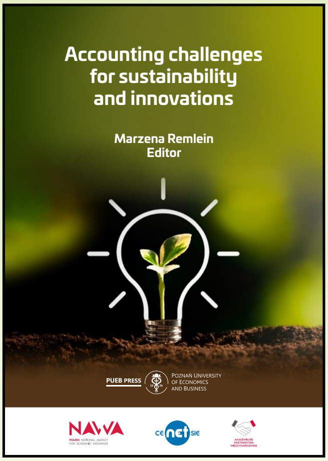

Accounting challenges for sustainability and innovations

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Editor

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4.

INTEGRATED REPORTING

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Abstract: Companies struggle to communicate value through traditional reporting. Integrated reporting can prove to be an effective tool for businesses looking to shift their reporting focus from annual financial performance to long-term shareholder value creation. Such a shift should cover the demand from investors for a structured reporting framework that goes beyond the traditional financial reporting. The International Integrated Reporting Framework will encourage the preparation of a report that shows business performance against strategy, explains the various capital used and affected, and gives a longer term view of the organization. The framework will be attractive to companies who wish to develop their narrative reporting around the business model to explain how the business has been developed. Integrated reporting attained various degrees of popularity depending on the geographical regions. While it is mandatory for all companies listed in South Africa's stock exchange, in other regions it is used by businesses on voluntary basis. Research shows that in the USA the adoption of integrated reporting is slower than in most of the other developed regions.

Keywords: business model, intangible assets, integrated reporting, value creation.

Integrated reporting reflects how our company thinks and does business. This approach allows us to discuss material issues facing our business and communities and show how we create value, for shareholders and for society as a whole

Dimitris Lois, CEO, Coca-Cola HBC

4.1. Introduction

The primary purpose of an integrated report is to explain to provider of financial capital how an organization creates value over time. An integrated report benefits all stakeholders interested in company´s ability to create value, including employees, customers, suppliers, business partners, local communities, legislators, regulators and policymakers, although it is not directly aimed at all stakeholders.

Providers of financial capital can have a significant effect on the capital allocation and attempting to aim the report at all stakeholders would be an impossible task and increase the length of the report. This would be contrary to the objectives of the report, which is value creation.

An integrated report must be a specific and identifiable communication that can be either: a standalone report or included as a distinguishable, prominent and accessible part of another communication (e.g. annual report). It should be more than a summary of information in other communications but should provide insight into the connectivity of the information and how value was created over time. Companies may produce integrated reports for the following reasons.

- Internal reasons in order to integrate factors that are fundamental to business success.
- External reasons to demonstrate leadership and show investors and other stakeholders that they really understand the drivers of long term success.
- Regulatory reasons, since as of 2020, integrated reporting is mandatory for companies listed on the Johannesburg Stock Exchange. As efforts to modernize company law directives proceed and evolve we could expect integrated reporting to become mandatory in more stock exchanges.

4.2. Motivations to introduce integrated reporting

Historical financial statements are essential in corporate reporting, particularly for compliance purposes, but do not always provide meaningful information regarding business value. Users need a more forward-looking focus without the necessity of companies providing their own forecast.

A study by the Association of Certified Chartered Accountant (ACCA), *Understanding investors: Directions for corporate reporting* (2013), found that two-thirds of investors had lost trust in financial statements following the onset of the global financial crisis from 2007. Edelman's research to develop a *Trust Barometer* (2013) showed a greater importance was placed on integrity based issues rather than operational based issues such as financial performance. Findings of this nature prompted evolution of integrated reporting in order to address these problems. Besides that, established reporting schemes face two additional issues. Intangible assets do not feature on the face of financial reports the way that would be adequate to their increasingly important role. On the contrary, they would be fully contained within integrated report in a relevant manner. Secondly, in the past decades there was a proliferation of various non-financial reporting duties, often without formalized framework, which companies needed to adhere to. This led to the need to develop a structured formalized reporting framework that integrated reporting aims to be. These two issues are discussed a more detail in the next two subsections.

4.2.1. Invisible assets, loss of confidence in financial data

As a result of increasingly tense global competition, technological developments and deregulation, competition shifts into new areas. Currently, these areas are constituted by investment into qualified personnel and other non-tangible assets such as research and development, product design, trademarks, intangible distribution channels, customer relations, and business models. Such a trend could be observed in the content of the traded goods and services. They typically include a significant amount of knowhow and technical knowledge (e.g. multifunctional smart phone) or have a significant symbolical value thanks to their brand name (e.g. Nike). Consequently, these intangible assets play an equally important role as the tangible assets in the modern economy.

It is not possible to exactly quantify the ratio of tangible and intangible assets, however, it is possible to estimate this ratio by using several well-known global indicators such as *price-to-book value (P/BV),* which represent market capitalization to equity book value presented in statutory financial statements. Studies indicate that P/BV has been rapidly increasing over the past decades confirming the raising importance of intangible assets. For example, Lev (2001) shows that in the period between 1980–1999, P/BV rose almost six fold. Similar increase was found by a research firm Ocean Tomo as shown in Figure 4.1.

Figure 4.1. Intangible Asset Market Value Study

Source: (Ocean Tomo, 2015).

Indicator P/BV is used to show the proportion of intangible assets since intangible assets are presented in the statutory financial statements insufficiently. Currently, International Financial Reporting Standards (IFRS) provide accounting guidance in IAS 38 Intangible Assets, however, only a small proportion of intangible assets could be reported through this standard because of its reliability requirement that are difficult to meet. Similar issues exist with US GAAP as well. Estimated proportion of the intangible assets reported is shown in Figure 4.2.

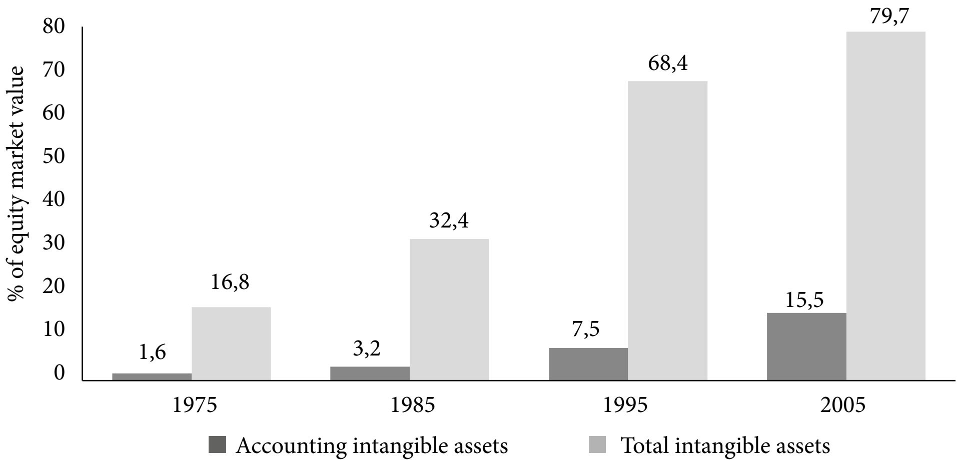

Figure 4.2. Reported versus total intangible assets

Source: (Cardoza, Basara, Cooper, & Conroy, 2006, adjusted).

4.2.2. Convolution of reporting schemes and a need for a structured approach

Corporate reporting has evolved over time and it is possible to divide this evolution into several stages. Until about 1980s the only required set of reports consisted of financial statements and notes to the financial statements. Going forward new reports were added next to the financial statements. Those were related to Environmental reporting, Governance and Remuneration reporting as well as Management Commentary. On the turn of the 20th century Sustainability reporting was also added to the list. These reports were driven by a guidance, however, this guidance was built-up over the time. Integrated reporting aims to become the centre ground and the reporting focus which would encompass topics from other reports, resulting in less clutter and improved comparability across reporting entities. Also, with integrated reporting in place the information containment is expected to be more useful and understandable.

4.3. International Integrated Reporting Council

The framework for integrated reporting is released by International Integrated Reporting Council (IIRC) which 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 (IIRC, 2013).

In 2009, the Prince of Wales convened a high level meeting of investors, standard setters, companies, accounting bodies and UN representatives including The Prince's Accounting for Sustainability Project, International Federation of Accountants (IFAC), and the Global Reporting Initiative (GRI), to establish the International Integrated Reporting Committee (IIRC), a body to oversee the creation of a globally accepted Integrated Reporting Framework. In November 2011, the Committee was renamed the International Integrated Reporting Council. The IIRC began a pilot program in 2011 in order to underpin the development of the International Integrated Reporting Framework. The framework for integrated reporting was finally released in 2013. That was preceded by a three-month global consultation and trials in 25 countries.

4.4. Objectives of integrated reporting

The integrated report should create the next generation of the annual report as it enables stakeholders to make a more informed assessment of the organization and its prospects. In order to achieve that, integrated reporting should:

- Improve the quality of information available to providers of financial capital to enable a more efficient and productive allocation of capital.
- Provide a more cohesive and efficient approach to corporate reporting that draws on different reporting strands and communicates the full range of factors that materially affect the ability of an organization to create value over time.
- Enhance accountability and stewardship for the broad base of capital (financial, manufactured, intellectual, human, social and relationship, and natural).
- Promote understanding of the capitals their interdependencies.
- Support integrated thinking, decision-making and actions that focus on the creation of value in the short, medium and long term.

4.5. Fundamental concepts of integrated reporting

The centre of integrated reporting is the nature of value and the value creation process, which is depicted in Figure 4.3. These terms can include the total of all capital, benefits captured by the company, market value of cash flows of the organization, and the successful achievement of the company's objectives. However, the conclusion reached was that the framework should not define value from any one particular perspective, because value depends upon the individual company's own perspective. An integrated report should not attempt to quantify value, as assessments of value are left to those using the report.

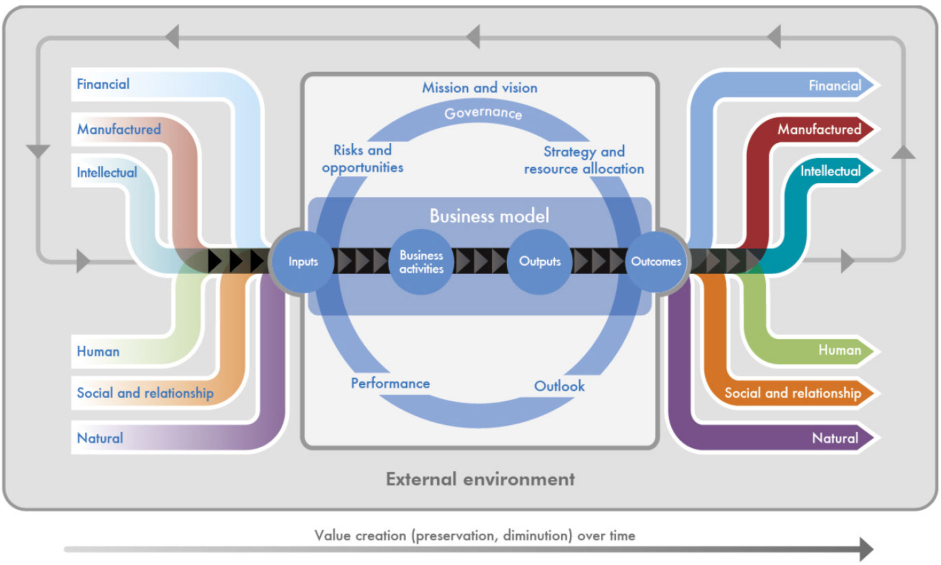

Figure 4.3. The value creating process

Source: (IIRC, 2013).

The external environment, including economic conditions, technological change, societal issues and environmental challenges, sets the context within which the organization operates. The mission and vision encompass the whole organization, identifying its purpose and intention in clear, concise terms.

At the core of the organization is its business model, which draws on various capital as inputs and, through its business activities, converts them to outputs (products, services, by-products and waste). The organization's activities and its outputs lead to outcomes in terms of effects on the capital. The capacity of the business model to adapt to changes (e.g. in the availability, quality and affordability of inputs) can affect the organization's long term viability.

Business activities include the planning, design and manufacture of products or the deployment of specialized skills and knowledge in the provision of services. Encouraging a culture of innovation is often a key business activity in terms of generating new products and services that anticipate customer demand, introducing efficiencies and better use of technology, substituting inputs to minimize adverse social or environmental effects, and finding alternative uses for outputs.

Chart in Figure 3 also depicts content elements which surround the business model and are described in subchapter 4.6. Individual capitals are described in subchapter 4.7.

4.6. Preparation of integrated report—Content Elements

The Content Elements are fundamentally linked to each other and are not mutually exclusive. The order of the Content Elements listed here is not the only way they could be sequenced. Content Elements are not intended to serve as a standard structure for an integrated report with information about them appearing in a set sequence or as isolated, standalone sections. Rather, information in an integrated report is presented in a way that makes the connections between the Content Elements apparent. Integrated reporting is built around the following content elements:

- **Organizational overview and the external environment in which it operates**: What does the organization do and what are the circumstances under which it operates?
- **Governance**: How does an organization's governance structure support its ability to create value in the short, medium and long term?
- **Business model**: What is the organization's business model?
- **Risk and opportunities**: What are the specific risks and opportunities that affect the organization's ability to create value over the short, medium and long term, and how is the organization dealing with them?

- **Strategy and resource allocation**: Where does the organization want to go and how does it intend to get there?
- **Performance**: To what extent has the organization achieved its strategic objectives for the period and what are its outcomes in terms of effects on the capitals?
- **Outlook**: What challenges and uncertainties is the organization likely to encounter in pursuing its strategy, and what are the potential implications for its business model and future performance?
- **Basis of preparation and presentation**: How does the organization determine what matters to include in the integrated report and how are such matters quantified and evaluated?

The framework does not require discrete sections to be compiled in the report, but there should be a high-level review to ensure that all relevant aspects are included. The linkage across the above content can create a key storyline and can determine the major elements of the report, such that the information relevant to each company would be different.

4.7. Preparation of integrated report—capitals

The integrated report aims to provide an insight into the company's resources and relationships which are known as the capital and how the company interacts with the external environment and the capital to create value. These capital can be financial, manufactured, intellectual, human, social and relationship and natural capital, but companies need not adopt these classifications. Below is the outline of the capital as describe by the International Framework material (IIRC, 2013).

- **Financial capital**—the pools of funds that is available to an organization for use in the production of goods or the provision of services and obtained through financing, such as debt, equity or grants, or generated through operations or investments.
- **Manufactured capital**—manufactured physical objects (as distinct from natural physical objects) that are available to an organization for use in the production of goods or the provision of services, including: buildings, equipment, infrastructure (such as roads, ports, bridges, and waste and water treatment plants). Manufactured capital is often created by other organizations, but includes assets manufactured by the reporting organization for sale or when they are retained for its own use.
- **Intellectual capital**—organizational, knowledge-based intangibles, including intellectual property (such as patents, copyrights, software, rights, licences) and "organizational capital" (such as tacit knowledge, systems, procedures and protocols).

- **Human capital**—people's competencies, capabilities and experience, and their motivation to innovate, including their: alignment with and support for an organization's governance framework, risk management approach, and ethical values, ability to understand, develop and implement an organization's strategy, loyalties and motivations for improving processes, goods and services, including their ability to lead, manage and collaborate.
- **Social and relationship capital**—the institutions and the relationships within and between communities, groups of stakeholders and other networks, and the ability to share information to enhance individual and collective well-being. Social and relationship capital includes shared norms, and common values and behaviours, key stakeholder relationships, and the trust and willingness to engage with the wider community.
- **Natural capital**—all renewable and non-renewable environmental resources and processes that provide goods or services that support the past, current or future prosperity of an organization. It includes air, water, land, minerals and forests, biodiversity and eco-system health.

4.8. Preparation of integrated report—guiding principles

The reporting framework is principle-based rather than specifying a detailed disclosure and measurement standard. This enables each company to set out its own report rather than adopt a checklist approach. The report acts as a platform to explain what creates the underlying value in a business and how management protects this value. This gives the report more business relevance than the compliance led approach. Integrated reporting will not replace other form of reporting, but the vision is that preparers will pull together relevant information already produced to explain the key drivers to their business value. Seven guiding principles are defined as follows:

- **Strategic focus and future orientation**—insight into the organization's strategy.
- **Connectivity of information**—showing a holistic picture of the combination, inter-relatedness and dependencies between the factors that affect the organization's ability to create value over time.
- **Stakeholder relationships**—insight into the nature and quality of the organization's relationships with its key stakeholders.
- **Materiality**—information will only be included in the report where it is material to the stakeholder's assessment of the business.
- **Conciseness**—sufficient context to understand the organization's strategy, governance and prospects without being burdened by less relevant information.
- **Consistency and comparability**—ensuring consistency over time and enabling comparisons with other organizations.

4.9. Integrated reporting practice—selected studies

The question whether companies have recognized the benefits of showing a fuller picture of company value and a more holistic view of the organization prompted a research into integrated reporting usage. This research indicates mixed conclusions depending on particular geographies. Several recent findings are cited below.

In depth research by Gibassier, Adams and Jérôme (2019) provides a definitive view of the global adoption of integrated reporting and how it is spreading. They found that 85% of self-declared integrated reporters discuss at least four capitals and 58% of those self-identifying as integrated reports are SMEs. In terms of numbers of reporters, South Africa and Japan were out ahead, with the UK, Netherlands and Spain in the next group. Industries with high intangibles, such as banking, are amongst the biggest reporters along with those with high environmental footprints, such as chemicals.

ACCA (2016) polled views of the users of financial information on integrated reporting. Overall, from the evidence gathered from equity investors and other providers of finance / financial users, it appears that sustained growth of demand for integrated reporting is needed for it to succeed in becoming the mainstream reporting framework. At present, while there is evidence of some use of and familiarity with integrated reporting among providers of financial capital, this appears to be limited mostly to those involved with specific ESG or ethically related investments / decision making and for those already familiar with broader sustainable reporting and/or have been involved at a firm or institutional level in the development and emergence of integrated reporting. There is at present little evidence of either use of or demand for integrated reporting among many mainstream fund managers or sell-side analysts.

A study by Eccles, Krzus and Solano (2019) explored the extent to which companies around the world use the integrated reporting framework to prepare their reports and whether the reports of the companies that do use it vary in quality and content measured by special scores. Five companies from each of the following countries were selected for the study: Brazil, France, Germany, Italy, Japan, the Netherlands, South Africa, South Korea, United Kingdom, and the United States for the study. The Netherlands and South Africa were the only two countries ranked high across all scores, and the United States was the only country ranked Low across all scores. The researchers found a wide gap in the quality of integrated reports around the world. The researchers assume that this gap reveals much more than whether companies in one country adhere to the IR Framework Guiding Principles and Content Elements better than those in other countries. Given the absence of generally accepted and enforceable standards for integrated reporting, companies are free to declare that they have published an integrated report, even if in doing so they demonstrate a misunderstanding of the concept.

As it seems that South Africa is a leader in integrated reporting while the USA is lagging significantly behind other developed countries, these two countries are discussed in more detail next.

Integrated reporting began in South Africa, and the country has contributed significantly to its development worldwide. South Africa is the only country where integrated reporting has been mandated on a "comply or explain" basis. JSE listed companies have been made to adopt this reporting system on "apply and explain" basis. Studies from South Africa generally confirm usefulness of integrated reporting for investors. Citing the same is research by Moloi (2020) who found a significant difference in firm value on account of differences in integrated reporting quality. This signals that the extent to which integrated reporting provides pertinent information is proportional and/or directly related to investors' confidence in the entity, which holistically has a value-adding effect for firms.

In the USA integrated reporting has seen much less usage. It is, however, worthwhile to heed the Investor Responsibility Research Institute (2018) which produces that there are indications that investors are fuelling demand for more and standardized corporate environmental and social data. Currently, most companies reporting on sustainability issues are navigating the landscape in their own way, using multiple reporting models and customizing guidance for their own needs. The number of integrated reporters in the S&P 500 has doubled between 2013 and 2018, although from a low baseline—14 in 2018 issue integrated reports, up from seven in 2013 (Investor Responsibility Research Institute, 2018).

Questions / tasks

1. Who are the beneficiaries of integrated reporting?
2. What are the main reasons for which companies publish integrated report?
3. Describe the wider factors that led to the need for integrated reporting framework.
4. How is integrated report related to financial statements and other established reporting duties?
5. How was the International Integrated Reporting Council created and when was the integrated reporting framework issued?
6. What are the major objectives of integrated reporting?
7. Describe what is meant by value creating process and what are its individual elements.
8. What are the pillars of a company's business model and how does it fit within the value creating process?
9. Describe the six capitals which represent the basic resources in integrated reporting framework.

10. What are the guiding principles based on which an integrated report should be created?
11. How widespread is the utilization of the integrated reporting framework in the world as of 2020?
12. What is the experience in applying the integrated reporting framework in various regions and states?
13. Contrast the utilization of the integrated reporting framework in South Africa and the USA.

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