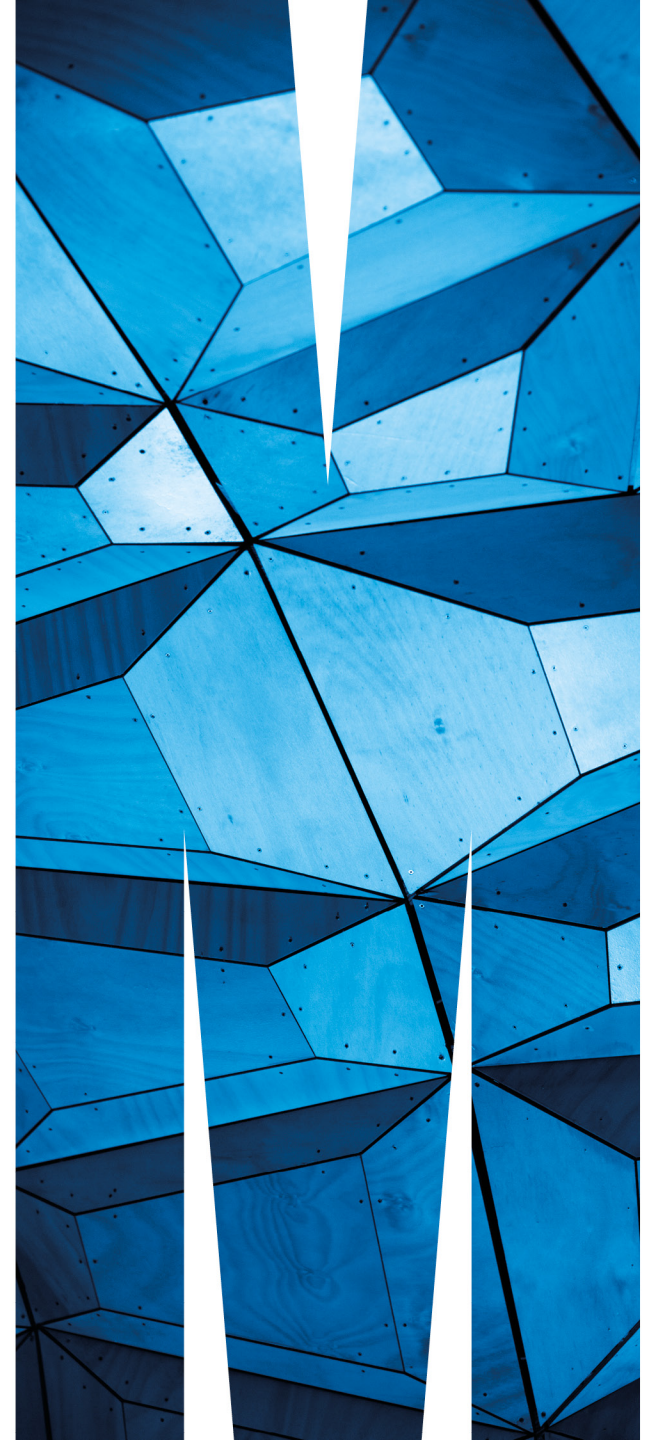


ACX2900

Accounting for Sustainability

External Reporting and Integrated Reporting



INTRODUCTION AND OUTLINE

- Introduction
- Recap of Week 4 – Performance Measurement
- Corporate Governance & External Reporting
- The case for Integrated Reporting
- What is <IR>?



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Recap Week 4

PERFORMANCE MEASUREMENT SYSTEMS

■ Performance Measurement

- Usually done through **Key Performance Indicators** (KPIs)
- **Quantitative indicators** to assess how an organization has been doing in achieving its desired objectives and targets, and to identify areas of strength and weakness
- Based on **organizational data**

■ Different organisations use different KPIs

- KPIs depend on the **type of organisation** (e.g., corporate, NGO...)
- KPIs depend on **objective of the organisation**

■ Examples of performance measurement

- **Children:** Performance at school through test scores and report cards
- **Home:** Monthly reports on investment performance, water, electricity usage etc
- **Health:** Performance of body through weight, blood pressure, cholesterol levels etc

Learning outcomes for this week

- After today, you will be able to
 - Discuss the need for Integrated Reporting
 - Know what is meant by Integrated Reporting
 - Identify the benefits and challenges of taking on an Integrated Reporting Perspective in a company
 - Draw-up a basic, initial Integrated Report

CORPORATE GOVERNANCE & EXTERNAL REPORTING

- The term “governance” refers to areas such as
 - Executive pay
 - Bribery and corruption
 - Political lobbying
 - Donations
 - Board diversity
 - Board structure
 - Tax strategy
 - EXTERNAL REPORTING STRATEGY

- Traditional form of external reporting
 - Financial statements
 - Balance Sheet (or Statement of Financial Position)
 - Income Statement
 - Cash Flow Statement
 - Statement of changes in owners' equity or stockholders' equity
- More recently, more entities are reporting on non-financial matters, boosting emerging forms of external reporting (EER)
 - Integrated reporting
 - Sustainability reporting
 - Service performance reporting (mostly in NGOs)



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THE CASE FOR INTEGRATED REPORTING

- Many companies voluntarily produce integrated reports in various formats
- Few jurisdictions mandate integrated reports (e.g., Denmark)
- A number of initiatives by governmental and non-governmental groups have developed sustainability-related frameworks
 - Most notably, the International Integrated Reporting Committee (IIRC)
 - However, absence of a generally accepted framework
 - What issues may companies that wish to move toward integrated reporting encounter?

The case for Integrated Reporting (IR)

- Growing expectations from society that businesses do more than simply turn a profit
- Businesses must operate and (maybe even more importantly) be perceived to operate that is
 - Responsible
 - Ethical
 - Sustainable
- Hence, organizations want to, or at least be perceived to do business in a way that
 - Minimizes negative impacts on the environment
 - Takes the varied needs of a spectrum of stakeholders into consideration (stakeholder rather than shareholder theory)
 - Positively contributes to the communities in which they operate and the planet generally

However...

- EER not always governed by accounting standards
 - Can present auditing challenges: Assurance (audit) not always mandated by legislation and regulation
- **Key challenges** according to a report published by ACCA (The Association of Chartered Certified Accountants) in 2017
 - **Value creation**: Explanation of how the organisation creates value for others vs how it creates value itself
 - What does value mean for stakeholders?
 - **Connectivity**: Breaking down silos within the organisation and changing data collection processes
 - **Defining performance measures**: Value derived from non-financial capitals
 - **Materiality**: Reconciliation of the needs of different stakeholders
 - **Conciseness**: Most reports >150 pages – meaningful communication with stakeholders?

Companies that have adopted an IR perspective

1. Which company pledged to sell more locally grown produce in the U.S.?
2. Which company yielded to public pressure and removes palm oil from its products in New Zealand?
3. Which outdoor apparel company vowed to plant 5 Mio trees in Haiti and China?
4. Which consumer products company pledged to “help more than 1 billion people improve their health and well-being” by 2020?

The case for Integrated Reporting (IR)

- Trend extends to investors
 - The United Nations Principles for Responsible Investment (UNPRI) estimates that approx. US\$ 22 Trillion are invested in socially responsible funds
 - This represents about 10% of the global capital markets
 - Research study by Zhou et al. (2017) provides evidence “that analyst forecast error reduces as a company’s level of alignment with the <IR> framework increases”
 - This is further associated with a subsequent reduction in the cost of equity capital for certain reporting companies
 - Overall, study suggests “that <IR> is providing incrementally useful information to the capital market over and above existing reporting mechanisms”



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What is <IR>?

Integrated reporting <IR> – What it is not

- An account of trees saved, carbon offsets purchased, or funds donated
- A sustainability report appended to a financial report, or vice-versa
- A marketing, advertising, or PR initiative that tries to present a more balanced view of a company's performance

Integrated reporting <IR> – What it is

- According to the International Integrated Reporting Council (IIRC):
 - “An integrated report is a **concise communication** about **how an organization’s strategy, governance, performance and prospects**, in the context of its external environment, **lead to the creation of value** over the short, medium and long term.”

The International <IR> Framework

- Takes a principles-based approach
- Does **not prescribe specific KPIs** or measurement methods
- Instead, **includes a small number of requirements** that are to be applied
- Aims to **provide insight about the resources and relationships used and affected by an organization** – referred to as “capitals”
 - **Capitals are stocks of value** that are increased, decreased or transformed through the activities and outputs of the organization
- Seeks to explain **how the organization interacts** with the external environment and the capitals **to create value** over the short, medium and long-term

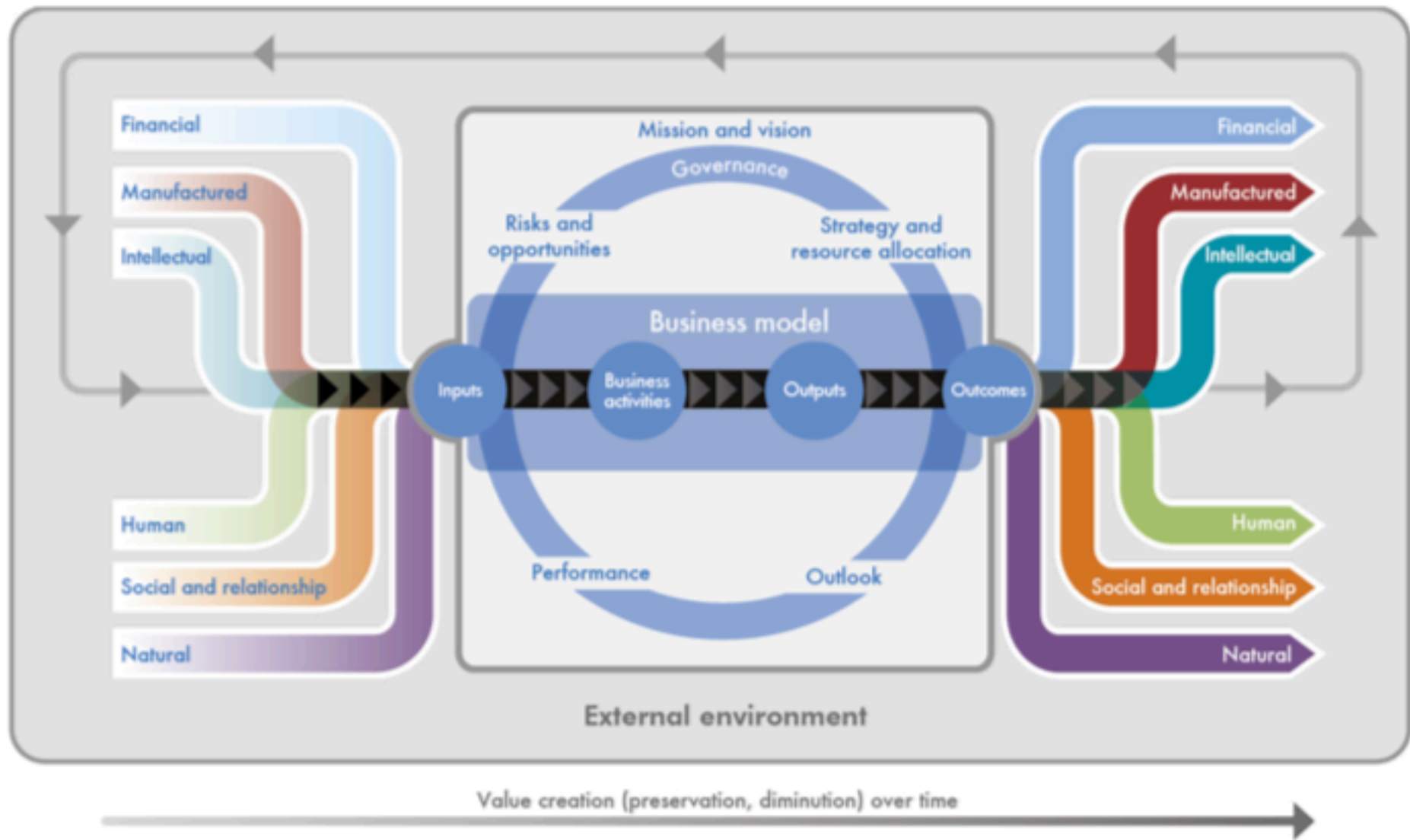
Integrated reporting <IR> – Aim and Overview

- An integrated report explains **how an organization creates value** over time
- Value is **not created by or within the organization alone**
- Instead, it is
 - Influenced by the external environment
 - Created through relationships with stakeholders
 - Dependent on various resources
- An integrated report **aims to provide insight** about:
 - The **external environment** that affects an organization
 - The **resources and the relationships used and affected** by the organization (referred to as “capitals” under <IR>)
 - How the organization **interacts** with the external environment and the capitals

The value creation process

- At the **core of the organization** is its business model, which **draws on various capitals 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 capitals**.
- 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 longer term **viability**.

Integrated reporting <IR> – Value Creation



Integrated reporting <IR> – Capitals

The **capitals are stocks of value** that are **increased, decreased or transformed through the activities and outputs** of the organization.

- **Financial capital** – The **pool of funds** that is:
 - available to an organization for use in the production of goods or the provision of services
 - obtained through financing, such as debt, equity or grants, or generated through operations or investments

- **Manufactured capital** – **Manufactured physical objects** that are **available 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)

Integrated reporting <IR> – Capitals

The **capitals are stocks of value** that are **increased, decreased or transformed through the activities and outputs** of the organization.

- **Intellectual capital** – Organizational, knowledge-based intangibles, including:
 - intellectual property, such as patents, copyrights, software, rights and licences
 - “organizational capital” such as tacit knowledge, systems, procedures and protocols

- **Human capital** – People’s competencies, capabilities and experience, and their motivations 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

Integrated reporting <IR> – Capitals

The **capitals are stocks of value** that are **increased, decreased or transformed through the activities and outputs** of the organization.

- **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, including
 - shared norms, and common values and behaviours
 - key stakeholder relationships, and the trust and willingness to engage that an organization has developed and strives to build
- **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, including:
 - air, water, land, minerals and forests
 - biodiversity and eco-system health

Integrated reporting <IR> – Capitals

- Not all capitals are equally relevant or applicable to all organizations
- Organizations may categorize the capitals differently
 - For example: Relationships with external stakeholders and the intangibles associated with brand and reputation (social and relationship capital), might be considered by some organizations to be
 - separate capitals,
 - part of other capitals or
 - cutting across a number of individual capitals
 - Another example: Some organizations define intellectual capital as comprising what they identify as human, “structural” and “relational” capitals

Reporting value – Quantitative indicators

- **Quantitative indicators**, such as KPIs and monetized metrics, and the context in which they are provided can be very helpful in explaining
 - How an organization creates value
 - How it uses and affects various capitals
- Can help **increase comparability** and are particularly helpful in expressing and reporting against **targets** if suitable
 - Relevant to the circumstances of the organization
 - Consistent with indicators used internally by those charged with governance
 - Presented for multiple periods (e.g., three or more periods) to provide an appreciation of trends
- But, be careful: **Purpose** of an integrated report is **not to quantify or monetize the value of the organization** at a point in time, the value it creates over a period, or its uses of or effects on **all** the capitals

Reporting value – Qualitative information

- The ability of an organization to create value can **best be reported** through a **combination of quantitative and qualitative information**
- **Qualitative information** to **provide context and improve meaningfulness**
- Relevant qualitative information **includes** an explanation of:
 - **Measurement methods** and underlying assumptions
 - The **reasons for significant variations** from targets, trends or benchmarks,
 - and why they are or are not expected to reoccur



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Recap and Next week