IR Insight

Prepared by Tokyo consultancy Investor Impact, Inc., **IR Insight** provides analysis about the latest IR trends and recommendations on communications strategies that positively impact corporate value.

April 2013

INVESTOR IMPACT

Integrated Reporting: Fundamental Issues for IR—Target Audience & Materiality

DEBATING about integrated reporting

One of the most-debated issues in investor relations (IR) today is "integrating reporting," and whether or not to prepare an "integrated report."

First, let us define some terms. The International Integrated Reporting Council (IIRC), which is a global coalition of regulators, investors, companies, standard setters, the accounting profession, and NGOs, has stated that:

✓ "An integrated report is a concise communication about how an organization's strategy, governance, performance, and prospects lead to the creation of value over the short, medium, and long terms."[1]

And according to KPMG:

✓ "Integrated Reporting provides a basis for organizations to explain their business story more effectively to the capital markets. Any organization can apply Integrated Reporting principles to improve their Annual Report. Reporting is built around the business model to provide a more-complete understanding of long-term business value. Reports do not replace existing financial and

1 IIRC, *Integrated Reporting <IR>*, "What is Integrated Reporting <IR>?," http://www.theiirc.org/

sustainability reporting though they may link to or incorporate it where relevant."[2]

WHAT is the current status of integrated reporting?

Relatively few companies so far, but the trend is gradually upward: According to the *KPMG International Survey of Corporate Responsibility Report 2011*, "…it is clear that most [surveyed companies] of those [surveyed companies] that claim to integrate CR [corporate responsibility] only go as far as including a special section in their annual report. Given that the vast majority now communicate their CR information across multiple channels, it seems clear that integrated reporting already encompasses more than just the annual reporting process." And elsewhere in the 2011 KPMG survey: "All this illustrates that integrated reporting is still largely in an experimental stage" and "Currently, one out of every 15 companies [surveyed] weaves environmental and social information into the directors' report to the extent that CR information is virtually indistinguishable from other key business information."

Similarly, according to Corporate Register.com, "During 2011, integrated reports made up around 6% of CR reporting and annual growth is modest but steady …"[3]

In Japan, at the end of 2012 reputedly some 40 companies had issued some form of integrated report.

Overall, our impression is that relatively few companies have made the transition to full-fledged integrated reporting, and that integrated reporting per se is still in the provisional, or "experimental," stage.

WHO are the advocates of integrated reporting?

Management academics: Among advocates of integrated reporting, David Kiron, executive editor of Innovation Hubs for MIT Sloan Management Review, and Robert Eccles, a professor of management practice at Harvard Business School, are among the most outspoken. Kiron and Eccles have been quoted as saying, in summary, that companies should "Get ready: Mandated Integrated Reporting Is the Future of

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[2] KPMG, *Integrated Reporting: Performance Insight through Better Business Reporting Issue 2,* "Key Insights," page 41
http://www.kpmg.com/au/en/issuesandinsights/articlespublications/better-business-reporting/pages/integrated-reporting-issue-2.aspx

[3] http://www.corporateregister.com/blog/crra12/getting-to-grips-with-integrated-reporting

Corporate Reporting." But even these two proponents have also been quoted as stating, "For most companies, the question of whether to pursue integrated reporting is optional, and one that they have not yet chosen to pursue." The gradual pace of adoption of integrated reporting by companies seems to underpin these proponents' support of mandatory integrated reporting.

Commentators like Kiron and Eccles, who on balance appear to have a moderately activist turn of mind, apparently believe that they can bring changes to the world because their view is that "reporting has the potential to be a mechanism for not just articulating actions more clearly but for spurring them, too." In other words, if disclosure is mandatory, corporations will have to incorporate the addressing of CSR issues into their strategies. Thus, these two proponents apparently feel the world will become a better place in one or two decades from now because companies will have to deal seriously with environmental and other CSR-related issues.

Nonprofits: The IIRC and the Global Reporting Initiative (GRI), which promotes sustainability reporting, are collaborating on the issue of an integrated reporting framework. In this vein, the IIRC is sponsoring an integrated reporting pilot program aiming at a globally accepted integrated reporting framework, citing the following factors.

Intangibles are playing a growing role in explaining corporate value: In its 2011 working paper, "Towards Integrated Reporting,"[4] The IIRC quotes the findings of consulting firm Ocean Tomo, which issues "Ocean Tomo's Intangible Asset Market Value Study," as an important basis for its advocacy of integrated reporting. According to that study, in 1975 83% of market valuations of the S&P 500 were accounted for by physical and financial factors, and only 17% were due to other factors (including intangibles). By 2009, the situation had changed dramatically. Only 19% of valuations were explained by physical and financial factors and 81% were due to other factors.

Consequently, there is a rising need for information on intangible factors: As a result of this trend, according to the IIRC, "although there is evidence that investors recognize the materiality of non-financial factors, they do not feel that the information they have available is adequate for decision making. For example, while there is management recognition that sustainability issues should be fully integrated into the strategy and

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[4] IIRC, *Towards Integrated Reporting, Communicating Value in the 21st Century* http://theiirc.org/wp-content/uploads/2011/09/IR-Discussion-Paper-2011_spreads.pdf

operations of a company (with 96% of CEOs from the world's largest companies expressing this opinion), only 21% of listed companies report any sustainability information based on Bloomberg research."

For IROs, what practical issues does integrated reporting pose?

An integrated report could mean transitioning from the current suite of disclosure documents, including the annual report (AR), which is the key financial disclosure document for shareholders, and the corporate social responsibility (CSR) report, which, as part of a company's efforts to take responsibility for its impact on the environment and society, aims at a broader mix of stakeholders. Publication of an integrated report would somehow combine the content of the AR and the CSR report into what some commentators have called "One Report."

As mentioned, another approach to integrated reporting is "connected reporting," where financial and CSR information is obtained from a number of connected reports and information sources and media formats.

At least on the surface, "integrating" the content of the AR and CSR report might seem attractive from simply a cost standpoint, but is this the most-vital criteria? The AR is essentially well defined, contains the most-important disclosure items, and is of reasonable length in this era of information overload. CSR reports can be another matter. Some of these now run up to 300 pages. Combining the CSR report with the AR, according to some companies, might somehow place a cap on length and eliminate duplication of information between the two documents. However, a more-careful review of the impact of shifting to integrated reporting suggests that simply combining the two reports might be unsatisfactory to both shareholders and other stakeholders. For shareholders, there would be a marked increase in what some investors perceive as "clutter," or too much information less pertinent to investment decisions. For other stakeholders, such as local communities where companies have production facilities, governmental organizations, or NGOs, the volume and quality of information provided could be insufficient.

QUESTIONS integrated reporting raises

For whom is value to be created? The issue of integrated reporting raises a number of questions. According to the Association of Chartered Certified Accountants (ACCA): "For example, some big issues to be addressed include whether the proposed investor focus is appropriate and the need for clarification about 'value to whom' – whether investors, stakeholders, or society at large. There is also much debate about whether one concise report can meet different needs, and whether an integrated report should be the primary report."

Securities analysts: Analysts have reported they sometimes have a difficult time understanding the real value of an integrated report because of the need to see a clear link between CSR activities and the short- and medium-term performance of the company, as well as its long-term prospects. Here are a few anecdotal snapshots.

- ✓ Analyst in New York: "How integrated reporting is done depends on the company's sector. Energy, drug, or B2C companies can benefit from integrated reporting because the connection with the triple bottom line is clear; for financial firms, the weight should be on the annual report versus CSR-type reporting."
- ✓ Different analyst: "We want to see the link between CSR activities and corporate performance. Please don't give us endless lists of cultural activities, litter cleanups, musical concerts, or charitable events. Focus, please."
- ✓ Another analyst: "Looking at [this company's] integrated report, I immediately searched for a discussion about its business performance, which comes much later in the document. Instead, it appears as if a CSR report has been appended to the front of its AR. Whatever the actual page count, contentwise, it seems 20% of the document is an AR and 80% a CSR report."

A more down-to-earth approach for IR professionals

Refocusing on audiences, their information needs, and materiality: The principal roles of corporate IR departments and IR officers (IROs) in their capacities as interfaces between the companies they work for and investors in Japan and in overseas financial centers include:

- ✓ **Targeting investors**: Identifying their company's audiences among investors, selecting investor targets, and keeping track of investor information needs
- ✓ **Engaging with investors:** Working proactively to engage with and give timely responses to investors
- ✓ **Communicating materiality:** In March 2011, the US Supreme Court ruled "that the materiality requirement under Section 10(b) of the [US] Exchange Act is satisfied when there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information." In this context, IROs have a responsibility to explain the concept of "CSR materiality" to investors, which we may on a

preliminary basis define as the link between CSR issues and the future capabilities of the company to sustainably generate corporate value.

WHAT are the implications?

Why IROs and C-suite management need to work together: The parties acting as driving forces for transitioning to integrated reporting, including nonprofits and business school academics, seem to concentrate on the policy or theoretical level, but are not focused on day-to-day IR—what IROs must do today and tomorrow to obtain a fair valuation for their company's shares, which is the strategic management responsibility of IR.

Accordingly, our view is that "working with C-suite management" and "CSR materiality, namely, linkages between CSR and sustainable corporate value creation," is vital for bringing the issue of integrated reporting to the working level.

To make "working with C-suite management" possible, some companies in Japan will have to reexamine the positioning of IR within their organizations. IROs need to be as close to C-suite management as possible, as they typically are in leading companies in the United States and Europe. C-suite management needs to understand the CSR issues and make an assessment of what is and is not material for the future of the company, and then incorporate it into strategy.

Becoming more closely aligned organizationally is a first step toward making it possible for IROs and C-suite management to demonstrate the "connections between CSR issues and sustainable corporate value creation" and explain to analysts whether particular CSR issues will be material for the company during a specified time period.

KEY IR Insights

1. Globally, integrated reporting is still in the experimental or provisional stage, both in terms of (a) what the standards in integrated reporting are and also (b) the number of companies who say they have produced some form of integrated report.

2. IR is a strategic management responsibility that contributes to a company's securities achieving fair valuation. As such, when CSR information is discussed in an AR, it is more valuable to investors and other stakeholders the more it meets the test of materiality
3. Similarly, an integrated report needs to be focused, easy for busy analysts and investors to comprehend, and linked to corporate performance.

4. A key question is what impact will any plan for an integrated report, or linked reports, have on allowing investors, and other stakeholders, to assess and act on the potential of the company for creation of value over the short, medium, and long terms.
5. As mentioned, "[Integrated reports] do not replace existing financial and sustainability reporting though they may link to or incorporate it where relevant." The best disclosure practices and formats will vary depending on the type of company, industry sector, shareholder and stakeholder mix, cost of capital, and other factors. Indeed, without careful planning, simply deciding to combine the AR and CSR report may well do more harm than good.

As a management and IR focused consultancy, Investor Impact, Inc. impartially recommends the specific mix of disclosure reporting and tools that best meet the financial, strategic management, and corporate communications objectives of each particular client.

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