Integrated reporting
Tips for organizations on elevating value
This paper is designed to give organizations tips on how to implement integrated reporting, strategy and thinking.

For more in-depth analysis, commentary and information graphics, please consult the paper *Integrated reporting: Elevating value*, which can be downloaded at ey.com/ccass
Foreword

Over the past 40 years, reporting has evolved as organizations seek to meet investors’ demands for more information. However, research indicates that investors feel disclosure shortfalls remain, especially in the reporting of strategy, risks and future performance. Also, non-financial information, which is often disclosed in different ways, isn’t easily comparable between organizations.

In the first section of this paper we look at the move to address these issues with more effective performance disclosure through integrated reporting. We believe integrated reporting, as proposed by the International Integrated Reporting Council (IIRC), is the direction for the future of corporate reporting by providing a holistic and longer-term view of an organization’s performance.

We recommend that organizations take into account the guidance of the IIRC when adopting the process of integrated reporting. In this paper we offer our vision on integrated reporting and value creation which goes beyond the IIRC framework where KPIs and monetization are concerned. We are confident it will inform organizations that want to take their reporting to the next level, and help them articulate their unique value creation stories; stories that will ultimately help to attract investors who demand clear performance analyses to assess current and future prospects.

The integrated report is the product of the processes of connectivity and integrated thinking in the organization. Integrated reporting is therefore not just about the report, but about the process of the organization’s unique approach to value creation.

The IIRC is a global coalition of regulators, investors, organizations, standard setters, the accounting profession and NGOs.

Together, this coalition shares the view that communication about businesses’ value creation should be the next step in corporate reporting.

The IIRC aims to create the globally accepted integrated reporting framework. This framework will elicit information from organizations that is material to their strategy, governance, performance and prospects in a clear, concise and comparable format. The IIRC is also seeking to secure the adoption of this framework by report preparers and gain the recognition of standard setters and investors.

More information on the IIRC can be found at www.theiirc.org.
The global economy has been in a state of flux for the last few decades. The market value of organizations has slowly shifted from a price based largely on tangible assets to greater emphasis on intangible assets. In turn, the concept of value has shifted and broadened. Therefore, now, more than ever, creating sustainable value for organizations depends on two things:

- Adapting to change and the challenges and opportunities in their environments
- Effectively managing intangible assets, which can represent a substantial portion of market value

Integrated reporting is a new concept that has been created to better articulate the broader range of metrics that contribute to long-term value and the role organizations play in society. Central to the approach is the view that today, value is increasingly shaped by factors such as reliance on the environment, social reputation, human capital skills and others. This value creation concept is the backbone of integrated reporting and, we believe, is the direction of the future of corporate reporting.

Today, organizations rely on increasingly scarce resources. They own some of these resources but others are owned by society. The value creation process is based on the concept of “shared value”. All economic activity consumes resources that to some extent belong to society. The value created by an organization should therefore be shared between its owners and society and other stakeholders. This is known as co-creation and this share value process can be seen as one of the fundamentals of integrated reporting. However, current approaches to financial reporting don’t make it easy to assess an organization’s long-term value creation prospects therefore are not deemed sufficient by investors.

There are two key interrelated reasons for investor unease:1 First, it’s not easy to compare non-financial information that’s often accounted for in different ways. And second, intangible assets – as the graphic below shows – have gone from accounting for just 17% of market value in 1975 to 80% by 2010 (based on the S&P 500). Integrated reporting aims to explain how organizations use both tangible and intangible assets to better demonstrate sustainable value creation. The most essential part of showing sustainable value creation is describing the strategy and business model.

1 ACCA, Eurosif; “What do investors expect from non-financial reporting,” June 2013.

### Increasing value of intangible assets

**Components of S&P 500 market value**

<table>
<thead>
<tr>
<th>Year</th>
<th>Intangible Assets</th>
<th>Tangible Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>17%</td>
<td>83%</td>
</tr>
<tr>
<td>1985</td>
<td>32%</td>
<td>68%</td>
</tr>
<tr>
<td>1995</td>
<td>68%</td>
<td>32%</td>
</tr>
<tr>
<td>2005</td>
<td>20%</td>
<td>80%</td>
</tr>
<tr>
<td>2010</td>
<td>20%</td>
<td>80%</td>
</tr>
</tbody>
</table>

Changing corporate reporting

The global economy is changing and our current ways of measuring and reporting value have not yet adapted to the pace of this change. Integrated reporting could provide a more holistic picture of this value.

The IIRC Framework gives guidance on what an integrated report should address. Integrated reporting goes beyond just creating a report. It refers to the underlying thought process and can result in a written account in a report. Elements to consider according to the IIRC framework are: organizational overview and external environment; governance; business model; risks and opportunities; strategy; performance; outlook; and basis of preparation and presentation.

South Africa is at the forefront of integrated reporting – as of 2009 it became the first country to include integrated reporting concepts into official reporting requirements – on an “apply or explain” basis.

In the following section we look at the key components of an integrated report including: the business model; capitals (tangible and intangible); key performance indicators; risk and opportunity management; materiality; and accounting for value.

Many of the components of an integrated report are strategic in nature. The framework therefore stresses the importance of the involvement of those charged with governance in preparation of the report. An explicit statement on their involvement, as requested in the framework, could contribute to the overall reliability of the report and can contribute to widespread support in the organization as well.
3.1 The business model

The definition of the business model lies at the heart of the integrated report. It defines the essence of the organization and maps out the processes by which sustainable value is created. When describing the business model in an integrated report we recommend considering the following questions:

- How does the organization define value?
- What are the organization’s mission and vision?
- What’s the organization’s environment?
- How does the organization define its strategy and what resources does it use?
- What are the main opportunities and challenges faced by the organization?
- What indicators are meaningful in terms of measuring the extent to which the organization achieves its stated value creation goals?

The input and output of the business model described in terms of capitals is explained in the next section.

3.2 The multiple capitals model

A central tenet of integrated reporting is a belief that sustainable development requires a balance between economic progress, social advances and environmental protection. This requires an approach that distinguishes between different kinds of capitals and accounts for both tangible and intangible assets. The new economy could require capturing the full contribution of all capitals to effectively show business performance.

The IIRC identifies six capitals: natural; social and relationship; human; intellectual; manufactured; and financial. Prevailing accounting regulations seriously limit the ability to recognize internally generated intangible assets on the balance sheet. Integrated reporting aims to track how the various capitals are used, how they relate to each other and the trade-offs the organization makes.

The business model and strategy will articulate how capitals will translate into value creation and can be measured by the use of key performance indicators (KPI).

EY insight: securing management buy-in and building a team of talent

When starting your project, securing senior management buy-in for integrated reporting is critical. In addition, we recommend bringing together talent from across the organization to create both a steering committee and operational team. The steering committee typically includes senior representatives from finance, compliance, sustainability, HR, operations, legal and internal audit. The operational team usually involves additional people from the above-mentioned groups to form a cross-functional team which is responsible for gathering the core information and reporting back to the steering committee. While either sustainability or financial teams often initiate integrated reporting projects, involving teams from across the organization, and convincing them of the benefit, will help build momentum behind the project.

EY insight: assess the gaps

The business case for integrated reporting can be developed around the value creation story for shareholders and the improvements in planning and measurement that will help build long-term sustainable value.

A practical first step to achieve this is to benchmark the reporting data the organization has against the IIRC framework. This will reveal any additional information the organization needs to align with the IIRC framework. If the organization needs to create new sources of data, preparing a timetable to collect this information will be part of the key milestones for the project. Given that your teams will already be busy, we have created processes that will help you define a realistic time-line and benchmarks for how to move to integrated reporting and deliver the project as efficiently as possible.
3.3 Strategy and key performance indicators

The strategy should describe the process and tools earmarked for value creation for shareholders and other key stakeholders such as customers, suppliers, employees and society as a whole. We recommend that it also:

• Articulate a balance between short-term financial performance and sustainable value creation over the longer-term
• Discuss the choices to be made when consuming resources and show how resources are used as efficiently as possible
• Explain how intangible assets relate to strategy and the value the assets have
• Focus on the issues that have a clear material impact on the business

KPIs allow for quantification of value. They also provide a means for tangible and intangible assets to be measured, other than just monetary. When senior management determines the appropriate indicators, management can focus on monitoring strategic and material matters, while investors can assess value creation.

The exercise also allows organizations to understand how to minimize negative externalities (externalities are an organization’s impact – positive or negative – on capitals, including society as a whole) and maximize positive ones. This will shore up the value of their intangible assets and, by extension, their performance.

It’s necessary to link measurable indicators (e.g., employee turnover, energy efficiency, media coverage) and their impact on the organization’s tangible and intangible assets (such as brand, and customer relationships) that have a direct impact on shareholder value. For example, KPIs related to waste reduction generated by a manufacturing operation might indirectly measure the creation of external value (enhanced environmental performance), as well as the value of the organization’s intangible assets (e.g., better reputation among customers with the corresponding impact on customer loyalty). Integrated reports should disclose the KPIs used by management to track performance. This helps investors compare organizations and understand their performance.

**EY insight: define and align materiality and performance indicators to the business strategy**

Identifying the issues and capitals that have a material impact on performance is pivotal to effective integrating reporting. This can seem like a challenging task given the range of issues that influence value creation. Knowing this, we have worked with clients who are releasing the first wave of integrated reports, developing processes that take into account the business model, challenges, vision, strategy, sustainable business activities, performance and future outlook to more easily identify material issues. The processes help organizations efficiently conclude what can be a time-consuming activity. And critically, they define the vast, repeatable and comparable KPIs – based on the balance between tangible/intangible assets and asset depletion – that help investors fully assess value creation over time.
3.4 Risk and opportunity management

Effective risk management is crucial to ensuring the viability of the value creation process and achieving the strategic value creation targets. This requires incorporating risk management into the organization’s decision-making process as well as strategy, then aligning it with prevailing industry circumstances. The goal is to reduce uncertainty with respect to the organization’s performance and future resilience. It’s important to explain risk management processes in the integrated report as they are a clear indicator of likely long-term value. It’s also important to explain the scope of the integrated report.

3.5 Materiality defined

A materiality assessment is crucial to ensure that the report focuses on the factors that significantly impact value creation now, and performance over the longer term. Determining what should be disclosed can be based on:

- **Relevance**: Matters that have already impacted the organization’s strategy, business model or strategic capitals, or may do so in the future
- **Significance**: An assessment of a matter’s significance and probability of occurrence
- **Prioritization**: People charged with the organization’s governance need to prioritize the material matters based on their relevance and significance to investors

**EY insight: determining material matters**

To pinpoint the material factors, we advise starting with a broad list of matters related to the various capitals that your organization depends on. This list is filtered as a function of internal factors (such as strategy, based on the concept of value creation, and the risks emerging from the enterprise risk management system) and external factors (the needs, interests and expectations of stakeholders). This will determine the material matters to investors that influence value over time and therefore need to be disclosed in the integrated report. Determining materiality in an integrated report requires the use of the above criteria in a four-step framework, as offered in the graphic below.
Measuring value creation

Value is created or destroyed by an organization by how it uses and affects the various capitals. In general, the value created by an organization materializes in tangible and intangible assets when it affects the capitals owned by the organization. In addition, it can affect the externalities when capitals are owned by others.

When externalities are positive, they are a source of competitive advantage and perhaps financial returns in the longer term. In fact, an organization can turn the production of positive externalities into an intangible asset or a driver for increasing the value of existing intangibles. For this to happen, an organization has to be able to identify these externalities, estimate their value whenever possible and communicate them to the market.

For instance, the production of renewable energy could have an impact on the reduction of a nation's foreign energy dependence (economic externalities), on jobs (social) and on the preservation of natural capital by reducing emissions (environmental).

With natural capital increasingly scarce, environmental externalities are becoming a key economic issue as clearly illustrated in the graphic below. It is estimated that the external environmental costs caused by human activity on a global scale were around US$6.6 trillion in 2008, or 10.97% of world GDP that year. The projections for 2050 estimate growth in external environmental costs of 62%, which is a total of 17.78% of global GDP.

4.1 Monetization of intangibles

It is possible to measure changes in the value of intangibles as a result of a sustainable growth strategy or a specific initiative. These initiatives can be communicated to show the value of intangibles in an integrated report. The process of identifying and measuring intangibles and communicating the outcome can help investors to:

- Recognize, to a greater extent, the cash flows that the organization is capable of generating in the future
- Associate the generation of these cash flows with the various intangible assets that create value on a sustainable basis
- Perceive reduced investment risk

Environmental impact

<table>
<thead>
<tr>
<th>Environmental Impact</th>
<th>External costs in 2008 (US$ billions)</th>
<th>External costs relative to global GDP in 2008</th>
<th>Projected external costs in 2050 (US$ billions)</th>
<th>Projected external costs relative to global GDP in 2050</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greenhouse gas (GHG) emissions</td>
<td>4,530</td>
<td>7.54%</td>
<td>20,809</td>
<td>12.93%</td>
</tr>
<tr>
<td>Water abstraction</td>
<td>1,226</td>
<td>2.04%</td>
<td>4,702</td>
<td>2.92%</td>
</tr>
<tr>
<td>Pollution (SOx, NOx, PM, VOCs, mercury)</td>
<td>546</td>
<td>0.91%</td>
<td>1,926</td>
<td>1.20%</td>
</tr>
<tr>
<td>General waste</td>
<td>197</td>
<td>0.33%</td>
<td>635</td>
<td>0.39%</td>
</tr>
<tr>
<td>Natural resources</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Fish</td>
<td>54</td>
<td>0.09%</td>
<td>287</td>
<td>0.18%</td>
</tr>
<tr>
<td>- Timber</td>
<td>42</td>
<td>0.07%</td>
<td>256</td>
<td>0.16%</td>
</tr>
<tr>
<td>Other ecosystem services, pollutants and waste</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Total</td>
<td>6,596</td>
<td>10.97%</td>
<td>26,615</td>
<td>17.78%</td>
</tr>
</tbody>
</table>

4.2 Monetization of externalities

The extended value an organization produces or destroys impacts the value of its intangibles such as brand reputation or license to operate. It can also reveal the long-term feasibility of the business model and whether it relies excessively on a contribution from society or the environment.

There are a wide variety of externalities produced as a consequence of business activity. The first challenge lies with acknowledging or identifying their existence. When the externality is destroying society's value (e.g., global warming or biodiversity loss), the challenge is how to mitigate the impact and develop a “profit and loss” approach to identify mitigation costs and compare them with the value for society of implementing mitigation actions. These efforts should be communicated to the market because they can contribute to preserving or increasing intangible asset value. They can also show a decrease due to hidden intangibles which can affect value in a negative way.

Some approaches to estimate the impact of externalities on the value of intangible assets include:

- Relating externalities generated with share price
- Increasing customer loyalty or brand equity
- Securing bids for operating licenses or public tenders, paving the way for operating cost savings within the organization as well as geographic and sales growth
- Reducing energy dependence and natural capital depletion
- Proactively reducing negative externalities (this can reduce the potential for more legislation)

EY insight: secure consensus

Integrated reporting goes beyond today’s reporting requirements. And with some clients, we have seen that parts of the business — e.g., legal — teams in some might be concerned that revealing too much information could blunt the competitive edge. Because of this it is important to realize the difference between having a strategy, executing a strategy and communicating the strategy. We guide an organization’s project team in order to help them strike the right balance between protecting the organization’s competitive standing and giving stakeholders clear indicators of its long-term sustainable value prospects, thus securing consensus.
4.3 The value of measuring value

There are challenges to overcome when measuring and monetizing value. For instance, a lack of one global monetization guideline limits consistency and comparability of monetized outcomes. Secondly, monetizing externalities poses a challenge as it’s heavily based on assumptions. Additionally, in some regions, there may be limitations on what can be disclosed in terms of monetized value within an integrated report. Finally, revealing excessive detail regarding monetized value can be seen as a risk.

Despite these challenges, there are significant benefits in measuring value. Most importantly, it clearly demonstrates the extent of the positive or negative impacts on each of the capitals caused by the value-adding activities of the business model. It also assists in the process of ensuring that growth in the value of one capital doesn’t depend (at least excessively) on the destruction of another capital’s value. And critically, it helps investors better understand, “what’s in this for me?”

EY insight: building corporate reputation

In the last few years, integrated reporting has come to the fore. This is partly due to a belief that the onus on short-term performance metrics had become too prominent. Also, markets are pushing for fuller disclosure that includes an accepted way to evaluate and compare intangible assets. Recognition is growing among organizations that the discipline of integrated reporting can create improvements. These improvements include strategic planning, the delivery of that strategy and performance measurement.

Over time, we anticipate integrated reporting playing a role in legislation in more regions. A number of our clients are moving to integrated reporting to be ahead of this trend. They have concluded that the financial and time investment will pay back by differentiating their business, enhancing reputation and building closer relationships with stakeholders.

Contacts

EY Climate Change and Sustainability Services

For further information on integrated reporting and other EY climate change and sustainability services, please contact:

Area leaders
Juan Costa Climent
Global, Europe, Middle East, India and Africa (EMEIA)
T: +34 9 1572 7381

Christophe Schmeitzky
Europe, Middle East, India and Africa (EMEIA)
T: +33 1 4693 7548
E: christophe.schmeitzky@fr.ey.com

Steve Starbuzz
Americas
T: +1 704 331 1980
E: stephen.starbuck02@ey.com

Mathew Nelson
Asia-Pacific
T: +61 3 9288 8121
E: mathew.nelson@au.ey.com

Kenji Sawami
Japan
T: +81 3 4582 8044
E: sawami-knj@shinnihon.or.jp

Lucia Argüelles
Global
T: +34 93 366 3709
E: lucia.arguelles@es.ey.com

Integrated reporting specialists
Hugo Hollander
Global, Europe, Middle East, India and Africa (EMEIA)
T: +31 88 40 74059
E: hugo.hollander@nl.ey.com

Hester Touwen
Global
T: +31 88 40 7 3115
E: hester.touwen@nl.ey.com

Brendan LeBlanc
Americas
T: +1 617 585 1819
E: brendan.leblanc@ey.com

Matthew Bell
Asia Pacific
T: +61 2 9248 4216
E: matthew.bell@au.ey.com
About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity, Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

About EY’s Climate Change and Sustainability Services

Governments and organizations around the world are increasingly focusing on the environmental, social and economic impacts of climate change and the drive for sustainability.

Your business may face new regulatory requirements and rising stakeholder concerns. There may be opportunities for cost reduction and revenue generation. Embedding a sustainable approach into core business activities could be a complex transformation to create long-term shareholder value.

The industry and countries in which you operate as well as your extended business relationships introduce specific challenges, responsibilities and opportunities.

Our global, multidisciplinary team combines our experience in assurance, tax, transactions and advisory with climate change and sustainability skills and experience in your industry. You’ll receive a tailored service supported by global methodologies to address issues relating to your specific needs. Wherever you are in the world, EY can provide the right professionals to support you in reaching your sustainability goals.

© 2014 EYGM Limited.
All Rights Reserved.

EYG no. AU2356
ED none

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.