DIRECTIONS

Integrated reporting: measurement matters

Inside:

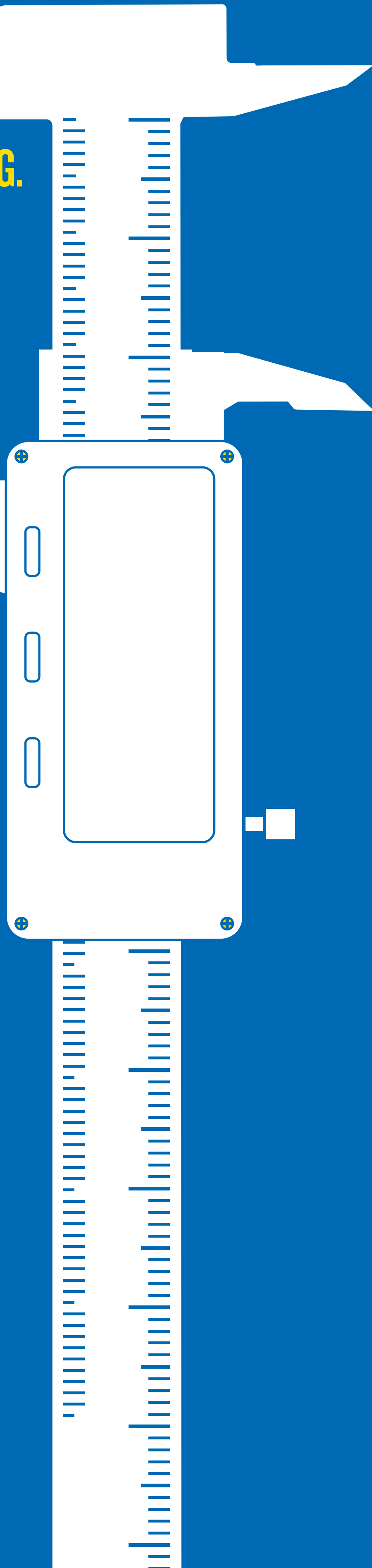
How are the best integrated reporters meeting the challenge of measuring all the value they create?

CAN YOU MEASURE THE UNMEASURABLE?

SALTERBAXTER MSLGROUP

EVERYONE'S TALKING ABOUT INTEGRATED REPORTING.

BUT NOT EVERYONE HAS REALISED THAT THERE'S A NEW DIVIDE OPENING UP WITHIN THE INTEGRATED REPORTING MOVEMENT. TWO YEARS ON FROM THE FIRST INTEGRATED REPORTING FRAMEWORK, WE THINK IT'S CLEAR THAT MEASURING OUTCOMES, NOT JUST LISTING INPUTS AND OUTPUTS, IS WHAT PUTS THE BEST INTEGRATED REPORTERS FIRMLY AHEAD OF THE REST.



It's now more than two years since the International Integrated Reporting Council (IIRC) published its integrated reporting framework. Many reporters now know what integrated reporting is, and there are some great examples out there. But, having looked at the best integrated reports the world has to offer, we sense that a divide is opening up – one at least as big as that between companies who spurn integration, and those who have embraced it. And that divide is the measurement of outcomes.

It seems clear to us that the integrated reporters who show, rather than tell, are the only ones able to truly convince their stakeholders that their company is doing something different. These measurement-focused integrated reporters have the courage to cover not only value creation, but also value depletion. They talk plainly about cause and effect, and typically use the language of the 'capitals' (see 'Quick primer: the capitals') to do so. They are focused not just on inputs ('we rely on A, B and C to do business') and outputs ('this year we achieved X, Y and Z') but also on outcomes ('this year our business affected A, B and C both positively and negatively'), and they don't shy away from discussing value that can't be quantified.

Why do some reporters go to these lengths? Because it means that they can offer their stakeholders concrete proof that integrated thinking is really happening. They can articulate a strong argument for the continued operation of their business. They can tell a richer, more holistic story in their reports (and across their communications) about the value their business creates, and the associated impacts. And, of course, they can demonstrate clearly how they plan to survive, and thrive, over the long term.

But what does all this look like in practice? Well, we think that, having surveyed the best integrated reporters from around the world, certain patterns begin to emerge. It's not a straightforward spectrum from 'bad to good', but some approaches are certainly more effective than others.

QUICK PRIMER: THE CAPITALS

Capitals (also referred to as 'resources and relationships') are stocks of value or assets that can be added to, or diminished, by the activities of a business. The IIRC lists six in its framework, but, critically, notes that companies need only report on those capitals material to them.

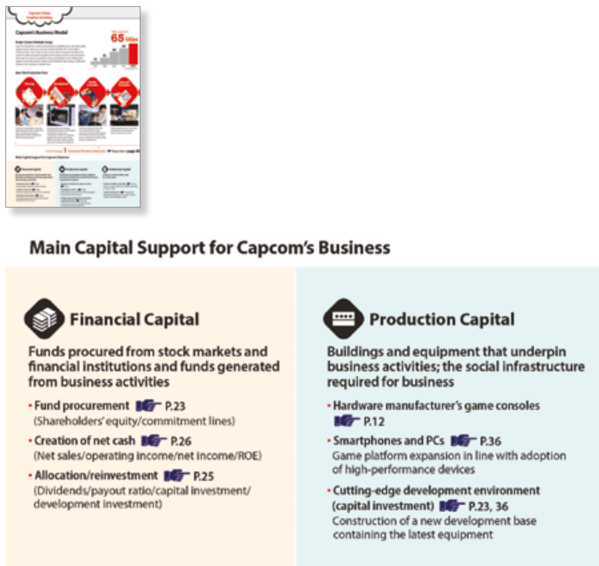
- **FINANCIAL** (internal and external funds available to a business)
- **MANUFACTURED** (e.g. buildings, equipment and infrastructure)
- **INTELLECTUAL** (knowledge-based intangibles, e.g. brands and patents)
- **HUMAN** (people and their capabilities and experience)
- **SOCIAL AND RELATIONSHIP** (stakeholder and network relationships)
- **NATURAL** (environmental resources, e.g. air, water and land)

The four key ways integrated reporters have impressed us:

In this Directions supplement, we will show how each of these four techniques marks a particular step-change in integrated reporting, and discuss how, in combination, they bring us meaningfully closer to the kind of integrated reports envisioned by the IIRC and many business and sustainability leaders. We also offer some guidance around how to bring more measurement of outcomes into your own reporting (page 9), and then take a look at what the future might hold (page 10).

ALIGNING PERFORMANCE WITH THE CAPITALS

MANY INTEGRATED REPORTERS ARE BEGINNING TO ALIGN THEIR PERFORMANCE DISCUSSION WITH THE CAPITALS, AND SO ARE ABLE TO OFFER A MORE BALANCED, HOLISTIC VIEW OF THE VALUE THEIR ORGANISATION CREATES.



Main Capital Support for Capcom's Business

Financial Capital

Funds procured from stock markets and financial institutions and funds generated from business activities

- Fund procurement P.23 (Shareholders' equity/commitment lines)
- Creation of net cash P.26 (Net sales/operating income/net income/ROE)
- Allocation/reinvestment P.25 (Dividends/payout ratio/capital investment/development investment)

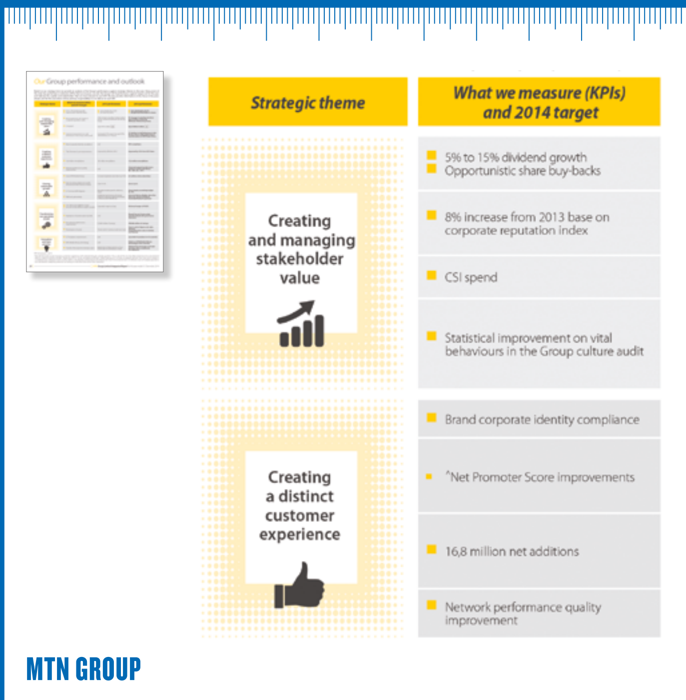
Production Capital

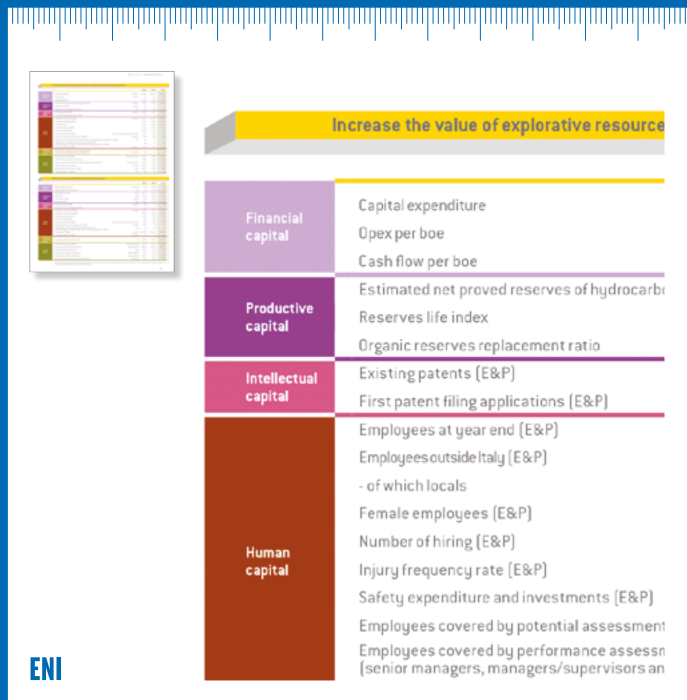
Buildings and equipment that underpin business activities; the social infrastructure required for business

- Hardware manufacturer's game consoles P.12
- Smartphones and PCs P.36 Game platform expansion in line with adoption of high-performance devices
- Cutting-edge development environment (capital investment) P.23, 36 Construction of a new development base containing the latest equipment

CAPCOM

CAPCOM, the Japanese videogame company, are at the start of this process of alignment. Accordingly, within their business model description they make clear that the later parts of the report, largely focused on performance, can be mapped against the different capitals. For example, they pull discussion around the construction of a new, well-equipped development base under the 'production capital' heading, and discussion around the growth of their brands via deployment of popular content under 'intellectual capital'.





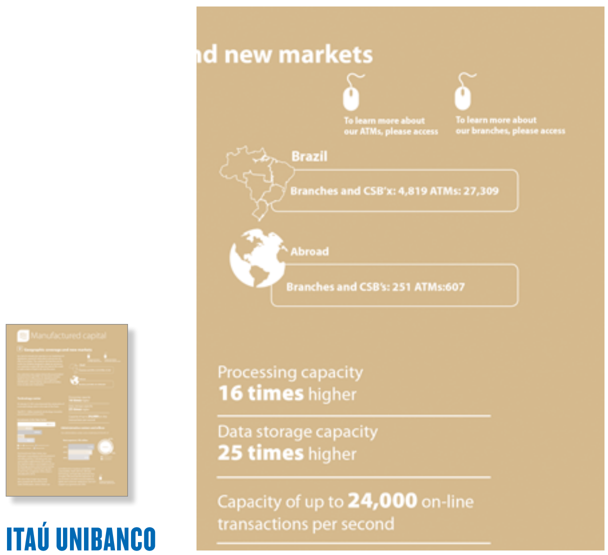
MTN GROUP, the South African telecommunications business, offers a similar level of integration with the capitals, using their 'Group performance and outlook' section to highlight each strategic objective in turn, which are then linked to, among other things, the capitals. It's worth noting that – unusually – MTN acknowledges that the same actions can affect more than one capital – for example, transferring best-practice between operating companies impacts both intellectual and human capital.

Italian oil and gas multinational **ENI** also focuses on pulling performance measures underneath the 'capitals' umbrella, but does so in a considerably more detailed way. The company offers tables for each strategic objective, which include a long list of performance indicators. These tables are then split up (and colour-coded) by the capitals. For example, the objective 'Return to structural profitability in the gas and power business' includes indicators measuring worldwide gas sales (productive capital) and injury frequency rate in the gas and power division (human capital).

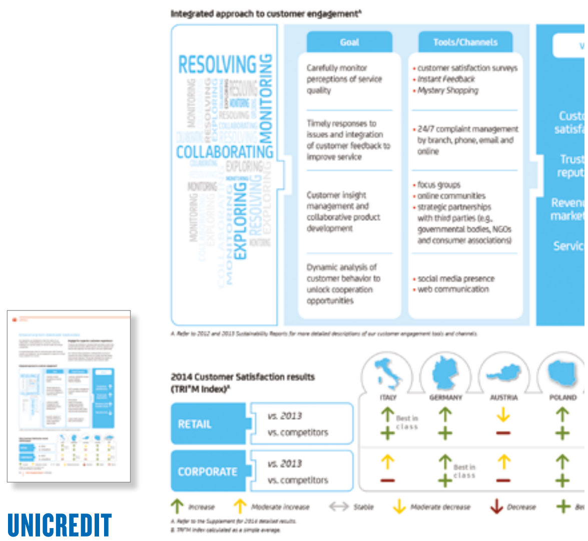
Other reporters who have made progress in this area include **BIDVEST** (South Africa) who present their material issues and KPIs through the lens of the capitals, and **TELEFÓNICA** (Spain) whose KPIs are all associated with a relevant capital.

USING THE CAPITALS TO MEASURE PERFORMANCE

THIS YEAR, WE'VE SEEN MORE REPORTERS THAN EVER BEFORE OFFER SIZEABLE PERFORMANCE SECTIONS WHICH COVER OUTCOMES AGAINST EACH OF THE CAPITALS.



ITAÚ UNIBANCO

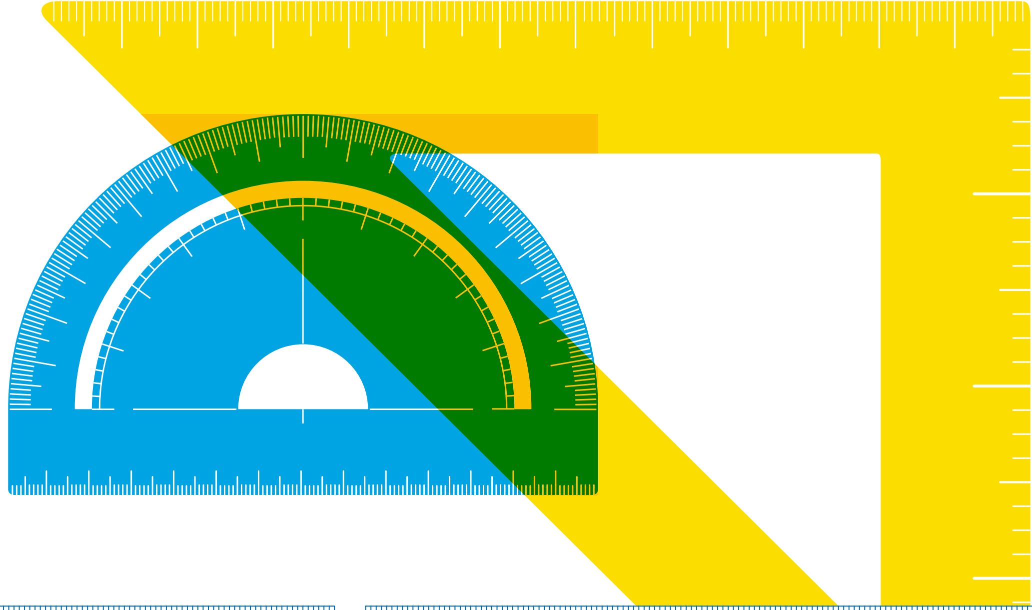


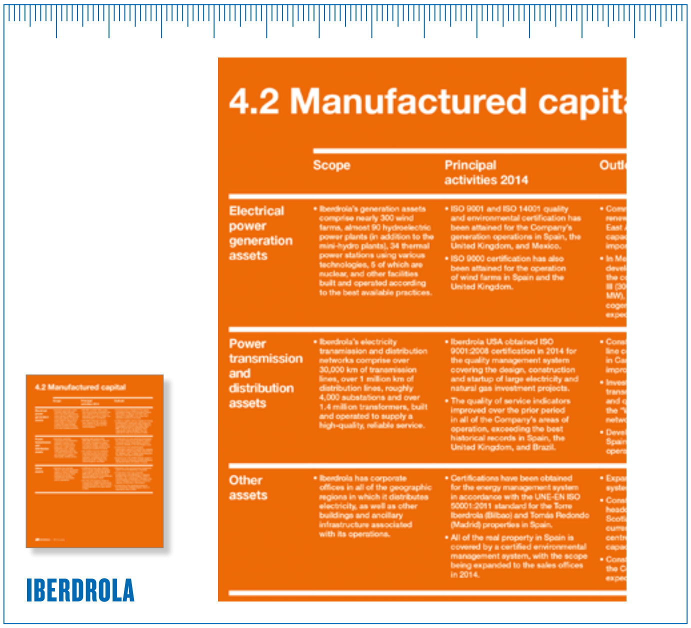
UNICREDIT

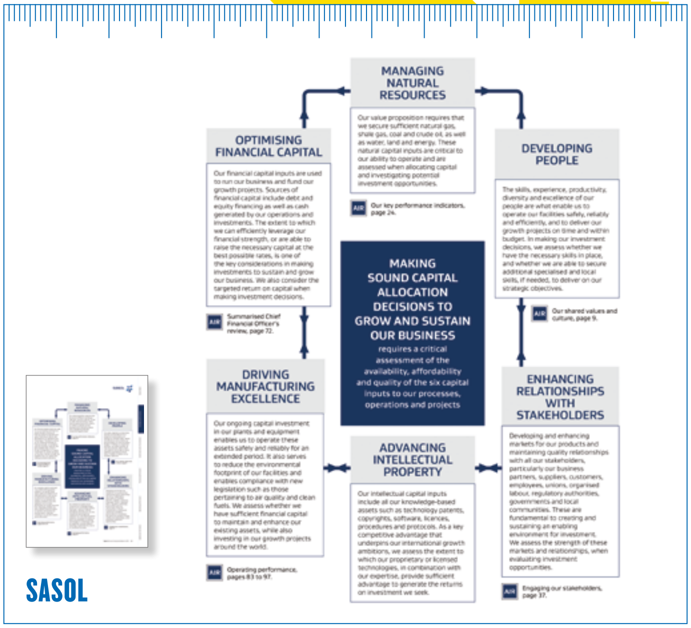
Just two or three years ago, substantial, capitals-based performance sections were practically unheard of, but we are very pleased to say that this sort of effort is now becoming more and more common. Many have even replaced more traditional per-division or chiefly financial performance sections entirely.

ITAÚ UNIBANCO, the Brazilian bank, offers considerable detail around each capital (with financial capital included at the start, but very much presented as on a par with the others), supplying both qualitative and quantitative information where appropriate. Many reporters still struggle to talk convincingly about intangibles like intellectual capital, but the bank handles this very well, explaining clearly how they have invested in their brand during the year.

UNICREDIT, the Italian financial services company, offers a similarly strong capitals-focused performance section, brought to life via several infographics and small case studies.



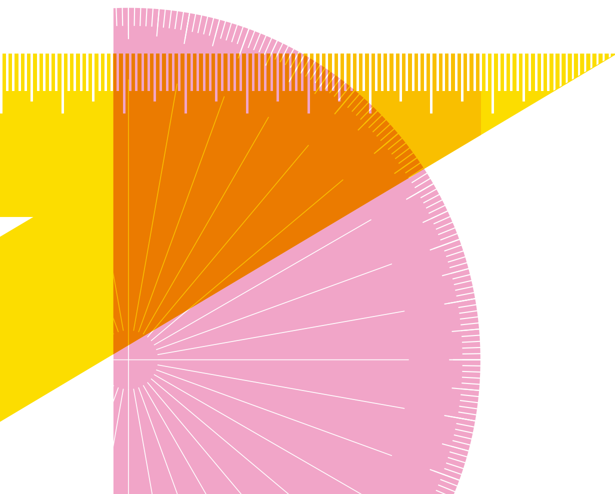




Spanish electricity company **IBERDROLA** takes a slightly different approach to the same concept, offering a performance dashboard per capital, which shows what the relevant management approach has been during the past year, what the quantifiable results or principal related activities were, and then what's planned for the immediate future.

In South Africa, meanwhile, energy and chemical company **SASOL** offers a standardised per-capital format for their disclosure which covers how the company uses the capital in question, key inputs and outputs (for example, coal is a natural capital input, and GHG emissions are an output), and relevant activities during the year.

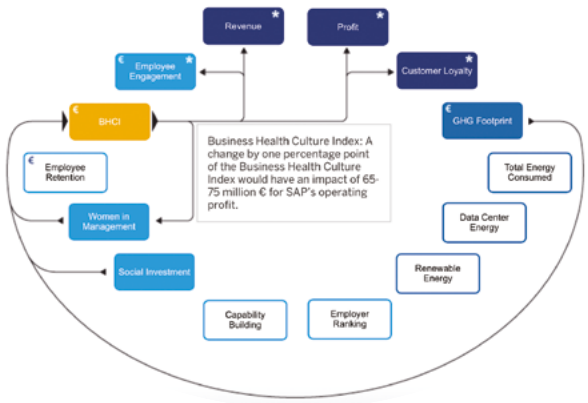
Progress in reporting in depth against the capitals has also been made by UK property company **THE CROWN ESTATE**, who, via their 'Total Contribution' initiative, are developing a comprehensive set of indicators which means that they will soon be able to quantify their social, environmental and economic contribution using the language of the capitals. **CCR** (Brazil) also offers a detailed performance section, as does Dutch company **AKZONOBEL**.



MEASURING THE UNMEASURABLE

MANY REPORTERS STRUGGLE WITH THE NOTION OF DISCLOSING INFORMATION AROUND THINGS THAT ARE, BY NATURE, INTANGIBLE, SUCH AS SOCIAL AND RELATIONSHIP CAPITAL – BUT SOME ARE SUCCEEDING.

EISAI



SAP

We applaud the reporters that have, despite the inherent difficulties, chosen to face the task of 'measuring the unmeasurable' head-on. For example, all of the reporters who provided capitals-centric performance sections within their reports attempted to explain their activities regarding intellectual and social and relationship capital in some way. Many did so successfully and, notably, without necessarily feeling the need to quantify their activities. Best-practice in this area is still emerging, but there are some interesting examples out there.

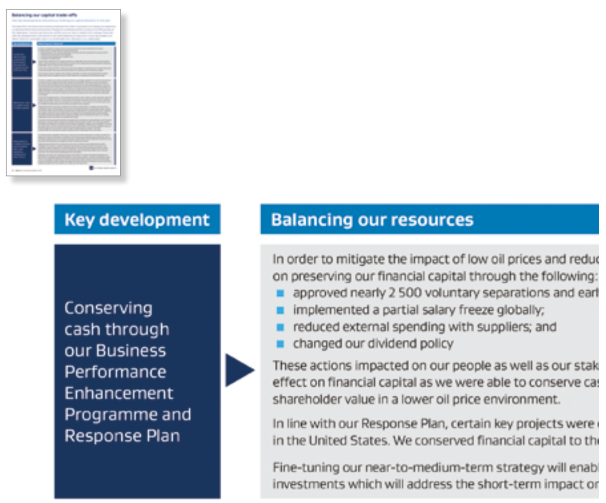
Japanese pharmaceutical company **EISAI** offers a particularly interesting take on reporting against social and relationship capital, opting to focus on their 'partnership initiatives'. They offer an overview of why such partnerships are particularly important to their business, supported by a graphic which shows the two most common varieties of partnership (technology and regional) and then, over two pages, they provide a list of their partners, supported by brief descriptors. This sort of disclosure doesn't require new information to be gathered, nor much conceptual thinking, but it is nonetheless highly relevant for Eisai, and extremely useful to the report's readers.

SAP, the German multinational software firm, offer perhaps the most notable innovation in this area, having created a framework which firmly establishes the link between non-financial and financial performance. This means that the company is able to offer not only insight into the underlying indicators which are used to measure, for example, the health of their business culture or employee engagement, but that they are also able to show how, for example, an increase (or decrease) of one percentage point in the results of their 'Business Health Culture Index' survey would have an impact of €65-75 million on profits. This framework is also used to assess the impact of non-financial indicators on SAP's strategic objectives; in this way the company is able to draw (and explain) a clear link between growing customer loyalty and employment of more women in management positions.

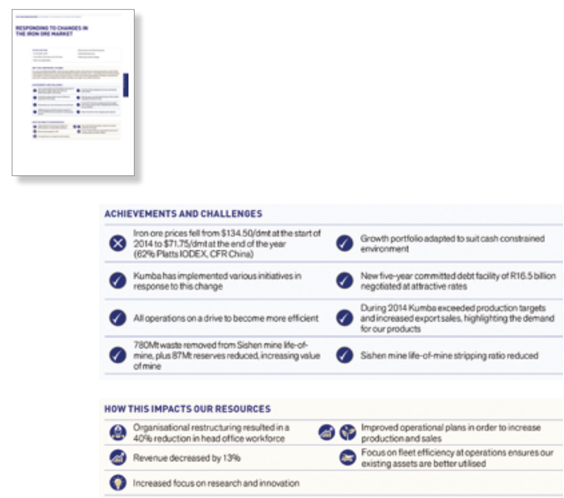
We were also impressed by the intellectual capital disclosure offered by **UNICREDIT**, a business that, operating in the financial services sector, is more reliant than most on innovations in information technology, processes and organisation. And, as discussed earlier, Itaú Unibanco does a great job of explaining how it has grown the value of its brand during the year.

TREATING THE CAPITALS AS CONNECTED STOCKS OF VALUE

THE MARK OF A TRULY SOPHISTICATED INTEGRATED REPORTER IS INCLUDING DISCUSSION OF THE CAPITALS' ROLE AS INTERDEPENDENT STOCKS OF VALUE, WHICH ORGANISATIONS CAN AFFECT BOTH POSITIVELY AND NEGATIVELY.



SASOL



KUMBA IRON ORE

Very few reporters have thus far offered truly sophisticated discussion around the capitals, where they are treated as interdependent stocks of value that can be affected positively and negatively. Furthermore, all those that have done so thus far are based in South Africa (understandably, given the 'head start' provided by the King III regulations). But what do we mean by 'sophisticated' discussion?

Well, we think that energy and chemical company **SASOL** offers perhaps the most impressive disclosure on this front. They include a section titled 'Balancing our capital trade-offs', in which they explain, among other things, that, by reacting to rapidly evolving environmental policy, they will on the one hand be preserving natural capital, but on the other diminishing the value of their manufactured capital, given the technical implications of installing emission abatement equipment. Sasol's frankness concerning possible negative impacts in addition to positive ones is to be applauded.

KUMBA IRON ORE, meanwhile, also offers highly advanced discussion around the capitals. For example, in the section covering their first material issue, 'Responding to changes in the iron ore market', they show how their actions have had an impact on their resources – so restructuring contributed to a 40% reduction in headcount (human capital) while greater efficiency means that their existing physical assets are better utilised (manufactured capital). It sounds simple enough, but the vast majority of integrated reporters do not yet draw this clear line from their activities to impacts on multiple capitals.

Fashion brand **TRUWORTHS** also offers something interesting in this area – they show clearly which capitals are affected by the actions they are taking to address their material issues. Again, this appears simple, but many reporters don't take that extra step of thinking about how actions can have ramifications that affect not just one capital, but many.

6 STEPS TOWARDS MEASURING WHAT MATTERS

1: WALK BEFORE YOU RUN

Reporting meaningfully against all six capitals is a big job, so start with the ones you are most comfortable with, and work from there. For example, state-of-the-art manufactured capital is particularly important to miners, while highly-trained human capital is most important to software developers.

2: IT'S A FRAMEWORK, NOT A RULEBOOK

The IIRC would be the first to say that the integrated reporting framework isn't a definitive set of rules. If not all of the capitals are material to your business and stakeholders, don't give them too much (or indeed any) space. Equally, if one is particularly material, it is appropriate to focus on it.
And if you already use, or want to start using, particular terms to refer to your assets rather than 'capitals' that is fine, too.

3: BALANCE AND CONNECTIVITY ARE KEY

The best integrated reporters discuss the ways in which the capitals can be grown and drawn down, and how they are linked (i.e. certain actions may build up one while diminishing another).

4: NOT EVERYTHING CAN BE COUNTED

Social and relationship capital and intellectual capital in particular don't necessarily lend themselves easily to quantification; fortunately it is more than acceptable to discuss things that can't be 'measured' in a meaningful sense, if they are important to your stakeholders and enable your company to create value.

5: BALANCED REPORTING IS CRUCIAL

The best integrated reporters, like the best financial and sustainability reporters, explain negative developments as well as positive ones.

6: LET STAKEHOLDERS SEE BEHIND THE CURTAIN

If you are in the process of improving how you measure outcomes in your integrated report, it's likely that such an improvement will take place over a few years. Share your plans with your stakeholders, and they will likely respond well to your openness.

MEASUREMENT MATTERS. SO WHAT'S NEXT?

Given that many reporters are only just beginning to move towards meaningful reporting on non-financial outcomes, it may seem a little premature to think about what's coming next. The big accountancy firms are, however, already active on this front. EY, KPMG, PwC and Deloitte have all put out various think-pieces in which the future of integrated reporting is discussed. And, by and large, they all point in one direction: monetisation. But what does that entail?

Essentially, it means going further than offering straightforward qualitative and quantitative outcome reporting (e.g. broad discussion around social and relationship capital, hard numbers on carbon emissions) by taking the (sizeable) step of assigning a financial value to non-financial capitals, so that they can ultimately be accounted for in the financial statements of listed companies. The best-known example of a similar process in practice is Kering and Puma's work on creating an 'environmental' profit and loss account.

EY, in their 2014 publication 'Integrated reporting: elevating value' present monetisation as an inevitable next step, and it is a core component of KPMG's 'True value' methodology. Moreover, PwC talks about the imperative of putting "value in a language business understands". Undoubtedly, this is an important goal. After all, the ultimate aim of the IIRC is to change the information set upon which investment decisions are based, facilitating a gradual move of capital away from unsustainable enterprises.

However, as many involved freely admit, monetisation is not an easy process. Fundamentally, it involves making assumptions about how the world works, which is hardly simple or foolproof. Furthermore, many enterprises currently benefit substantially, in share price terms, from the costs of their firm's heavy negative impacts on certain capitals staying in the background – it is very difficult to imagine such companies signing up of their own accord for prominent monetisation of non-financial capital. And that's a big problem – if some companies don't offer this information, investors will not be able to make decisions by comparing like with like. The only viable solution, then, would seem to be a government-imposed method of pricing negative impacts on capitals – yet such a method would undoubtedly be both highly controversial and costly to implement.

For these reasons, among others, broad adoption of monetisation currently seems like a far-off aspiration. It's worth asking, though, whether monetisation is really something to which leading reporters should be aspiring.

Crucially, many thinkers in this area have arguably lost touch with the fact that the placement of financial capital at the apex of the six capitals, with the remaining five fitted roughly into its mould, could be said to contradict much of what the sustainability reporting movement has traditionally advocated. Many don't believe that everything a company does could, or should, be reducible to cold, hard cash. For example, monetisation of emissions could lead to trade-offs being made without regard to the ultimate capacity of the atmosphere to absorb carbon – as if that absorption capacity were not ultimately finite, rather just grew more expensive to use over time.

Mark McElroy (founder and Executive Director at the US-based Centre For Sustainable Organisations) is a prominent critic of monetisation without recourse to context, advocating instead for a 'multi-capital scorecard' approach. This involves quantifying, but not monetising, impacts on all six capitals, with the result a 'triple bottom line' (social, environmental and financial) which offers a holistic and, critically, contextual picture of value creation. This may, in time, prove to be a valuable alternative to monetisation.

As we write, it seems clear that there remain several different paths open to reporters who agree that measurement matters. Monetisation is one, and a context-based scorecard approach another. We think though, that reporters taking the path of pure monetisation, disregarding environmental context, will not serve their stakeholders or the wider world particularly well. Furthermore, we believe that a key role remains for high-quality narrative reporting on non-financial value creation; it's perfectly acceptable, and entirely realistic, to say that not all of the value that your company creates could, or should, fit on a spreadsheet.

SALTERBAXTER MSLGROUP

About Salterbaxter

Salterbaxter helps business and brands step up to the challenge of the changing relationship between business and society. We combine strategy, sustainability and creative communications to help drive change, support commercial objectives and connect with external and internal audiences.

As part of MSLGROUP (Publicis Groupe's strategic communications network) we have built an exciting and unique agency that is designed specifically to give our clients the breadth and depth of skills they require to navigate today's strategy and communications landscape.

Every client, company and ambition is different, so we take a bespoke approach, blending our clients' needs with sector-specific expertise, insight and methodologies from our extensive experience.

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