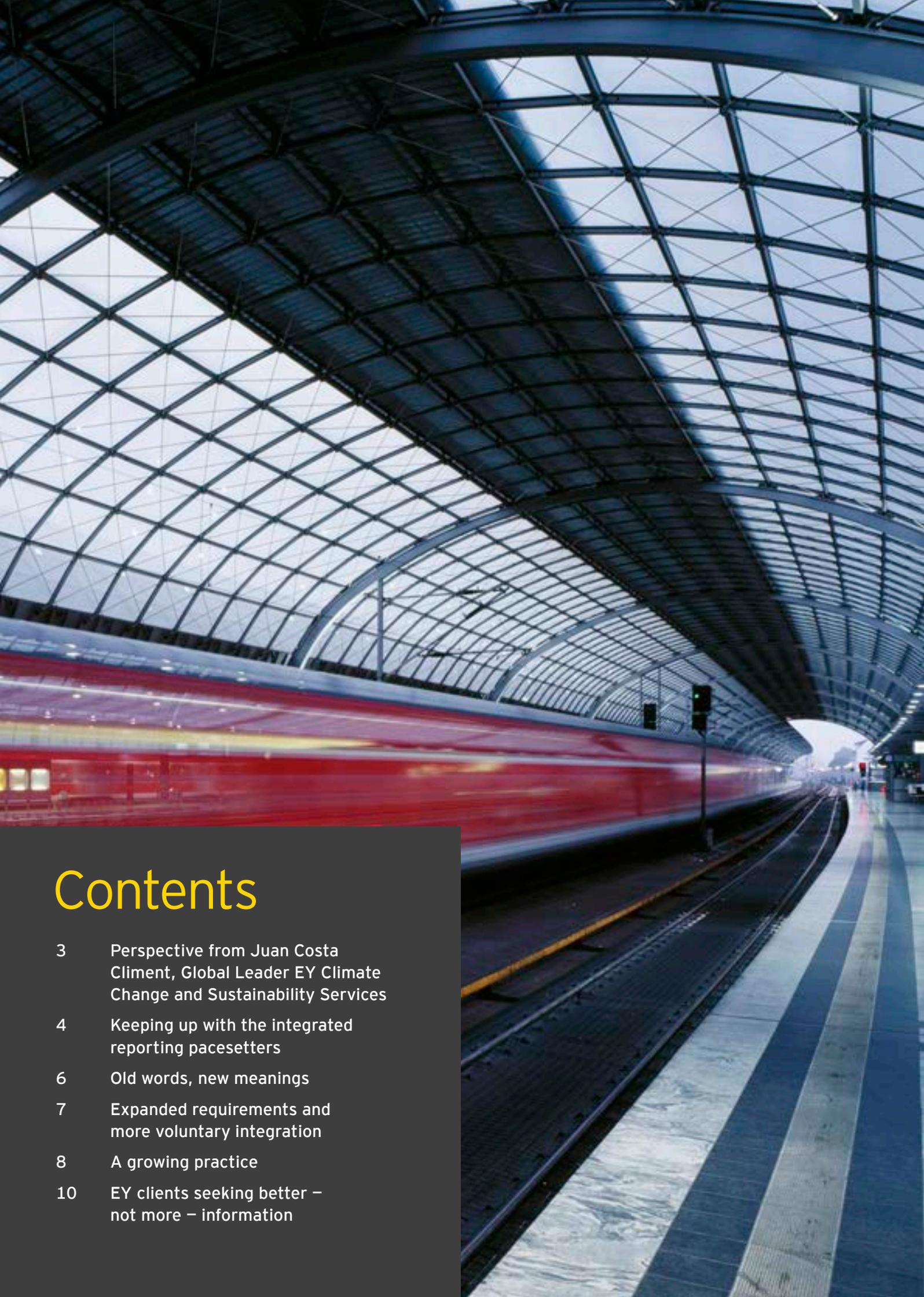


# Integrated reporting

Linking strategy,  
purpose and value



Building a better  
working world



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# Perspective

from Juan Costa Climent



**Juan Costa Climent**  
Global Leader, EY Climate Change  
and Sustainability Services

For a growing number of business stakeholders, traditional reporting models are being challenged to keep pace with a 21st century redefinition of value and a growing desire to see beyond conventional financial data. A broader understanding of value is taking hold. It goes beyond financial capital to recognize two further territories: first, the shared value an organization creates which benefits its direct stakeholders; and second, the value it generates for society and the environment. Using all three of these value territories to guide reporting holds huge potential for companies, enabling a fuller understanding of their risks and, crucially, of opportunities too.

I am excited by the ability of this new approach to build richer pictures of companies' unique value creation stories. It builds a more holistic foundation on which to base improved decision-making by both companies and investors. This is precisely why investors are asking for nonfinancial information: they understand its potential to close the gap between intrinsic and market value. But adding nonfinancial disclosures as an afterthought to financial disclosures isn't the answer: investors want better, not more, data. Companies looking to respond are working to, first, widen the value territories explored and, then, narrow their focus by prioritizing those issues that are material in each individual case. This focus is what excites us most; we know each client is going to demand a tailored approach and the progressive companies understand that it takes more than relying on standard formulae. This creates streamlined and relevant reporting, answering real investor needs rather than taking the tick-box approach that has typically guided sustainability reporting in the past.

We are privileged to work with many of the market leaders in this new space, helping them to tell their stories on their own terms and building market confidence in the process. Such stories draw together the multiple ways in which organizations create value to tell one complete narrative, recognizing the interdependency between its component parts. Given the increasing uptake of this integrated approach, I anticipate a different looking reporting landscape 10 years from now and forward-thinking companies can position themselves to be ahead of the curve. Will integrated reporting be mandatory? How will intangibles be represented on the balance sheet? And what will investors look for when they seek to understand a company's value? According to key members of the International Integrated Reporting Council (IIRC), between 1,200 and 1,500 companies were expected to publish integrated reports last year, which makes anticipating such questions vital for companies wishing to flourish in the 21st century.

# Keeping up with integrated reporting pacesetters

EY's day-to-day proximity to leading-edge integrated reporting practices provides a growing portfolio of indicators that innovation in corporate reporting is beginning to take hold. Successful companies are finding new ways to make corporate reporting fit-for-purpose in the 21st century. And purpose is key here. Often obscured by bureaucracy and increasing numbers of guidelines, reporting is really very simple: it exists so that everyone with an interest in an organization's behavior and performance can understand its purpose, impacts and future prospects. Financial data enables this, and nonfinancial data does as well. Nonfinancial data often becomes financially relevant over time and discussions around "nonfinancial data" should include sustainability, ESG, EH&S and CSR measures. Investors use this information as a decision-making tool; in fact, three-quarters of investors surveyed in our 2015 report, *Tomorrow's investment rules 2.0*,

said that nonfinancial performance information played a crucial role at least once a month in their decision-making. And so the market is influenced by the information that companies and other organizations provide: the quality, content and consistency of disclosures are therefore important to functional and flourishing capital markets.

But a series of shocks has contributed to a series of apparent moves toward new, more integrated disclosure techniques.

The 2008 financial crisis was a watershed moment. While progressive companies were demonstrating an understanding of how sustainability issues affected their overall operations, many companies adopted a tick-box approach to reporting on those issues. Some chose to publish the traditionally necessary information, overlooking information that might have been most useful for investors and broader society.

When the crisis hit, capital markets' decision-makers realized that while information was abundant, there was a lack of good and reliable nonfinancial information that may have helped to add detail and context. That experience is one of multiple pressures that is propelling reporting into a new phase: our growing understanding of environmental limits and new expectations of responsible business are crucial, as it flips externalities to "internalities."

Resource use, emissions and reliance on all forms of human, natural, social and intellectual capital can no longer be considered as separate to company operations, relegated to a corporate responsibility department. Instead, they bring revolutionary implications for the balance sheet over the medium and long term, if not now. And these implications aren't always negative: companies often stand to benefit when they openly identify activities external to an organization and directly link them to the creation of intangible asset value for the organization. Understanding externalities is vital in an age of global connectivity and its accompanying scrutiny: anyone can now tweet a photo from a company supply chain or access reporting information online. There are few dark corners left in which corporate practices can hide, meaning that companies need to tell their story on their own terms if transparency is to work in their favor rather than against them.

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# Familiar words, new meanings for business

The words remain the same, but these shifts are redefining some key concepts underpinning corporate reporting. The concept of value is broadening to encompass resources that are shared between an organization and wider society. At the same time, emphasis is shifting from tangible to intangible assets. For example, in a 2015 study looking across component companies of the S&P 500, intangible assets accounted for just 17% of total market value in 1975 but 80% by 2010.<sup>1</sup> Capital is no longer a singular term; it has evolved into the “multiple capitals approach” in recognition of the range of resources on which organizations rely (see box at right).

Similarly, the definition of materiality is broadening as companies consider appropriate nonfinancial measures or KPIs. In our report, *Integrated reporting: elevating value*, we embrace the common financial definition that a matter is material if it’s of such significance that it could substantively influence the assessments and decisions of the organization’s highest governing body or providers of capital. The Global Reporting Initiative (GRI) suggests that instead of using a threshold of financial impact to identify material issues for sustainability reporting, we might instead focus on impacts that affect “the ability to meet the needs of the present without compromising the needs of future generations.”<sup>2</sup> Both of these definitions take into account a broader

understanding of the resources and events that affect business, enabling better risk management in the process. They provide nonfinancial data with its own, more appropriate litmus test for prioritization of what is important. Companies no longer view nonfinancial data as simply “nice to have” and added on as an afterthought; they now understand that nonfinancial data is an essential management tool, one that

provides a fuller and more detailed picture of a company’s role in the world. Most often, it is talked about in the context of demonstrating and managing risks, but when collected and used properly, it also highlights commercial opportunities that may otherwise be obscured. The success stories of tomorrow, therefore, recognize that nonfinancial disclosures are integral to business today and have an indirect financial impact over time.

## Beyond financial capital

The International <IR> Framework issued by the IIRC identifies six capitals that reporting organizations may find useful as a tool for considering disclosures. For more information, see our report, *Integrated reporting: elevating value*.

### Natural capital

This includes resources such as water, fossil fuels, solar energy, crops and carbon sinks, which cannot be replaced and are essential to the functioning of the economy as a whole.

### Social and relationship capital

This encompasses the relationships – and attendant resources – between an organization and all its stakeholders, including communities, governments, suppliers and customers.

### Intellectual capital

This accounts for the intangibles associated with brand and reputation, in addition to patents, copyrights, organizational systems and related procedures.

### Human capital

The skills and know-how of an organization’s personnel, in addition to their commitment and motivation – which affect their ability to fulfill their roles.

### Financial capital

The traditional yardstick of performance, this capital includes funds obtained through financing or generated by means of productivity.

### Manufactured capital

This encompasses physical infrastructure or technology pertaining to this, such as equipment and tools.

# Expanded requirements and more voluntary integration of risks

Regulatory measures and non-governmental initiatives are speeding up this evolution. The EU Directive on Non-Financial Reporting will soon see 6,000 more companies across Europe making disclosures on relevant environmental and social factors, including emissions, corruption and employee diversity.<sup>3</sup> In France, the Grenelle II Act mandates environmental and social performance reporting for companies and requires third-party verification of such disclosures.<sup>4</sup> In Australia, the ASX now requires listed organizations to disclose whether they have material exposure to economic, environmental and social sustainability risk and, if they do, how they manage or intend to manage those risks. In the US, Dodd-Frank Section 1502 requires companies to report on their use of conflict minerals,<sup>5</sup> and the Shanghai stock exchange has guidelines encouraging corporate social responsibility (CSR) reports from all listed companies.<sup>6</sup> These regulatory impacts only serve to reinforce a wider move to the issuance of sustainability reports.

But while supplementing financial with nonfinancial reporting certainly represents a step forward, it is only the first step on a longer journey toward fit-for-purpose reporting. Publishing separate financial and nonfinancial reports suggests that a company sees nonfinancial data, and the management of the impacts to which the data relates,

as separate and distinct. Increasingly, progressive companies recognize such issues as integral to how the business is managed and are therefore pursuing a more joined-up approach. They understand that a diverse range of issues have effects across functions and operations, and that these issues – financial and nonfinancial – interact with one another. In this context of interdependency, integration is necessary to build a proper picture of an organization and the risks and opportunities that it faces.

There is a crucial shift underlying this: nonfinancial reporting has frequently focused on fulfilling requirements, whether governmental or societal. Because of this, it has often taken a generic approach, rather than drilling down into the unique situation of each organization to identify those risks

and opportunities of most relevance. Integrated reporting represents the maturation of this practice: nonfinancial information is integrated with financial data to tell a richer story about an organization. Instead of sending the financial report to one audience and the nonfinancial to another, this integrated whole is seen by the same audiences. This, combined with the ability of an integrated report to close the gap between market and intrinsic values by accounting for intangible assets and externalities, enables investors to make more informed decisions. This meets their need for good information straight from companies themselves; our report, *Tomorrow's investment rules*,<sup>7</sup> found that investors are more likely to value nonfinancial information coming directly from the company itself than from third-party sources, such as Bloomberg, index ratings or media coverage.

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## A growing practice

Integrated thinking around reporting is still in its infancy, but thanks to early adopters and the work of the IIRC, it is gaining considerable traction. In 2010, the Johannesburg Stock Exchange mandated integrated reporting in compliance with the King III Code of Governance Principles (2009).<sup>8</sup> This has led to several interesting developments; for example, companies are now frequently reporting on South Africa's shortage of skilled workers as a material risk and consequently setting out their approach to human capital development.<sup>9</sup> This is crucial for the

success of individual companies but also to the prosperity of South Africa as a whole.

From 2011 to 2014, the IIRC ran a pilot program with more than 100 businesses around the globe interested in learning about this next stage of reporting. It provided the opportunity to test and develop technical material and acted as a forum for sharing experiences. The IIRC's Integrated Reporting Framework was published in December 2013, providing guidance for organizations seeking to draw on the new concepts

underpinning reporting. The Framework suggests a multiple capitals approach: namely, that reporting organizations might want to consider all the stocks of value that affect, and are affected by, their operations. The six capitals are financial, manufactured, intellectual, human, social and relationship, and natural. By taking these into account when reporting on performance, a company provides a fuller picture of the way in which it creates value. For organizations that have yet to embrace this new value paradigm, our report, *Integrated reporting: elevating value*,<sup>10</sup> provides a concise explanation of the nuts and bolts of the integrated reporting approach, including an exploration of the capitals and how they may affect value creation.

The relevance of integrated reporting to the market and the rigor with which it has been developed are evidenced by the growing number of companies expected to publish integrated reports this year. However, there remains considerable diversity across regions in uptake of integrated reporting and sustainability reporting more broadly (see box on next page).

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## A patchwork evolution

### Americas

Nonfinancial reporting continues to grow in these regions, particularly in Argentina, Mexico, Canada and the United States. However, assurance lags behind. On integrated reporting, Brazil is seeing strong adoption from prominent companies spanning a number of key sectors. Much of this can be attributed to participation in Brazil's IR Pilot Program. Companies in Canada and the United States have nonfinancial reporting high on the agenda, but it's mainly those that participated in the IIRC Pilot Program that are choosing to pursue an integrated approach. Nonetheless, discussions around nonfinancial disclosures and "purpose" are increasingly echoing the need for companies to better integrate different capital measures and nonfinancial indicators into their strategies. Such steps will increase opportunities to understand and tell an organization's complete value creation story.

### Europe, Middle East, India and Africa (EMEIA)

There is a very wide range in uptake of nonfinancial reporting and integrated reporting, but some common themes emerge. Generally, there is a need in EMEIA to educate organizations about what integrated reporting is, its benefits and how it can be applied practically. The United Kingdom is expected to be a leading force in this space, with many organizations already adopting the IIRC Framework's multiple capitals approach, albeit without producing fully fledged integrated reports. The Netherlands is also demonstrating leadership: some multinationals are publishing integrated reports and many more are developing relevant processes. France's Grenelle II Act has caused many companies to adopt i-negrated reporting concepts but few are explicitly considering <IR> itself. And in Russia and India, new networks have been created to push <IR> higher up the agenda: the Russian Regional Network on integrated reporting and the IR Lab India, respectively. Unsurprisingly, South Africa remains largely ahead of the pack due to the introduction of mandatory integrated reporting in 2009, for companies listed on the Johannesburg Stock Exchange (JSE).

### Asia-Pacific

Australia is showing observable growth in nonfinancial reporting across all sectors, with 85% of ASX200 companies reporting on sustainability factors.\* Despite slower growth towards IIRC aligned integrated reporting, momentum is building with significant growth in companies integrating financial and nonfinancial disclosures and communicating broader value creation.

There has been observable growth in integrated reporting in the Singapore and Hong Kong market. China has also seen a rapid increase in CSR reporting in recent years due to government and stock exchange requirements and there is increasing interest related to integrated reporting.

### Japan

According to research results conducted by the ESG Communication Forum,\*\* 142 companies showed movement towards the creation of an <IR> in 2014. Attention to integrated reporting has been increasing since the Japanese government established the Stewardship Code in 2014 and Corporate Governance Code in 2015. Both codes encourage constructive communication between companies and investors about corporate value including strategies, risks and opportunities and governance. Additionally, the Corporate Reporting Lab organized by the Ministry of Economy, Trade and Industry (METI) endorsed integrated reporting as a good tool to improve investor relations in an "Ito Review."\*\*\* This movement is further encouraging companies to try <IR>.

\*The Australian Council of Superannuation Investors (ACSI) "Corporate Reporting in Australia - Disclosure of sustainability risks among S&P/ASX200 companies," p3, 2014

\*\*<http://www.esgcf.com/english/archive/>

\*\*\*The Ito Review of the Competitiveness and Incentives for Sustainable Growth: Building Favorable Relationships between Companies and Investors; Graduate School of Commerce and Management at Hitotsubashi University

# EY clients seeking better – not more – information

Publishing an integrated report is not the end of the journey, and it is important that it is not seen as such. Rather, it is one part of a deeper, broader journey leading to better aligned, more efficient and investor-friendly organizations. The market doesn't need *more* information; it needs *better* information. Data is only useful if it tells a clear and full story about an organization. And this story is best generated by integrated *thinking*. Such *thinking* is the input; the report is one of its many outputs. EY's Climate Change and Sustainability Services (CCaSS) practice has been asked to assist this process with numerous clients, and many have been focused on outcomes other than producing an integrated report: Westpac sought to improve stakeholder trust by providing more transparency and accessible disclosures and the World Bank wanted to understand how different internal functions were contributing to overall organizational strategy. An integrated approach addressed these needs by focusing on robust and relevant nonfinancial data and assessing internal alignment to make sure that all the different parts of the business were working together. The value added by this approach casts the integrated report more as a beneficial by-product than the main attraction.

When the largest infrastructure concession group in Latin America, Grupo CCR (CCR), decided to take a new strategic direction, it recognized that moving beyond mainstream reporting was integral to making this shift a success. But like many companies and other organizations, CCR needed to understand how to move from its current reporting practices toward a different approach. Relying on insight from within the company, a roadmap was developed to enable this. More than 300 employees across diverse functions were engaged to explore the connections between different types of information. CCR not only produced an award-winning integrated report, but also built a better integrated organization as a whole.

The Crown Estate's (TCE) award-winning first integrated report in 2013 shows how such an approach helps to instill integrated thinking throughout an organization. The report identified 14 material issues with the potential to affect TCE's business, including standard financial concerns such as optimization of the portfolio for long-term total return, and broader issues, including attraction, development and retention of the best talent, climate change and government policy changes. The breadth

of these issues demonstrates underlying thinking that breaks down internal silos and recognizes the interdependency at the heart of business.

## Value at the core

The one thing these client experiences highlight is their individuality: the beauty of reporting on an integrated whole is that each whole is unique. This is why the International <IR> Framework issued by the IIRC operates on a principles basis rather than dictating the specifics of how its approach should be applied. The key performance indicators (KPIs) an organization chooses, and the specific issues on which it reports, must relate to its own unique value creation story.

For EY, the key is for each company it works with to orient around creating something new and tailored. Businesses need to know from the outset that one size does not fit all. This enables them to meet diverse needs, creating award-winning reports in the process. It is still too soon to talk about best practice on integrated reporting, but leading practices are emerging.

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- <sup>5</sup> U.S. Securities and Exchange Commission, "Fact Sheet: Disclosing the Use of Conflict Minerals," 2014.
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- <sup>8</sup> Institute of Directors in Southern Africa, "King Code of Governance for South Africa," 2012.
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