Sustainability Reporting Briefing: Part 2 - Integrated reporting - The complete picture

Posted by Stephen Gardner [1] on Sep 5, 2012

Integrated reporting requires companies to think hard about their long-term sustainability

In principle, it seems like a good idea. While financial reports deal with the hard facts of the bottom line, and sustainability reports demonstrate how environmentally friendly a company is, an integrated report should be a more philosophical exercise. It enables a company to take a step back and set out its understanding of its place in the world, the risks it faces, and the strategies that will be employed to manage them.

The Johannesburg Stock Exchange certainly thinks integrated reporting is a good idea. Since 2010, South Africa's listed companies have been required to disclose if they apply integrated reporting, and if not, to explain why. Johannesburg is the first stock exchange to implement such a rule.

The South African understanding of an integrated report is that it is a "holistic and integrated representation of the company's performance in terms of both its finances and its sustainability". Ansie Ramalho, chief executive of the Institute of Directors in Southern Africa, says: "It has been found that reporting drives behaviour and therefore [there is] the need for integrated reporting to drive integrated thinking".

There has been a mixed response from South African companies. Ramalho says: "Some companies are of the view that this adds to compliance requirements. Others understand that it is not intended as an additional compliance requirement but rather to encourage companies to approach business, strategy setting and reporting differently."

The results of the South African integrated reporting exercise have also, so far, been mixed in terms of quality. Paul Scott, managing director of CorporateRegister.com, a resource centre for corporate responsibility reports, says South African integrated reports are "still predominantly annual reports with short sustainability sections".

Writing in the 2012 review of the CorporateRegister.com Reporting Awards, Scott says that his website only "profiles annual reports with at least six pages of relevant non-financial information, but most 'integrated' South African reports fall below this threshold".

Grasping the concept

In fairness to South African companies, they are just beginning to grapple with a concept that has generated much theorising, but has been taken up in practice by few companies, and lacks an international standard. The idea of integrated reporting provokes a number of questions. What should the report include? How should it balance financial and non-financial information? Does the integrated report replace or supplement financial and sustainability reports?

The best integrated report in 2011 out of about 350 surveyed, according to CorporateRegister.com, was produced by Danish company Novo Nordisk, which makes medication for diabetics. Novo Nordisk began producing an integrated report in 2004, disclosing indicators of its social and environmental performance along with its financial performance.

Although it includes sustainability performance information, the Novo Nordisk report largely concentrates on the company's financial performance. Where sustainability indicators are included, they mainly relate to cost management. For example, Novo Nordisk has reduced water and energy consumption by 34% and 21% respectively since 2007 – figures that seem to indicate a rigorous approach to input, and thus cost, control.

However, for other corporate responsibility issues, Novo Nordisk discloses some tantalising figures but provides little context or assessment of the risks they might represent. For example, the company's 2011 integrated report notes that the volume of wastewater it discharged to public sewers increased by about 5%, and the number of animals bought for tests increased by about 4,000. No information is given on what is being done to manage these potential environmental or reputational risks.

The Novo Nordisk report illustrates one of the greatest difficulties with integrated reporting. An integrated report is supposed to be an overview of what is material for the long-term sustainability of the company. Jonathan Labrey of the International Integrated Reporting Council says: "Integrated reporting starts from the vantage point of strategy: how do the strategy and the business model create value over the longer term?"

Value to society

This means the company must make judgments about its broader role – what value does it offer to society? This opens the door to subjectivity. Although there are a number of obvious categories in which disclosures should be made, such as greenhouse gas emissions and water use, the company will have to decide how far it goes in identifying the risks that might undermine its societal value.

To take an extreme example, oil companies count proven but so far unexploited fossil fuel reserves as assets. But there is concern about how far they can go in exploiting those assets without causing runaway global warming. Non-profit energy analyst Investor Watch has calculated that emissions from proven fossil fuel reserves would exceed by about five times the "carbon budget" available to humanity if the world wants to avoid dangerous climate change.

American environmentalist and author Bill McKibben in a high profile article for Rolling Stone magazine (Global Warming's Terrifying New Math in July 2012) writes: "If you told Exxon or Lukoil that, in order to avoid wrecking the climate, they couldn't pump out their reserves, the value of their companies would plummet."

Exxon does not produce an integrated report, and its annual report says little about this risk to the sustainability of its basic business model. It does acknowledge that "addressing the risks associated with climate change will require significant efforts by private industry, government, and civil society". Integrated reporting might help it to quantify the risk to its business.

Forthcoming framework

The International Integrated Reporting Council is attempting to fit the value judgments inherent in integrated reporting into a framework. IIRC spokesman Jonathan Labrey says: "Companies and investors want a framework to enable comparability. The primary audience is the investor but [integrated] reporting is of interest to many stakeholders."

Integrated reporting is not about making more disclosures, but about informing better decisions, he says. "It's going back to the basics of reporting – focusing on the most relevant information. Materiality is absolutely crucial. That's what investors tell us."

The IIRC has published a "draft framework outline", a basic structure for the future framework. Completion of the framework is still more than a year away. The IIRC expects a version 1.0 at the end of 2013. When it finally arrives, the framework will set out the conceptual basis of integrated reporting, and will describe the likely content of an integrated report, within broad categories, such as a company's "operating context including risks and opportunities" and "strategic objectives and strategies to achieve those objectives".

Labrey is adamant that integrated reporting is "not about replacing other forms of reporting, which are hugely valuable". Different reports are "useful to different audiences". Ultimately, there might be harmonisation, or single reports, but "over time the market will decide what is the best way of reporting", Labrey says.

On the question of value judgments – or the materiality – of integrated reports, Labrey says: "Risk lies in a lack of transparency. The market will make up its mind if the company is not being transparent. For a company with risk inherent in its business model, it is far better that the board demonstrates that it is dealing with that risk. That is what integrated reporting enables businesses to do."

Integrated reporting framework timeline

The **International Integrated Reporting Council** defines integrated reporting as a demonstration of "the **linkages** between an organisation's strategy, governance and financial performance and the social, environmental and economic context within which it operates". Often, integrated reporting is viewed as a simple marriage of the corporate financial and sustainability reports, but it would be more accurate to see it as a public demonstration of **strategic thinking**, encompassing all the various **threats** and **risks** that a company might face.

The IIRC published an integrated report "draft framework outline" in July 2012. This will be followed by a more detailed "prototype" in autumn 2012, and a draft framework in spring 2013 – the "main document that will be out for public consultation", according to IIRC spokesman Jonathan Labrey. A finalised framework will be published by the end of 2013.

To follow the framework's development, go to www.theiirc.org [2].

Links:
[1] http://www.ethicalcorp.com/users/stephen-gardner
[2] http://www.theiirc.org/