on the significance of the various risks and opportunities, constraints regarding the availability of resources and significance of key relationships, as well as issues that are significant to stakeholders, such as environmental and social impacts of production. Reporting can reveal an organisation's understanding of stakeholder needs and the extent to which it takes them into account.

BWise, a company that provides enterprise risk management and corporate compliance software, included questions on sustainability and materiality in an employee survey as part of moving towards <IR> and preparing to publish its first public Annual Report. Energy company Enagás S.A. conducts an annual survey to identify the most important issues to its stakeholders and updates its strategic plan annually. Enagás now reports specific information on its strategy and business model, which was previously embedded in other chapters. Enagás currently reports information on finance and employees for operations that it controls with 100% ownership. However, it is considering extending its reporting boundary to include information on companies in which Enagás is the major shareholder, and to integrate information on major suppliers, such as health and safety and environmental impacts.

**"Demand from investors and other stakeholders demonstrates that non-financial information is relevant. Because of that, we take sustainability criteria into account in our analysis of investment opportunities and due diligence process."**

Jose Miguel Tudela Olivares, Enagás

## Pilot Programme businesses comment on technical topics

### Materiality

Another energy company found that an integrated approach can create value in challenging economic times by providing a bigger picture than financial numbers reveal. Tough conditions can make it even more important to focus on materiality and communicate strengths and weaknesses to investors.

A materiality assessment that engages with internal departments as well as key stakeholders such as shareholders, customers and policymakers can help clarify issues that are high on their agendas and formalise an organisation's understanding of which risks to target.

The growing importance of Socially Responsible Investing (SRI) has changed Enagás's perception of non-financial issues. Director Jose Miguel Tudela Olivares said, "Integrated Reporting has helped us go beyond the integration of non-financial information in the definition of Enagás strategy."

Both Enagás and Indra analyse information used by SRI, CSR indices and sustainability ratings agencies, such as the Dow Jones Sustainability Index (DJSI) to help determine material issues. Indra also analyses the Sustainability Reports of sector peers and companies in industries that account for a large share of revenues to help identify relevant issues to include in its Annual Report. Indra considers the results of employees, supplier and customer satisfaction surveys, which include questions on corporate responsibility. In addition, the company concentrates on issues in the media spotlight that might damage the company's reputation and analyses factors that sector leaders and society as a whole consider relevant, using information from sources such as watchdogs and focus groups.

Several companies are using a materiality analysis to identify risks. Using a materiality assessment to link separate issues could reveal how they could combine to affect the organisation's value. Filters can be useful to prioritise information and identify which topics are likely to be most material to an organisation's reporting boundary and wider footprint. Senior managers can score aspects such as strategies, risks, capitals, impacts and trends on the extent to which they're critical to the business or its key stakeholders to inform judgements on what is material and who is accountable.

Indra uses a materiality analysis to identify the main economic, social and environmental impacts of business activities to include in its Annual Report. From a

sustainability scorecard with quantitative data and indicators on its main business impacts, Indra selects non-financial factors that it considers to be material to its business model and strategy.

The master plan is used to identify key issues and actions to take in the short, medium and long term. Indra updates the plan annually and takes relevant external and internal factors into account, based on the materiality analysis and recommendations from the previous year's verification process.

Novo Nordisk uses a materiality filter to decide on performance indicators to include in its Annual Report and to report in detail on risks. The filter is used to identify upstream and downstream issues that could be material to the business model, and to help determine priorities. The company has an integrated financial and risk management system, which includes non-financial risk. It ranks risks in terms of the potential financial impact on the company and probability of occurring. However, it is challenging to quantify potential ethical risk. For instance, it is difficult to estimate the worst case scenario if an employee were to violate a regulation.

Companies can use scenario analysis with longer time horizons to deal with uncertainties surrounding future issues such as climate change policies in forward-looking statements on material risks. This can help address uncertainties surrounding the probability, timing and magnitude of potentially material factors.

### Some companies are connecting internal and external information to identify material issues that are relevant to strategy development

The Board of Japan-based Showa Denki Co Ltd, which manufactures electrical machines, is currently considering materiality. To date, its analysis has revealed that material issues include end-product users in its industry moving to other countries. <IR> is enabling its employees and customers to understand and manage related challenges.

Ernst & Young ShinNihon's executive management team used a range of metrics in order to understand 'connectivity' among key activities, business challenges and strategic objectives for a three-year 'medium term' management plan. The team is currently considering strategic objectives and has identified 15 business challenges as material issues for the financial years 2011-13.

**“The process of producing the report enabled us to align issues of materiality arising from a corporate responsibility master plan with the financial information disclosed in the Annual Report.”**

Alberto Muelas Plaza, Indra

# Q&A with Richard Scurr

## Head of Group Finance Operations at HSBC plc

**How has your organisation determined which issues are material**

HSBC has management structures at Group and local levels which consider issues affecting the Group at their respective levels and within their areas of expertise and, effectively, prioritise them in terms of their relevance and immediacy to HSBC. This process is akin to determining how material each issue is to the Group, the subsidiary operating entity, or the business.

**Do you assess whether an issue is material differently in the short, medium and long term**

There is generally a time dimension in any consideration of the materiality of issues but there is no formal application of periods to determining materiality.

**Are any of the issues identified as material specific to your sector**

A significant number of material issues affect the financial services industry, and those with the capacity to affect competitiveness include the different approaches of regulatory regimes around the world, governmental taxation policy and country-specific legislative changes.

**What are the main challenges in identifying material non-financial issues**

The main challenge is deciding on which non-financial issues affect existing reporting, and how. Many of them, although of interest, are not easy to quantify and, where they can be quantified, are not material to the Group from a financial perspective. For these issues, a decision then has to be taken regarding how they should be disclosed.

## Case studies

### Market risk informs ACCA's strategy

Engagement with stakeholders by the Association of Chartered Certified Accountants (ACCA), a global body for professional accountants, has been highly valuable in thinking about content of future reporting and also the development of the organisation's strategy. Helen Perkins, head of strategy communications, explained, "Starting from the point of view of what's really important to customers and the organisation will, we believe, simplify our reporting in the long run. By applying materiality and focus, you can deliver something valuable to the organisation and the people you're accountable to."

ACCA learned that global stakeholder engagement should start early in the process to determine materiality in order to allow time to gather and respond to feedback. "Because we conducted our stakeholder engagement work late in our reporting year, we couldn't use it to fully shape our 2011-12 reporting but we will use it as a foundation to build future reporting and to inform strategy development", says Perkins.

The process also highlighted some of the areas that ACCA already had plans to develop further; ACCA was already intending to extend engagement and formalisation of its risk management processes and taking in an <IR> approach underscored the value on this. By appointing a new person to improve organisation-wide engagement with its risk approach, ACCA believes it will not only realise further organisational benefits from analysis of risks and opportunities helping it to better achieve its strategic aims, but also be able to deliver more robust and transparent risk reporting.

For ACCA, the initiative is providing another valuable opportunity to build an understanding of stakeholder needs and expectations. Perkins said, "ACCA has already been strengthening the information used in management decision-making to improve the way the organisation is run and <IR> has been an excellent complement to this activity. The process is therefore as much about laying foundations for the future as about <IR>."

# NEXT STEPS



## Further research into the positive impact of <IR>

This research aims to capture differences in the pathways that each company takes towards integrated thinking and reporting. Corporate management and those charged with governance are likely to need to develop their understanding of interconnections between economic, environmental, social and governance factors in making decisions that contribute to success over time. This will involve closer collaboration between different teams and individuals within an organisation as well as other changes. Progress in <IR> will likely require a fundamental rethink of business activities and processes.

The research aims to shed light on key issues, challenges and benefits encountered during the process of moving beyond compliance-driven reporting to demonstrating sustainability as a corporate imperative. The research will seek to build the business case for <IR> and to provide evidence of the impacts of reporting on internal and external value from the organisations' perspectives. Companies have an exciting opportunity to innovate and influence the direction of corporate reporting.

### Research methodology

Black Sun launched a research project in July 2012 to help the IIRC track ways in which <IR> is changing corporate behaviour. Black Sun is working with the IIRC to examine 'behavioural change' experienced by Pilot Programme companies as they move towards <IR>. Recognising that successful <IR> is a challenging and lengthy process for many companies, this research will track organisations' progress as well as behaviour change over the next two years.

Black Sun's research is based on a comprehensive survey of all Pilot Programme participants.

The survey explores:

- approaches to reporting-processes that businesses currently have in place to deliver corporate reports and how these are expected to change as a result of the <IR> process, and
- the barriers and the benefits of <IR>.

The survey will be supplemented with in-depth phone interviews with the organisations in order to fully understand the challenges and opportunities that they face. Results will be published as a reference for the IIRC and other stakeholders to examine the impacts and benefits of reporting in line with the emerging <IR> Framework.

## International momentum

The International Federation of Accountants (IFAC) has called for the G20 countries to support the IIRC's development of the Framework. The IIRC will participate in several international processes during 2012 and 2013, including engaging with the World Economic Forum, Organisation for Economic Co-operation and Development, G8 and G20. This engagement will be complemented by targeted dialogue with stock exchanges in key capital markets. The main purpose will be to raise awareness and understanding of <IR> and its benefits to business and investors. While <IR> is a market-led initiative developed in partnership with businesses and investors, the inter-governmental, regulatory and standard-setting communities will be important catalysts for global adoption of <IR> in the future, breaking down regulatory and cultural barriers and putting in place the market requirements to enable <IR> to become the corporate reporting norm of the 21st century. The IIRC aims to develop the Framework to guide businesses towards communicating clear, concise information needed by investors and other stakeholders to assess their long term prospects.

In June 2012, world leaders at the United Nations Conference on Sustainable Development endorsed the concept of integration in corporate reporting in the Outcome Document – the statement of high-level principles supported by 196 nations, entitled 'The Future We Want'. Governments committed to taking steps to encourage companies to consider integrating sustainability information into their reporting cycle, and to encourage industry and relevant stakeholders "to develop models for best practice and facilitate action for the integration of sustainability reporting, taking into account experiences from already existing frameworks".

The IIRC will build on this progress by engaging with the UN process to coordinate action following Rio+20. This is essential to address the significant regulatory and liability barriers to directors' disclosing risks and providing forward projections, and to explore opportunities to harmonise reporting requirements within and across jurisdictions so that companies are able to develop <IR> that investors can rely on. <IR> is the language of 'sustainable' businesses, enabling them to communicate with greater clarity the factors that support value creation and preservation in the short, medium and long term.

## Conclusion

### Pilot Programme outlook and next steps

The IIRC will continue to work with organisations including businesses and investors in the Pilot Programme to develop the Framework during 2012/13. The development of the <IR> Framework needs to be an interactive, iterative process designed to enhance and consolidate existing reporting practices and through collaboration, consultation and experimentation, to move towards <IR>. The IIRC will consult widely with stakeholders in a range of jurisdictions through meetings, roundtables and conferences to build on responses received to the IIRC's 2011 Discussion Paper on <IR> and the experience gained from the first year of the Pilot Programme.

The IIRC will produce technical papers during 2012 and early 2013 and will draw on the Pilot Programme's work to understand how <IR> affects businesses and drives behaviour change. While the Pilot Programme is a key element of looking at <IR> through a corporate and investor lens, the IIRC is also examining practices by other companies striving to do <IR> around the world. During 2013, the IIRC will undertake a wide range of stakeholder engagement to prepare the ground for the

release of the Framework in December 2013. The IIRC also plans to update stakeholders on progress over the next 12 months and provide opportunities for them to help shape the Guiding Principles and Content Elements.

The first year of the Pilot Programme and responses to the Discussion Paper have made it clear that it might take several years for companies to produce a fully Integrated Report and the Pilot Programme should go into a third year, 2014. This will enable participants to trial version 1.0 of the Framework during the next reporting cycle so that the IIRC can assess <IR> outcomes and complete its work.

The Framework will help to provide broad parameters for policymakers and regulators and provide a focus for harmonising reporting standards. Companies that prepare for <IR> and understand the implications for businesses and investors will be better positioned for the eventual convergence of <IR> with the existing corporate reporting regime. The Pilot Programme's Investor Network Chair Colin Melvin said, "Better companies will anticipate the Integrated Reporting trend and realise they are likely to be asked to implement <IR> in the future."

**"We need a rallying cry from influential people responsible for business reporting, possibly including regulators, to get critical mass and momentum behind this as the right next step in corporate financial reporting."**

Bob Laux, Microsoft

2012

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# The IIRC's critical path

Pilot Programme (PP) Yr 1 Conference



Rio+20 Summit



World Bank Meetings



2012

International <IR> Framework Outline

IIRC Year 1 Yearbook

Examples Database goes live

International <IR> Prototype Framework

Baseline Report – Integrated Thinking

Topic-specific reports

PP Yr 2 Conference

World Economic  
Forum, Davos



OECD Conference



G20 Russia Summit



2013

International <IR> Draft Framework released  
for public consultation

International <IR> Framework version 1.0

PP Yr 3 Conference

G20 Australia Summit



World Economic  
Forum, Davos



OECD Conference



2014

Driving forward and testing the International  
<IR> Framework v1.0

