

Integrated Reporting: Addressing the reporting gap

There is a gap between current corporate reporting and investor needs. Some companies are taking the initiative to fill this gap through their narrative reporting. Integrated Reporting is one solution that could help you communicate your business story more effectively.



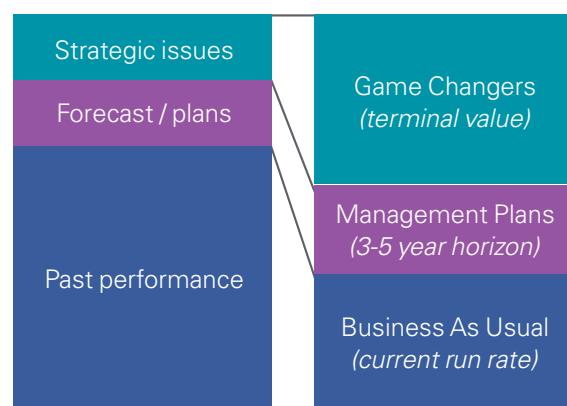
Investors and company boards have struggled for years to get a true picture of business value and how management is driving the business forward. The trend towards Integrated Reporting is being hailed as one way to close the gap between current reporting and investor needs.

Historical financial information plays an essential role in corporate reporting, but on its own fails to provide a complete picture of business value. More is needed to help readers understand how management is driving the business forward and how changes in the business environment might present new opportunities and challenges. Readers need a more forward looking focus to help them form their own views on how such issues may affect the business in the future - without necessarily requiring companies to provide forecasts or projections themselves .

The reporting gap

Reporting content

Business value



Businesses themselves have recognized the benefits of presenting a more complete picture of company value. We have seen this with the growth of less formal reporting channels such as Investor and Strategy Presentations. But this is not a complete solution in itself. The relevance of these free-form presentations varies, and there are corporate governance questions over the desirability of releasing price sensitive information through less formal channels, particularly without the back stop of the Annual Report.



A smaller group of companies have taken this a step further, aligning the narrative reporting in their Annual Report more closely with business value. The result has been significant improvement in the relevance of these companies' reports, yet many have not followed suit. One of the reasons for this is that there has been no definition of a 'good report' to follow. How do you even define 'good' when every company's value drivers are unique? A traditional compliance based approach is unlikely to provide the answer.

The International Integrated Reporting Council (IIRC), believes it has found the solution to closing the reporting gap. Its draft framework for an Integrated Report provides a principles based approach to reporting that should be of interest to every business – whether they are looking to produce a separate 'Integrated Report' or simply looking to improve the relevance of their Annual Report.

An Integrated Reporting approach to improving the annual report

Integrated Reporting ('IR') is built around seven components of content: Business Model; External Environment; Opportunities and Risks; Strategy; Performance; Future Outlook; and Governance. By linking content across these components, an Integrated Report can build the story of the business from a basic description of the business model, through the external factors affecting the business and management's strategy for dealing with them and developing the business. This provides a foundation from which to discuss the performance, prospects and governance of the business in a way that focuses on its most important aspects.

The linkage across the content elements helps determine what should and, importantly, what should not be included in the report. For example, if a central part of your business strategy involves developing a particular market, the logic of IR implies that you should be reporting on progress in developing that market. The result should be a report focused on the key drivers of business value - typically built around a thread of five or six key

issues that run throughout the report. These should be the same issues that management is focused on in the day-to-day operation of the business, and the same issues that should be driving investment decision making.

How will Integrated Reporting change the information being reported?

The information relevant to each business will be different but broadly we would expect IR to result in:

- More operationally focused measures of performance – information that will help readers understand progress in implementing strategy, developing business assets, and creating new income streams – leading indicators of performance rather than lagging ones.
- Greater focus on explaining how key business assets (such as the customer base, intellectual property, and reputation) have been managed and enhanced in line with the business strategy and changes to the external operating environment.
- More emphasis on explaining factors driving future performance – helping readers form *their own* views on what those factors are and how they might impact on future performance.

This should lead to reports that are far more aligned with investors' own cash flow valuation models. In particular, providing a clearer picture of how management's plans and changes in the operating environment are likely to affect medium term returns, and also helping investors assess the substantial element of value that is typically locked up in the 'terminal value' element of their models.

For executives frustrated by apparent investor short-termism, this is an opportunity to provide a more complete picture of value, how it's shaped by current and future events, and to explain what management is doing to create and preserve it.

Integrated Reporting in practice

South Africa has been a leader in the implementation of IR where (under the King III code) listed companies now need to adopt IR on an 'apply or explain' basis. It is early days yet but there has generally been a positive response from JSE-listed companies. This is increasingly reflected in some of the year-two reporting now being produced – full implementation of IR is a journey that will take several years to become fully established as companies' information systems adapt to the new requirements.

While the perfect integrated report has yet to be produced, KPMG's research shows there are many examples of the IR values being applied to individual reporting elements. Many come from South Africa but others come from companies simply looking to provide a clearer picture of their business and its value. The extractive and pharmaceuticals industries provide many good examples of reporting on non-financial assets.

Moving forwards with Integrated Reporting

IR takes a very different approach to narrative reporting. Understanding its full implications requires careful thought about how it should be applied to your unique business model and strategy. We are finding that many companies are interested in taking this first step as a basis for assessing the cost-benefit balance of moving forwards on a voluntary basis.

Ultimately, though, this is about business making its case for capital in a more effective way – bridging the gap between management's value creation story and investors' assessment of business value and stewardship. Whether or not IR becomes incorporated into the regulatory agenda, this evolution in reporting should at the very least be on your radar.

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