INTEGRATED REPORTING <IR>

International <IR> Framework revision

Focused engagement

Submission deadline: 20 March 2020

Topic Paper 2

Business model considerations

Help shape the future of integrated reporting

About the IIRC

The International Integrated Reporting Council (IIRC) is a global coalition of regulators, investors, companies, standard setters, the accounting profession, academia and NGOs. The coalition promotes communication about value creation as the next step in the evolution of corporate reporting.

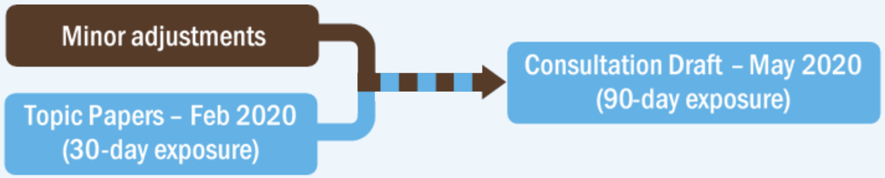
About the International <IR> Framework

Released in December 2013, the <IR> Framework explains the Fundamental Concepts underpinning integrated reporting and includes Guiding Principles and Content Elements that govern the preparation of an integrated report. The <IR> Framework is written primarily in the context of private sector, for-profit companies of any size, but it can also be applied to public sector and not-for-profit organizations. An integrated report is used to assess the organization's ability to create value over time.

Context for a revision

In 2017, the IIRC invited market feedback on the <IR> Framework's overall effectiveness and ease of implementation. Through regional roundtables and an online survey, one point became very clear: the core principles of integrated reporting continue to stand the test of time. The IIRC Council echoed this view in November 2019 when it endorsed a modest 2020 update to the <IR> Framework. Such a revision would mark the IIRC's ten-year anniversary and ensure the <IR> Framework's continued relevance in an evolving business and policy environment.

With this in mind, minor adjustments – including simple corrections and clarifications – are now underway. Concurrently, the IIRC seeks input on select themes raised by users and preparers of integrated reports. These include: (1) responsibility for an integrated report, (2) business model considerations and (3) charting a path forward. Each theme is explored in a dedicated Topic Paper, which invites feedback during a 30-day window. Responses to Topic Papers will inform the direction of <IR> Framework proposals. Per the IIRC's Procedures Handbook, all proposals will receive 90-day public exposure via a Consultation Draft.



How to respond to Topic Paper 2

All feedback, no matter how brief, is welcome and should be submitted via our online form at www.integratedreporting.org/2020revision/topic-paper-2. Your time is valuable, so we've limited the number of survey questions to just four, as shown on page 6 of this Topic Paper. Input is most helpful when it includes supporting rationale and specific recommendations.

Deadline for submissions: Friday 20 March, 2020 (23:59 GMT)

All comments received will be considered a matter of public record and will be posted on the IIRC's website after the closing date. A summary of feedback received will also be posted at a later date.

Introduction to the business model

Section 4C of the International <IR> Framework addresses business model disclosures in the integrated report. The following related definitions are relevant to this Topic Paper.

Business model An organization's system of transforming inputs through its business activities into outputs and outcomes that aims to fulfil the organization's strategic purposes and create value over the short, medium and long term.

Outputs An organization's products and services, and any by-products and waste.

Outcomes The internal and external consequences (positive and negative) for the capitals[1] as a result of an organization's business activities and outputs.

Matters under consideration

In the years following the <IR> Framework's 2013 release, the IIRC has monitored its implementation and continued to engage with users and preparers of integrated reports. Through these avenues, the IIRC has identified four issues related to business model disclosures:

1. Confusion between outputs and outcomes
2. Limited connection between outcomes and value creation
3. Imbalanced reporting of outcomes; tendency to promote the positive
4. Perception that integrated reporting overlooks 'impacts'.

Analysis

This section explores more deeply the issues that compromise reporting on business model considerations.

Confusion between outcomes from outputs. A 2016 review of randomly-selected integrated reports, conducted internally by the IIRC, showed that many preparers confuse **outputs** (whether in the form of products or services) and **outcomes**. In fact, fewer than one-third of sampled reports disclosed the effects of the business model on the various capitals (see right). Most reports, therefore, failed to provide a clear bridge between the business model and broader value creation.

- Financial
- Manufactured
- Intellectual
- Human
- Social and relationship
- Natural

Users and preparers of integrated reports backed these findings when, in 2017, the IIRC consulted on <IR> Framework Implementation.

- We note that preparers of integrated reports frequently confuse, or fail to distinguish between outputs, outcomes and impacts.
- Inputs and outputs are clearly defined and explained. The only improvement area could be the outcomes and value creation. Outcomes and value creation may need to be analyzed and could be reported and visualized in (a) more detailed manner.
- Differentiating between outputs and outcomes can be a bit difficult for reporters. It encourages the institutions to think and analyze their business models, and the impacts of their activities.

[1] Stocks of value on which all organizations depend for their success as inputs to their business model, and which are increased, decreased or transformed through the organization's business activities and outputs.

Connection between outcomes and value creation. The omission of outcome-based disclosures sets the stage for a second issue: failure to link the business model to broader value creation. As one respondent to the IIRC's 2017 consultation observed, "Outcomes (are) often omitted; reports are therefore light on impact measurement and, therefore, the report rather misses the mark." Other respondents offered the following:

- I see little linkage between these discussions and areas such as results-based and value-based management. I also see little discussion on the value creation or depletion aspects on non-financial capitals.
- Emphasis should be made of the fact that value creation and outcomes are one and the same.
- To assess an organization's ability to create value over the medium- to long-term, an integrated report should provide information about how … business activities are designed to achieve specific outcomes.
- There is a tendency to view the business model as (an) explanation of how revenue is generated, rather than more holistically as a value creation system.

Barring an analysis of business model outcomes – including trade-offs across the capitals – report users are ill-equipped to assess an organization's <u>net</u> value proposition. Furthermore, the omission of negative or harmful business model results throughout the value chain, and across the broader spectrum of capitals, introduces inherent biases as discussed below.

Imbalanced reporting of outcomes. The IIRC's 2016 review of integrated reports found that disclosures were generally balanced and neutral. That said, 25% of the sample exhibited at least one of the following:

- Exclusion of negative developments or underperformance
- Amplification of positive results and dampening of negative results
- Use of promotional language to cast performance in a favourable light.

While not confined to reporting on outcomes, such biases were raised during the IIRC's 2017 consultation. In particular, when asked about outcomes-based disclosures, one respondent alluded to unsubstantiated claims, noting that, "qualitative information is good, but most companies do not report hard data." A second respondent observed, "if we take the integrated report as the chronicle of the life of an organization, this should mean that both favourable and unfavourable events (if material) are to be reported."

Emphasis on short-term business model results. During the IIRC's 2017 consultation, a small segment of market feedback referenced a strong focus on near-term results. As one respondent remarked, "the main focus seems to be on short-term outcomes, with little attention paid to medium- and long-term outcomes." According to a report preparer, a near-term transactional focus continues to drive the analysis: "When we discuss business models, we are still looking at where we earn money, how we spend it and what this yields financially. We do report on the non-financial capitals, but for us a business model is still about how we make our money."

Treatment of impacts. Some contend that integrated reporting overlooks long-term societal and environmental impacts and focuses only on 'how the outside world affects companies' (and not 'how companies affect the outside world'). The 2020 revision provides an opportunity to address this view, which is reasonably premised on:

- The <IR> Framework's use of the word 'outcomes' over 'impacts'
- A belief that 'explaining to providers of financial capital how an organization creates value' (Para 1.7 of the <IR> Framework) equates to investor primacy, to the exclusion of wider societal and environmental interests
- Observed reporting practice, which continues to favour the short term.

This paper explores the first two factors, which are within the IIRC's direct control. The <IR> Framework's use of the word 'outcomes' is colloquially synonymous with 'impacts' (as well as results, effects and consequences). But, as the following page indicates, the word 'impact' can vary in meaning.

Understanding impacts

The following collation of definitions is helpful on two fronts. First, it demonstrates considerable variation and serves as a caution against adding further to the mix. The sampling also highlights common attributes to which the IIRC's definition of outcomes can map. The right-hand column of this page features such a mapping.

Capitals Coalition. The negative or positive effect of business activity on natural capital.[2] The persistent change experienced by a person or group of people that occurs as a result of an activity. It can be positive, negative, intended or unintended.[3]

positive | environment | society | long term | negative | intended | unintended

Embankment Project for Inclusive Capitalism. The medium to long-term effects resulting from business activities, such as changes in well-being.[4]

medium term | long term

GRI. The effect an organization has on the economy, the environment and/or society, which in turn can indicate its contribution (positive or negative) to sustainable development. The term 'impact' can refer to positive, negative, actual, potential, direct, indirect, short-term, long-term, intended or unintended impacts. Impacts on the economy, environment and/or society can also be related to consequences for the organization itself. For example, an impact on the economy, environment and/or society can lead to consequences for the organization's business model, reputation, or ability to achieve its objectives.[5]

positive | negative | actual | potential | short term | long term | direct | indirect | intended | unintended | economy | environment | society

Impact Management Project. A change in positive or negative outcome (the likely or achieved short-term and medium-term effects of an intervention's outputs) for people or the planet.[6]

positive | negative | society | environment

Hearn and Buffardi supplement this analysis with their review of the policy and programme development space. As the authors note, "some definitions focus on very specific and precise understandings of impact, while others cast an extremely broad net."[7] Despite wide variation, key themes emerge: positive or negative effects on society and nature, often over the longer term. The following <IR> Framework paragraphs reflect these themes:

2.3 Integrated reports provide insight about how organizations interact with the external environment and the capitals to create value over the **short, medium and long term**.

2.4 The value created by an organization reflects the value created for stakeholders and **society at large**.

3.19 Material matters may have direct implications for the organization itself or may **affect the capitals owned by or available to others**.

4.19 An integrated report describes key outcomes, including internal outcomes ... and external outcomes (e.g., ... and **social and environmental effects**). It also describes **positive** outcomes (those that result in a net increase in the capitals and thereby create value) and **negative** outcomes (those that result in a net decrease in the capitals and thereby diminish value).

4.58 Time frames may vary according to the nature of outcomes (e.g., some issues affecting **natural or social and relationship capitals** can be very **long term** in nature).

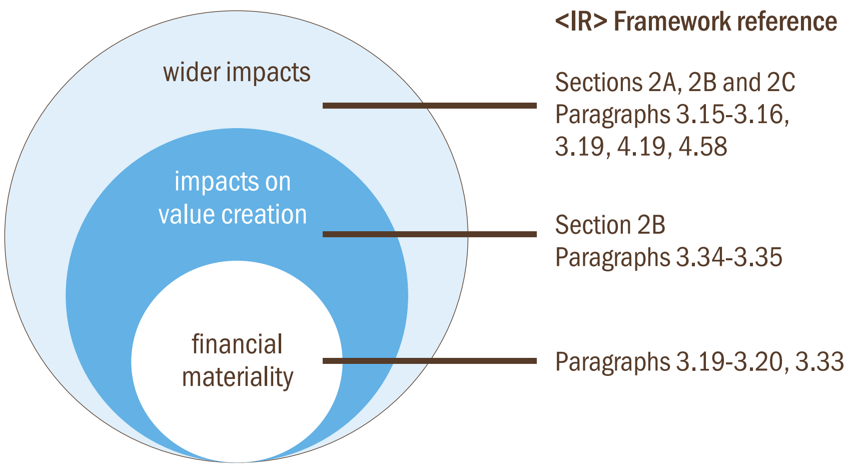
Integrated reporting tailors these themes to investors, by virtue of their power to influence. As the IIRC's 2013 Basis for Conclusions explains, through investment decisions, providers of financial capital can affect the allocation of all types of capital. Those interested in integrated reporting for its contribution to a sustainable planet see the investment lever as a vital means to this end.

2 www.naturalcapitalcoalition.org/natural-capital-protocol
3 www.social-human-capital.org/protocol
4 www.epic-value.com/#report
5 www.globalreporting.org/standards
6 www.impactmanagementproject.com/impact-management/what-is-impact
7 Hearn, S. and Buffardi, A.L. (2016) 'What is impact?'. A Methods Lab publication. London: Overseas Development Institute.

In addition to aligning with the characteristics of impacts found in sustainability reporting and the sustainable development space, the <IR> Framework also supports emerging proposals, such as that developed by Accountancy Europe in 2019. The paper, Interconnected standard setting for corporate reporting, does not explicitly define the term impacts, but nonetheless explores the concept's two components as follows:

- The universe of societal and environmental effects stemming from the organization's activities and outputs, whether directly or indirectly
- The subset of those impacts that materially affect (or have the potential to materially affect) the organization's continued ability to create value.

Integrated reporting prompts organizations to consider the former as a stepping-stone to disclosures on the latter. In this sense, integrated reporting and integrated thinking serve as the critical interface between traditional financial and sustainability reporting. On the basis that integrated reports marry capital market decisions with wider stakeholder interests, there may be a compelling reason to align terminology where possible.



Adapted from Accountancy Europe (2019), *Interconnected standard setting for corporate reporting*

Addressing the matters under consideration

Certain actions may serve to reduce confusion and improve the quality of business model disclosures in integrated reports.

Reduce confusion between outputs and outcomes

- Include a simple example to distinguish between the two concepts
- Add a clear visual break between the business model's **mechanism** (i.e. its inputs, activities and outputs) and its **results** (i.e. outcomes)

Explain the link between outcomes and value creation

- Use simpler language to explain that positive and negative outcomes across the capitals determine whether value is created, preserved or eroded overall

Promote balance in the reporting of outcomes

- Address an inherent bias introduced by the <IR> Framework's repeated use of the term 'value creation'
- Reinforce the importance of providing evidence for claims and conclusions

Reinforce the inclusion of impacts in integrated reporting

- Clarify that the <IR> Framework's use of 'outcomes' includes broader effects on society and nature

Proposals and consultation questions

Proposal A. Reduce confusion between outputs and outcomes

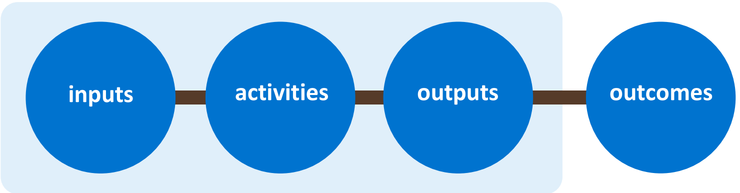
Add a simple example to distinguish between the two concepts

An illustrative example can showcase the difference between outputs and outcomes to direct and indirect stakeholders. Such outcomes can be mapped to the <IR> Framework's six capitals.

SAMPLE. The core **output** of an automobile company's business model is cars. **Outcomes** to customers include mobility and convenience (positive) and added expense and the risk of road-related accidents (negative). **Outcomes** to society include connected communities and economic prosperity (positive), as well as fossil fuel depletion, air pollution and health-related incidents (negative).

Create a visual break between the business model's mechanism and results

The <IR> Framework packages business model inputs, activities, outputs and outcomes as a single unit. In the <IR> Framework's Figure 2 (The value creation process), it may help to separate the **results** of the system of 'converting inputs through activities to outputs' from the **system** itself.



Q1 Should the <IR> Framework explore illustrative examples and visual techniques to elevate the significance of outcomes?

Proposal B. Explain the link between outcomes and value creation

Use an example to explain that positive and negative outcomes across the capitals determine whether value is created, preserved or eroded overall.

Q2 Should the <IR> Framework further explain the link between outcomes and value creation by including an illustrative example?

Proposal C. Promote balance in the reporting of outcomes

Address the inherent bias introduced by the term 'value creation'

In the <IR> Framework, Paragraph 1.6 and Figure 2 qualify that reference to value creation includes value preservation or diminution. **Section 4C** (Business model) and **Section 4F** (Performance) should remind preparers of this point.

Reinforce the importance of providing evidence for claims and conclusions

Paragraph 1.11 of the <IR> Framework notes that the ability to create value is best reported through a combination of quantitative and qualitative information. **Section 4C** (Business model) should further reinforce this point.

Q3 Should Sections 4C and 4F of the <IR> Framework further reinforce:

i. That the term 'value creation' also reflects cases in which value is preserved or eroded?

ii. The importance of providing evidence to support claims and conclusions made in the integrated report?

Proposal D. Reinforce the inclusion of impacts in integrated reporting

Clarify that the <IR> Framework's use of 'outcomes' includes broader effects on society and nature.

Q4 Should the <IR> Framework clarify its coverage of longer-term impacts on society and nature, under its existing 'outcomes' definition?

Integrated reporting enhances the way organizations think, plan and report.