

Private Sector Opinion

Integrated Reporting: Lessons from the South African Experience

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A Global Corporate Governance Forum Publication

Jonathon Hanks and Louise Gardiner

One of the more significant recent governance trends is the global shift to integrated reporting. This article offers historical background and practical guidance for company directors and executives as they approach this relatively new way of communicating with stakeholders. The authors draw on insights and experience gained in advising some of South Africa's top companies on integrated reporting as these companies respond to the King Code of Governance Principles for South Africa 2009 (King III) and the listing requirement of the Johannesburg Stock Exchange (that all companies issue an "integrated report" for financial years starting on or after March 1, 2010—or explain why they are not doing so).

Foreword

A critical part of good governance is good reporting. In the corporate world we have had about 100 years of financial reporting. Over the last 15 years or so, sustainability reporting has gathered momentum, driven by, among other things, ecological overshoot, greater expectations from stakeholders, evolutionary transparency, and population growth—elements of the changed world in which we live.

The two great challenges of the 21st century—financial stability and sustainability—are interconnected. Financial markets do not operate in isolation; we have commodity markets in coal, wood, iron, steel, and so on, and derivatives in the trading of those commodities. Besides external regulators there is internal regulation, which is a matter of good governance. So, it makes sense that reporting should reflect this interconnectedness.



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Two of the major pillars of an integrated report are transparency and accountability. These two pillars also drive the thinking of the Financial Stability Board. We can only speculate whether the financial crises since 2008 would have happened if integrated reporting had been well established.

My reason for such speculation is that there has been no system for creating the annual report. Typically, the preparer obtains reports from the human resource department, the finance department, the remuneration committee, and so on, then bolts one onto another onto another—along with a chairman’s statement, usually drafted by the company secretary and edited by the chairman—and places the whole thing into a glossy cover. This is not a system.

But there is a system for integrated reporting. And it starts with what we’ll call the collective mind of the board. Although each director is individually liable and responsible, board decisions are collective. For this reason it is critical that the board as a whole has a clear understanding of its mandate, which should include the purpose of the business of the company, its main value drivers, and the main stakeholders. And, the board should have ongoing strategic communication with those stakeholders to understand their legitimate needs, interests, and expectations. Thus informed, the board can make better decisions, and management can develop a more effective strategy for implementing them. Furthermore, during the reporting period, the corporation can use the better understanding of stakeholders’ needs, interests, and expectations to build a pathway of knowledge to prepare its integrated report.

The ideal—integrated thinking and integrated management—requires the collective mind of the board to be applied to understanding how the financial performance affects the nonfinancial and vice versa. In addition, the board must understand how the sustainability issues that are material to the business of the company have been embedded into the long-term strategy so that stakeholders, particularly the providers of capital, can make an informed assessment as to whether the company’s business will sustain value creation. This cannot be done from the financial report alone—which would be like looking only in a rearview mirror.

The collective mind of the board must articulate in clear and understandable language the financial and sustainability issues material to the business of the company and show that the business is one that is going to sustain value creation. It is still being debated whether this should be in a single report or the integration should be accessed in the various reports, such as financial, sustainability, management commentary, governance, remuneration, and health and safety. The objective is to demonstrate that there has been integrated thinking; the challenge in not doing a single integrated report is accessibility:

the stakeholder must be able to readily access the information to make the informed assessment that the business of the company is going to sustain value creation.

In short, in an integrated report, the collective mind of the board must tell the company stakeholders the state of play in the company. In the 21st century we cannot solve the problems of the changed world with the same mindsets that created these problems, nor can we solve them using the corporate tools that aided and abetted the creation of these problems. We need new decision-making methods, such as a complete understanding of the needs, interests, and expectations of stakeholders, and to take these into account in the decision-making process. But we also need to be guided by what is in the best interests of the company for the maximization of its total economic value. Intangible assets, such as reputation, are becoming as critical to a company as its tangible assets, which are additives in a balance sheet according to financial reporting standards.

Integrated reporting is a concept whose time has come. And, to paraphrase Victor Hugo, one can stop an army, but not a concept whose time has come.

Mervyn E. King

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Integrated Reporting: Lessons from the South African Experience

Jonathon Hanks and Louise Gardiner¹

Companies are in the public spotlight, perhaps more than ever. The global financial crisis, persistent economic disparities, climate change, and evidence of corporate governance failures are just some of the issues that are raising the profile of corporate transparency among regulators, civil society bodies, and the general public. Recognizing the significant potential influence—both positive and negative—that business has on the achievement of developmental objectives, it is hardly surprising that companies are increasingly being called to account on their social and environmental performance. Expectations are growing from across all sectors of society for companies to provide full and frank feedback of their social impacts, and of the steps they are taking to mitigate the negative impacts and enhance the positive contributions of their operations, products, and services.

Companies are increasingly being called to account on their social and environmental performance.

This increasing focus on greater accountability for the social impact of business activities is evidenced in particular by the recent shift toward integrated reporting, driven at a global level by the International Integrated Reporting Committee (IIRC). A powerful cross-section of representative bodies from the corporate, investor, accounting, securities, regulatory, and standard-setting sectors, the IIRC aims to build consensus among governments, listing authorities, businesses, investors, and accounting bodies on the future shape of corporate reporting practice.

The IIRC recently released a discussion paper on integrated reporting² that provides initial proposals on the development of an international integrated reporting framework and that outlines the proposed steps for its finalization and adoption. Various national and regional initiatives contributed to this discussion paper, including most notably South Africa's Integrated Reporting Committee (IRC), which was the world's first national initiative to issue a discussion paper outlining the objectives and characteristics of integrated reporting.³

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² International Integrated Reporting Committee, "Towards Integrated Reporting—Communicating Value in the 21st Century," Discussion Paper (September 2011), www.theiirc.org.

³ Integrated Reporting Committee of South Africa, "Framework for Integrated Reporting and the Integrated Report," Discussion Paper (January 25, 2011), www.sustainabilitysa.org. The South African IRC was established in May 2010 to develop guidelines on good practice in integrated reporting. It was founded by five major South African organizations: the Association for Savings & Investment South Africa, Business Unity South Africa, Institute of Directors in Southern Africa, JSE Ltd, and the South African Institute of Chartered Accountants. In August 2010, two more organizations—the Banking Association South Africa and the Chartered Secretaries Southern Africa—joined the IRC. And in 2011, the Principal Officers Association and the Government Employees Pension Fund joined.

Motivating the IIRC's promotion of integrated reporting is the belief that the business context has changed significantly and that this change has important implications both for how businesses create value and for the type of information needed for investors and other stakeholders to accurately assess their continuing ability to do so. Reflecting this belief, the IIRC argues that the current financial crisis was partly driven by the predominant focus on short-term profits irrespective of long-term sustainability, and that this crisis has thus “demonstrated the need for capital market decision-making to reflect long-term considerations and has called into question the extent to which corporate reporting disclosures, as they exist today, highlight the systematic risks to business sufficiently.”⁴ Therefore, the IIRC's goal is to develop a reporting framework that brings together—in a clear, concise, consistent, and comparable format—the information necessary to more accurately assess company value in the context of the drive toward a more sustainable global economy.

The process of integrated reporting shines a spotlight on the oversight and leadership provided by directors.

Understanding integrated reporting

The IIRC's September 2011 discussion paper provides the following definition of integrated reporting:⁵

Integrated Reporting brings together the material information about an organization's strategy, governance, performance and prospects in a way that reflects the commercial, social and environmental context within which it operates. It provides a clear and concise representation of how an organization demonstrates stewardship and how it creates value, now and in the future. An Integrated Report is expected to become an organisation's primary reporting vehicle.

Integrated reporting combines the most material elements of information currently contained in separate reports—such as financial, management commentary, governance and remuneration, and sustainability—into a single coherent whole. Further, it shows the strategic connectivity between these different strands of information and explains how they affect an organization's ability to create and sustain value in the short, medium, and long term.

⁴ Integrated Reporting <IR> (website), IIRC (July 2011), <http://www.theiirc.org/about/aboutwhy-do-we-need-the-iirc/>.

⁵ IIRC, “Towards Integrated Reporting”: 5.

The process of integrated reporting shines a spotlight on the oversight and leadership provided by directors. It challenges organizations to demonstrate their stewardship of multiple forms of capital—financial, manufactured, human, intellectual, natural, and social—and encourages collaboration and communication within the company. For the first time in many companies, accountants will be sitting down with specialists in sustainability performance to assess the return on investment from reductions in energy use, carbon emissions, waste, and water use, as well as social capital and reputational value derived from better relationships with stakeholders. Similarly, investor relations teams are developing ways to communicate with investors about the value created by the business through effective management of economic, environmental, and social performance. Companies that want to stay ahead will need to know how to quantify and communicate their value propositions, will be expected to take a longer-term, more forward-looking perspective, and will be required to demonstrate an understanding of the extent of the impact of social issues (resources and relationships) on their strategic growth objectives.

Motivations for the shift in reporting practice

Underpinning the shift to integrated reporting is the widespread recognition that annual financial reports and sustainability reports are not delivering the desired results. As Mervyn King puts it in the foreword to the South African discussion paper on integrated reporting, many stakeholders “question the relevance and reliability of annual financial reports as a basis for making decisions about an organization,” arguing that these reports “do not provide sufficient insight to enable stakeholders to form a comprehensive picture of the organisation’s performance and of its ability to create and sustain value, especially in the context of growing environmental, social and economic challenges.”⁶

Annual financial and sustainability reports fall short of delivering, because most of them fail the test of materiality. They are not providing the information needed for stakeholders to make an informed assessment of the total economic value of the organization.

Sustainability reports suffer similar perceived weaknesses. They often seem disconnected from the organization’s financial reports, typically provide only a backward-looking review of performance, and rarely make the connection between social challenges and the organization’s core strategy. Often, sustainability reports are also guilty of “carpet bombing,” covering too many nonmaterial issues in the hope of meeting the needs of all stakeholders (and in the process frequently failing to meet the needs of any of them).

⁶ IRC, “Framework for Integrated Reporting”: 1.

Typically, annual financial and sustainability reports fall short of delivering, because most of them fail the test of materiality. They are not providing the information needed to enable stakeholders to make an informed assessment of the total economic value of the organization, particularly in the context of increasing social volatility.

A publication from accounting firm PricewaterhouseCoopers sums up these weaknesses in reporting practice, arguing that “too many reports display the dead hands of compliance and the editorial committee.” It goes on to say, “Too few companies have cut through the historic clutter and the short-term financials to create a strategic picture of the business that is informative and convincing.”⁷ Our recent experience in various South African boardrooms suggests that this “dead hand of compliance”—the hand, largely, of corporate lawyers and chartered accountants—can be a heavy hand that undermines the ability to challenge the status quo, and that hinders a much needed drive for greater levels of innovation.

Toward effective integrated reporting practice

Given these concerns with current reporting practice, plus the international move toward integrated reporting, what does this mean for businesses, and in particular for boards of directors? What are the practical implications associated with implementing an effective process of integrated reporting that meets the anticipated objectives outlined in the IIRC’s discussion document?

Looking for answers to these questions, over 40 reporting practitioners from some of South Africa’s top companies participated in July 2011 in two one-day workshops organized by local sustainability consultancies Incite Sustainability and First Principles. One of the overriding observations coming out of these discussions was that directors need to be much more involved in the process—and that most of them need a significantly improved understanding of the underlying objectives and practical implications of effective integrated reporting.

Informed by the outcomes of these workshops, and by the experience we have gained in advising some of South Africa’s top companies on integrated and sustainability reporting over the past 10 years, we have identified the following five broad success factors. We believe they can assist companies in developing and implementing an integrated reporting process that will achieve its objectives and add value to the business.

Directors need to be much more involved in the process, and most of them need a significantly improved understanding of the underlying objectives and practical implications of effective integrated reporting.

⁷ PricewaterhouseCoopers, Integrated reporting: What does your reporting say about you? (United Kingdom: PricewaterhouseCoopers, 2010): 3.

1) Engage directors and top management early in the process.

For the integrated reporting process to function smoothly and meet its objectives, it is critical that it has the full backing of the directors and top management—and that they understand what integrated reporting is and what it is not. In our experience—and reflecting a view shared by many of the participants at the workshops—considerable misunderstanding persists among many directors regarding the nature and intent of integrated reporting. It is essential to involve executives early in the process to ensure that they understand that integrated reporting is not about combining the annual report and the sustainability report into one document; nor is it about trying to address all the interests of a broad range of stakeholder groups. Designing an effective reporting process requires securing the executive team’s agreement and understanding that integrated reporting involves their participation in interrogating the organization’s approach to creating value.

Informed and committed leadership from the top helps establish ambitious goals and boundaries for the integrated report. Such leadership enables reporting teams to accomplish more than they otherwise could. Corporate executives also have unique knowledge and perspectives on the direction the company is taking and on the issues most likely to affect performance and value creation in the short, medium, and long term. An effective process will incorporate these perspectives and tackle how value and performance are measured using a combination of financial and sustainability parameters.

2) Use the process to interrogate strategy.

The discussion paper on integrated reporting released by the South African Integrated Reporting Committee argues that the underlying objective of an integrated report is to “allow users of the report to determine whether the organisation’s governing structure has

applied its collective mind in identifying the environmental, social, economic and financial issues that impact on the organisation, and to assess the extent to which these issues have been incorporated into the organisation’s strategy.” By requiring this analysis, integrated reporting presents an opportunity to stress test the organization’s business strategy through an informed appreciation of value creation that recognizes the impact of the changing social context.

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Our experience in advising companies on their reporting and strategy processes has led us to believe that, in seeking to identify its material issues for the purposes of an integrated report, the organization's governing structure should ideally be engaged in a process that considers the following questions:⁸

- What are the links between the organization's value drivers and social, natural, and economic systems? What are the emerging risks and opportunities the changing social context places on these value drivers? What impact will these risks and opportunities have on the organization's capacity to create value?
- How does the organization position itself in the context of current social trends? For example, is the organization seeking mainly to reduce costs and manage risks, or is it striving to differentiate and brand itself explicitly on its approach to social challenges?
- What organizational competencies—employee skills, operating systems, strategic partnerships, company culture, and so on—are needed to deliver on its stated strategic commitment and to ensure that the company remains competitive in the context of a rapidly changing business environment?
- What are the key strategic focus areas and associated performance indicators required for the company to deliver on this commitment?

A recent reporting process in South Africa that reflects this approach is the one adopted by Vodacom, a pan-African mobile telecommunications company. Through a structured engagement that involved its executive team in systematically addressing each of the above questions, the company ended up revising its existing group strategy—identifying five strategic priorities that reflect the implications of social issues on its capacity to create and sustain value. Vodacom's award-winning integrated report—as well as the subsequent road show with investors and analysts—is explicitly structured against these strategic priorities. It provides an excellent example of the strategic integration that this kind of reporting seeks to promote, prompting an improved understanding by the organization of how it uses resources and relationships in delivering on its strategic objectives.

⁸ These questions are explored in greater depth in Incite Sustainability's handbook, *Sustainability 2.0: A Guide to Competing in a Changing World*, available free at www.incite.co.za.

3) Provide reporting teams with clear mandates, and ensure integration across corporate functions.

We believe that many executives underestimate the depth of the commitment that integrated reporting requires across the company. This underestimation may result in part from a misunderstanding of the nature and scope of integrated reporting. For some companies, the first year or two of integrated reporting may be resource-intensive as more integrated data-gathering systems are put in place and the company adopts a new way of communicating. Other companies may already have data systems in place but face challenges in ensuring effective coordination and integration between the different functions involved in the traditionally separate activities of annual financial and sustainability reporting.

If reporting teams are not given sufficient support and authority, and if there is insufficient clarity on roles and responsibilities, then the reporting process may be a burden with insufficient return on investment. Our recent experience with various companies across a range of sectors suggests that for many companies there is likely to be some initial tension between the investor relations or finance functions on the one hand and the sustainability or corporate affairs functions on the other. Establishing the new reporting systems and

ensuring clearly assigned responsibilities for integrated reporting will require unambiguous support from company leadership, informed by their understanding of the importance of cross-functional coordination. Leaving the reporting system in the hands of the investor relations department on its own, runs the risk that the traditional understanding of value creation and the historic approach to annual financial reporting will continue to predominate, undermining the shift in approach and understanding that integrated reporting seeks to inspire.

Establishing the new reporting systems and ensuring clearly assigned responsibilities for integrated reporting will require unambiguous support from company leadership, informed by their understanding of the importance of cross-functional coordination.

4) Embed reporting within new and existing management systems.

During the workshop discussions, most of the participants identified two parallel processes or cycles within their organizations. The first involves the cycle of report preparation that often drives the data collection and strategic components of integrated reporting; the second is the process of developing the corporate strategy and internal management systems.

A reporting cycle can range from 6 to 12 months, depending on the size of the company and the scope of the report. It includes various publication deadlines as well as opportunities for executives and the board to review drafts and provide editorial input. Too often, the focus will be on producing a publication rather than on maintaining a vibrant management system. The workshop participants recommended giving more attention to how the reporting system can feed and respond to other management systems.

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5) Use the report to communicate the outcome of the process effectively.

It is important to ensure that an effective *process* of integrated reporting results in an effective and sufficiently engaging *product*: the integrated report. Following are some important considerations that we believe will contribute to the effectiveness of an integrated report.

Focus explicitly on the material strategic business issues. To meet the underlying objective of integrated reporting, the report must disclose such material information about the organization's current and anticipated activities as is necessary to enable the report user to make an informed decision about the organization's ability to create value, now and in the future. Any information about issues that will not have a significant impact on the organization's ability to create value should be included in separate, additional reports (such as a more detailed sustainability report or the comprehensive annual financial statements).

Vodacom's 2011 integrated report, organized explicitly around five strategic priorities identified through a structured process of engagement with its executive team, provides a useful example of the anticipated strategic nature of an integrated report. Building on the process outlined above, we suggest including in the report (i) a clear account of the organization's value drivers, (ii) the social risks and opportunities that affect these value drivers, and (iii) the organization's strategic response to address these risks and opportunities.

Keep it short. The purpose of an integrated report is to provide a "clear and concise" strategic perspective on the organization. Very few of South Africa's first round of integrated reports have demonstrated sufficient boldness to be brief and strategic. Some of the most recent so-called "integrated reports" run to more than 200 pages, making it difficult to see how they provide the desired focused strategic review. This reluctance to be brief is a result (at least in part) of many local companies' continuing uncertainty about the requirement to publish printed annual financial statements, and to what extent to include them within the integrated report.

An effective report should help the user clearly understand the interconnectedness between the various aspects of the organization's business strategy, its internal activities, and the external resources and relationships on which its activities depend.

Do the analysis. An effective report should help the report user clearly understand the interconnectedness between the various aspects of the organization's business strategy, its internal activities, and the external resources and relationships on which its activities depend. The most recent reports by the chief financial officer of Sasol—a South African company involved in mining, energy, chemicals, and synthetic fuels—in its annual financial report provide a good example of succinct analytical commentary. Sasol's

report clearly shows the link between its internal value drivers and the external social context. The company further facilitates effective analysis by including in its sustainability report the transparent benchmarking of its safety and climate change performance against the performance of its peers.

Look forward as well as back. The report should provide analysis and data that allow the report user to assess the organization's capacity to respond to a possible future context of increasing volatility. Although the report should not be expected to include disclosure of forward-looking information that might have an immediate bearing on the organization's share price, it should be possible to assess from the report the possible longevity of the current business model. The report could include, for example, data that: (i) show a sensitivity of company results to commodity prices, interest rates, or exchange rates (for example, Standard Bank's 2010 report, page 36, and Anglo American's 2010 report, page 52); (ii) provide an analysis of fixed versus variable cost, highlighting the impact that revenue changes may have on profit (such as the Sappi 2010 report, page 37); or (iii) reflect possible future capacity constraints (for example, Sun International's 2010 analysis of room statistics, noting revenue per unit and current occupancy rates, page 28).

Show responsiveness to stakeholders. To demonstrate a knowledgeable appreciation of the strategic importance of maintaining positive relationships with its key stakeholders, and to contribute to building trust with these stakeholders, the report should provide evidence of the processes used to engage with key stakeholders and of the measures taken to respond to their interests and concerns. The series of publicly reported (2009) dialogues that Sasol executives undertook with some of their more vocal and informed critics provides a good illustration of stakeholder responsiveness.

Present a balanced picture. To be credible, the report should recognize the challenges and disappointments and not just focus on the good news. Vodacom’s integrated report (2010) is a good example of a balanced approach, creatively using graphics throughout the report to provide a simple and visible portrayal of its successes and disappointments.

Be engaging. While we were advising one of the Big Four auditing firms on its sustainability report some years back, one of the consultants expressed his desire that the firm’s first sustainability report should be a “thumping good read.” We suspect that we have yet to fully deliver on this goal. By its nature an integrated report will never compete with John Grisham or Stephen King—nor should it. We nevertheless believe that an integrated report should have a clear and engaging narrative structure. It should offer a sense of the genuine personal perspectives of some of the executives, be easy to navigate, and put a “human face” to the challenges and opportunities confronting the company.

To be credible, the report should recognize the challenges and disappointments and not just focus on the good news.

The way ahead: fulfilling the potential of integrated reporting?

In his foreword to the South African discussion paper on integrated reporting, King suggests that “if done properly, organisations that produce an integrated report for the first time will take a new look at themselves and their business models . . . and will be encouraged to explore new and potentially innovative opportunities in their products, services, processes and markets.” He maintains further that integrated reporting “has the ability to improve strategic decision making, improve performance and enhance reputation among stakeholders.”⁹

For this potential to be realized, however, it is essential that the process of reporting not become simply a compliance-driven exercise administered in isolation by the company secretary or investor relations department. Instead, it must involve the active engagement of the organization’s governing structure in a frank and critical review of its current approach to creating value.

⁹ IRC, “Framework for Integrated Reporting”: 1.

It is essential that the process of reporting not become simply a compliance-driven exercise, but instead it should involve the active engagement of the organization's governing structure in a frank and critical review of its current approach to creating value.

If integrated reporting results in an active process of internal reflection, then we believe that it not only will produce a report that is material and fit for purpose, but also, ideally, will assist in addressing what respected business strategy guru Michael Porter has called the “out-dated approach to value creation” that pervades much of business. Porter and co-author Mark Kramer describe this outdated approach as characterized by its obsession with “optimising short-term financial performance in a bubble while ignoring the

broader societal influences that determine their long-term success.”¹⁰ They argue that the alternative approach of shared value “holds the key to unlocking the next wave of business innovation and growth. It will also reconnect company success and community success in ways that have been lost in an age of narrow management approaches, short-term thinking, and deepening divides among society’s institutions.”¹¹

Although it is evident that integrated reporting represents an important *evolution* in reporting practice, we hope that it will also prompt a *revolution* in the current outdated approach to value creation.

¹⁰ Michael Porter and Mark Kramer, “The Big Idea: Creating Shared Value.” *Harvard Business Review* (January/February 2011), http://hbr.org/2011/01/the-big-idea-creating-shared-value/ar/1?cm_sp=most_widget_-_hbr_articles_-_The%20Big%20Idea%3A%20Creating%20Shared%20Value.

¹¹ *Ibid.*

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