FEATURE ARTICLE

Do Accountants Need to Know About Integrated Reporting Framework?

By Dr. Kamala Raghavan, CPA, CFF, CGMA, CFP

Integrated reporting (IR) is based on the concept of "integrated thinking," defined by the International Integrated Reporting Council (IIRC) as "the active consideration by an organization of the relationships between its various operating and functional units and the capitals that the organization uses or affects. Integrated thinking leads to integrated decision-making and actions that consider the creation of value over the short, medium and long term."

The financial crisis of 2008-10 and the growing income disparities across societies have caused many observers to blame the short-term focus of businesses for the social, environmental and economic problems, and demand a fundamental change in the paradigm. Such a change will require management to combine innovation, competitiveness and sustainability by using integrated thinking to change the way in which businesses plan and run their operations to create value.

IR provides a holistic view of the business by looking at the financials, strategies, operations, risks and opportunities, future outlook and governance. It combines information about the organization's business model, strategy, governance, performance and prospects to enhance the information content hidden in traditional reporting and to encourage long-term strategic thinking by managers. It enhances corporate reporting and transparency of all types of "capitals," including financial, intellectual, human, manufacturing, natural resources, social responsibility and sustainability in a coherent, whole structure and shows the connectivity between the various capitals and value creation over time.

Increasingly, investors and other stakeholders are demanding more information on the social, environmental and governance issues that affect businesses. IR is a driver of sustainability strategies, leading to enhanced financial performance when they incorporate an innovative business model, as shown by the real-life case studies listed below. By promoting IR and its business benefits, CPAs can play a key role in the development of financially successful sustainability strategies.

Real-life Case Studies

Southwest Airlines renovated its aircraft lighting system to more energy efficient LED lighting expected to last 10 times longer than the previous lighting system and replaced the steel brakes on its aircraft with new, lighter-weight carbon brakes, resulting in reduced fuel consumption and greenhouse gas emissions (http://www.southwestonereport.com/2012/). Southwest's decision to replace older aircraft with new, more fuel efficient ones that have reduced greenhouse gas emissions required a cost-benefit analysis, and results are measured based on environmental benefits and increased margins.

Dow Chemical Company shifted its focus from waste reduction to waste elimination and undertook massive innovations in products and processes. It also developed a new market in consulting with customers on environmental issues.

Baxter International Inc., a global medical products and services organization, measures return on investment for its environmental initiatives and produces an annual environmental financial statement detailing environmental costs, as well as environmental income, savings and cost avoidance. The company's 2010 Sustainability Report stated that its environmental initiatives have shown an annual savings and cost avoidance of about $3 for every $1 invested. The company solicits information about sustainability from potential suppliers in its requests for proposals, incorporated 20 "green" criteria into its purchasing policies and identified its top 100 suppliers in terms of sustainability.

PepsiCo Inc. provides access to its suppliers to the energy-assessment tools it uses for its own operations and provides three-day training workshops to its suppliers with a support team. The results show that sharing its own energy assessment tools with suppliers has increased mutual return on investment (https://webadnmcdproject.net). In the company's 2015 Global Reporting Initiative Report and Performance with Purpose 2025 Agenda (www.pepsico.com/sustainability/Sustainability-Reporting), it centered performance with purpose work on products (human sustainability), planet (environmental sustainability) and people (talent sustainability) and used strong sustainability governance as a foundation for delivering on the performance with purpose vision. Sustainability topics are integrated into the core business and the board considers sustainability issues an integral part of its business oversight.

Kraft Foods Group collaborated with TerraCycle, a company that rewards consumers for returning non-recyclable packaging to help divert it from going to landfills. Kraft was able to raise its brands' profile and influence consumers to make better choices. In addition, the company has taken action to reduce C02 emissions, decrease needed water for processes, reduce waste, and reduce road miles from its transportation and distribution network.

Nike Inc. responded to customer concerns about product design and manufacturing processes. The company is aiming for a goal of zero waste as one of several long-term goals for 2020, and for production and design standards to reduce waste, cut energy use and slash the use of solvent.

Wal-Mart Inc. also responded to consumer pressure by developing a complex plan to measure the sustainability of every product it sells and a goal to provide consumers with a scorecard for over 100 product categories. The effort has resulted in collaboration with suppliers and supply chain partners to move toward zero waste initiatives.

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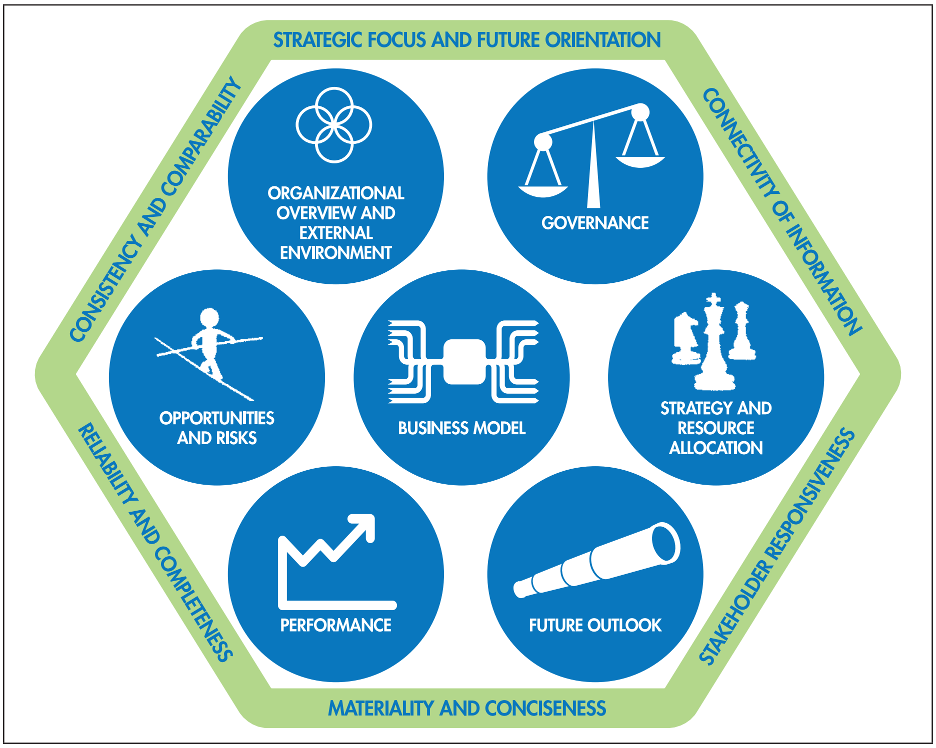
Figure 1: IR Guiding Principles and Content Elements



(Source: IIRC)

Tenets of IR

The six tenets of IR are:

1. Communication about the resources (capitals) used by businesses that are critical to long-term value creation;
2. Concise and clear communication;
3. Clear articulation of the business strategy, risk management and performance indicators to help investors understand the business;
4. Recognition of interconnectivity and dependency of information from different parts of the business and break down the traditional silos;
5. Use of historical and future-oriented information to provide a qualitative assessment of the risks and opportunities; and
6. Reflection on the impact of external environment on a business' ability to create value.

Hermes EOS, an investment firm, found that IR supports stewardship and ownership activities along with better investment decision-making and analysis. The IR business model is a description of the organization, and how longer-term factors fit into that description is the key to understanding the organization and its sustainability.

SAP, a global software provider, uses four key performance indicators to reflect its dependence on three capitals: financial, intellectual and human. The two financial performance indicators (revenue and margin) measure the historic performance and the two non-financial indicators (customer loyalty and employee engagement) look to the organization's future success and value creation. Producing an integrated report brought sustainability, investor relations, financial and communications department employees together. SAP's graphic showed the relationships between the financial and non-financial indicators and supported findings with external research. It reported that €220 million of costs were avoided since the beginning of 2008 by reducing its carbon footprint and that a 1 percent change in employee retention has an effect of €62 million on operating results.

IR Framework Structure

The framework tries to balance flexibility and prescription by providing the fundamental concepts, guiding principles and content elements to be included in an integrated report and encourages organizations to design reports outlining their strategy, governance, performance and prospects within the context of external environment. The framework's principles apply to corporate, nonprofit and governmental entities alike.

The fundamental assumption of the framework is that an organization creates value by using a business model that draws on various capitals as inputs and converts them to outputs (products, services, by-products and waste) through its business activities that lead to outcomes that affect the capitals. An integrated report reveals the challenges and uncertainties that the organization is likely to face in executing its strategy and the potential future implications.

The framework uses a principles-based approach to define the content and elements of the integrated report to satisfy the minimum requirements of "designated, identifiable communication," and focuses on the connectivity and interdependencies among internal and external factors in the business model and its value creation over time. It treats internally created and externally purchased capital similarly and defines the six types of capitals used by an organization to create value over time:

1) **Financial** capital includes funds generated by financial or internal operations available to the organization as it carries out its business activities.

2) **Manufactured** capital includes inventory, property, plant and equipment owned by the organization, as well as infrastructure (roads, bridges, etc.) that the organization has access to and uses in its business.

3) **Intellectual** capital includes traditional intellectual property and the organization's knowledge, systems and procedures that contribute to value.

4) **Human** capital includes employees' competencies, capabilities and experiences, as well as the skills of contractors and suppliers.

5) **Social and relationship** capital includes brand reputation developed by the organization and stakeholder relationships, such as banking, investors, suppliers and customer relationships.

Guiding Principles of IR

The seven guiding principles of IR are:

1. Strategic focus and future orientation – Reports should provide insight into the organization's strategy and the effect on its short, medium and long-term value creation.
2. Connectivity of information – Reports should take a holistic view of the business and show the inter-relatedness and dependencies between the organization's value-creating factors.
3. Stakeholder relationships – Reports should offer insight into the organization's relationships with stakeholders and its responsiveness to stakeholders' needs and interests.
4. Materiality – Reports should disclose information that materially affects the organization's value creation over short, medium and long-term horizons.
5. Conciseness – Reports should be concise and eliminate duplication.
6. Reliability and completeness – Reports should include "all material matters, both positive and negative, in a balanced way and without material error."
7. Consistency and comparability – Reports should be consistent over time and be comparable to industry.

6) **Natural** capital includes renewable and non-renewable environmental resources.

While the first three capitals are like those traditionally recorded as assets, the latter three are typically not shown on the balance sheet.

By enhancing the information relevance to financial capital providers, IR will enable better allocation of capital and provide concise communication about the organization's strategy, governance, performance and prospects, and shows how these can lead to value creation in the long run. It can also benefit all stakeholders, including employees, customers, suppliers, business partners, local communities, regulators and policy makers. The framework provides six tenets, seven guiding principles and nine key content elements for reporting. Figure 1 shows the seven guiding principles and nine content elements of the IR framework.

The framework is tested and driven by market forces and CPAs can benefit by understanding the framework and incorporating it into the business operations. The next sections describe the background and current state of the framework, regulatory standard-setting environment and implications for accountants

Background and Current State of Integrated Framework

The global coalition of accounting professionals, regulators, investors, organizations, standard setters and non-governmental

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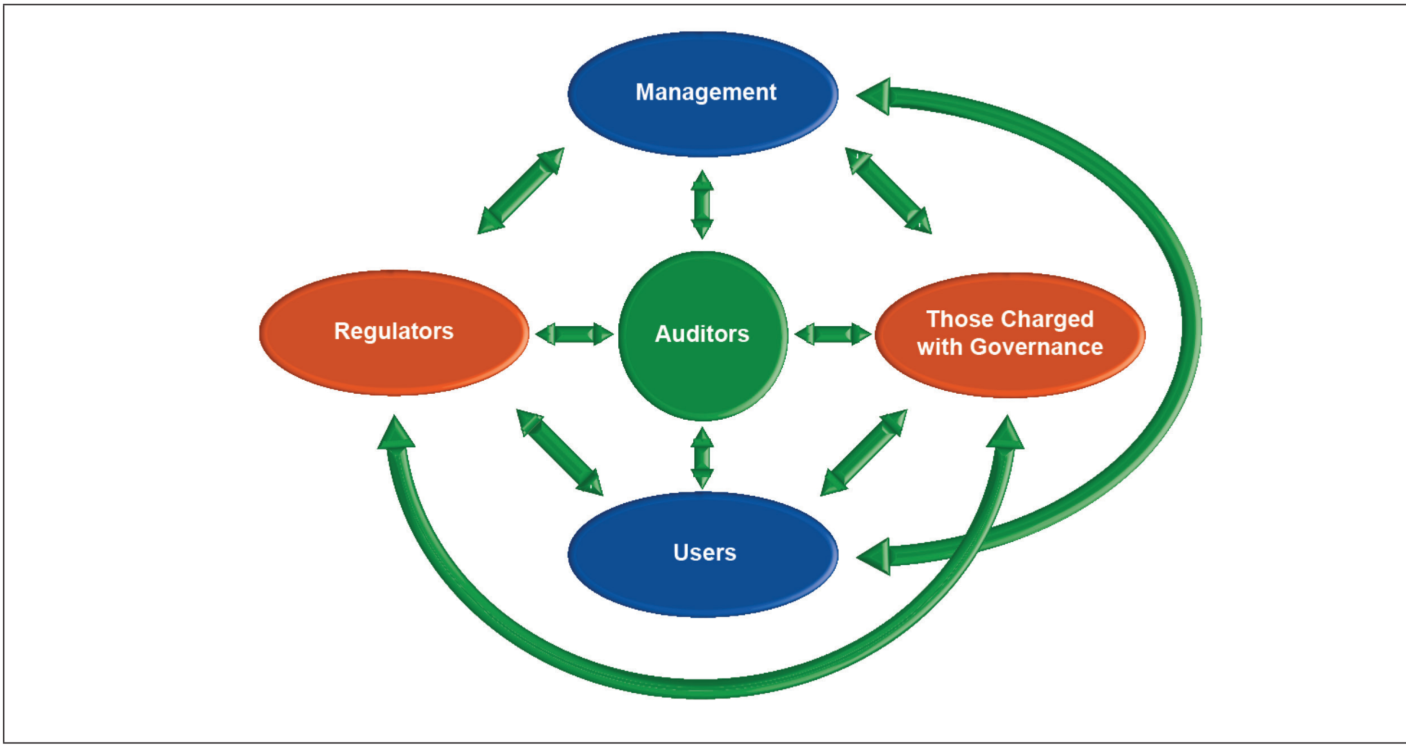
Content Elements for the Integrated Report

The nine content elements for the integrated report present a concise and holistic picture by including the business model, external factors impacting the business and management's strategy. They provide the basis for discussing the performance, prospects and governance of the business. The content elements include:

1. Organizational overview and external environment reports to address the organization's mission and vision, culture and values, ownership and operating structure, activities and markets, competitive landscape, revenue and staffing numbers, and external factors, such as legal, political and environmental aspects.
2. Governance reports to detail the organization's governance structure, including leadership, strategic direction, risk appetite and the impact of compensation structure of key personnel on value creation, plus the change in capitals over the short, medium and long term.
3. Business model reports to identify the organization's key inputs, business activities and outputs, and how they relate to the capitals. For example, the intellectual and human capitals are critical to the success of a service business while manufactured, financial and natural capitals are critical to a manufacturing organization.
4. Risks and opportunities reports to describe specific risks and opportunities from external sources and internal business activities, and the organization's risk responses.
5. Strategy and resource allocation reports should identify the organization's short, medium, and long-term strategies, and their impact on the organization's value creation.
6. Performance reports should outline the qualitative and quantitative overview of an organization's ability to achieve its strategic objectives, including the organization's key performance indicators.
7. Outlook reports should describe the organization's forward-looking information about the expected impact of current strategic objectives on future changes in capitals.
8. Preparation and presentation reports should summarize the organization's method for determination of materiality, and significant frameworks and methods used to determine material events.
9. General reporting guidance reports should include disclosures about material matters, capitals and policies for aggregation and disaggregation.

Figure 2: Key Interactions



(Source: IAASB Framework for Audit Quality)

organizations formed the International IR Council (IIRC) in 2009 to oversee the creation and implementation of an IR framework "to include long-term decision making, increased financial capital for investments and holistic picture of value creation over time." The American Institute of CPAs (AICPA) and the Chartered Institute of Management Accountants (CIMA) are members of the IIRC Council.

The mission of IIRC was to enable IR to be embedded into mainstream business practice in the public and private sectors (www.THEIIRC.Org). IIRC consists of a board with overall responsibility for the IR framework, council to provide guidance, working group to develop the framework, and support staff. A pilot program involving over 100 global businesses from various sectors and over 35 global institutional investors was conducted to enable businesses and investors to share experiences and create a framework of concepts and principles to be used for preparing integrated reports. Based on 350 responses from the participants, the IR framework was released on Dec. 8, 2013, as a key step to guide organizations on their reporting, and to enhance the relevance and usefulness of information to capital markets.

The participants in the pilot program found that using the capitals concept helped them to improve inter-departmental communications, enabled them to establish the causal relationship between their business model, strategy and performance, and led to increased non-financial communications to provide investors with potential leading indicators of financial performance.

They found that explaining their business models provided clarity and new insight to investors, as well as increasing their own understanding of inter-relationships of activities. Global organizations, including Microsoft, PepsiCo, Southwest Airlines and others, have voluntarily adopted IR and are recognizing the benefits of a cohesive, efficient and valuable reporting process.

Regulatory Accounting Standard-Setting Bodies

The Association of Chartered Certified Accountants (ACCA) has introduced IR within its qualification examinations. Together with the Institute of Management Accountants (IMA), they released a report in January 2016 on how accountants can play a key role in developing integrated reports to add value to their organizations. Integrated financial reporting is also addressed in the document titled *Framework for Audit Quality,* released by the International Auditing and Assurance Standards Board (IAASB) in February 2014.

Regulators like the UK's Financial Reporting Council and U.S. and Canadian professional organizations such as AICPA, ACCA and CAA, and stock exchanges are encouraging businesses to adopt and benefit from reporting innovations inherent to IR. Some of the key interactions within the financial reporting supply chain are reflected in Figure 2.

A New and Powerful International Practice

The development of the framework has been a collaborative, market-led activity involving extensive global consultation and market testing. The participants in the IIRC pilot program are acting as catalysts for IR by forming regional networks across the globe, refining the reporting by sharing their experiences, and engaging with policymakers, peers, standard setters and others in their geographical domain to drive the adoption.

As more businesses voluntarily adopt IR and get the benefits of a cohesive, efficient and valuable reporting process, changes in current reporting models will require CPAs to re-calibrate their thinking of financial and managerial reports, strategy and accounting information systems. IR combined with integrated thinking is morphing from a promising concept to powerful practice around the world.

The Governance & Accountability Institute surveyed the sustainability reporting practices – environmental, social and corporate governance (ESG) – of S&P 500 Index companies and found that 82 percent of the companies reported in 2016 vs. 20 percent in 2011. It observed that the companies are seeing dramatic benefits from their efforts and are engaging more with investors to make ESG data more strategically useful for decision making by management, stakeholders and investors. Global Reporting Initiative reports that 92 percent of the 250 world's largest corporations report on their sustainability performance, and large European companies are required by European Union directive to report on their performance regarding environmental, social, employee-related, human rights, anticorruption and bribery matters.

Since the framework was tested and driven by market forces, CPAs need to understand the framework and incorporate it into operations. Value creation for the organization will involve accountants in all areas of strategy, planning and implementation. Complex business transactions, globalization and technological developments continue to change the business environment making risk management, technological and managerial skills, and lifelong learning critical for accountants.

The innovative approach and flexibility of an integrated report offers opportunities for CPAs to leverage their existing skills. Accountants can play a critical role in the development and issuance of integrated reports, including financial statements and other financial information, as well as help in planning for the required disclosures about strategies, sustainability and corporate social responsibility.

Integration of knowledge, skills and ethical action has built the competency and professional responsibility of accountants. As expressed by the Pathways Commission report, a vibrant and strong accounting profession operates with a social contract encompassing a set of promises and commitments centering on the preparation of reliable accounting information. Roles and opportunities will exist for accountants to provide pragmatic balance between competitiveness and sustainable growth to guide their organizations towards enhanced value creation using integrated reporting. ■

Dr. Kamala Raghavan, CPA, CFF, CGMA, CFP® is a graduate faculty member at Texas Southern University in Houston, Texas.