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cutting through complexity

Corporate reporting reform – better alignment with investor decision making

The Journey to Better Business Reporting Continues

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"For long-term investors such as superannuation funds, it is essential that companies identify the risks, opportunities and key strategic issues that are relevant to them and to the industry in which they operate – and explain to their stakeholders how they are managing these. A lack of reliable and comparable disclosure of material corporate performance information, beyond that contained in traditional financial reporting, can undermine effective communication of these longer-term measures of business success by companies to their investors.

The Australian Council of Superannuation Investors (ACSI) sees the International Integrated Reporting <IR> Framework as a critical catalyst for fresh thinking and innovation within reporting entities, to better align their communication with the needs of all of their stakeholders including long-term investors. Along with other initiatives such as recent updates to the ASX Corporate Governance Council Principles & Recommendations, we expect to see <IR> contributing to an improvement in corporate disclosure practices within the ASX-listed entities that are the focus of ACSI's work, as well as more generally in Australia and internationally. We also believe that the <IR> Framework can be of great value to the investment managers engaged by ACSI's member funds, helping to deepen their integration of material risks and opportunities into their investment decision-making."

Gordon Hagart
CEO, Australian Council of Superannuation Investors
July 2014
www.acsi.org.au

Foreword

Corporate reporting reform is well underway in Australia and around the world – investors have a critical interest and role in driving the change agenda. Financial statements play an essential role in communicating business performance but cannot provide a complete picture on their own. The focus for reporting improvement is now switching to other aspects of the reporting portfolio to provide insight and analysis that can support an assessment of the organisation's prospects.

This publication outlines recent changes and trends in improving the quality of information provided to the capital markets. We focus on the recent change to ASX Corporate Governance Principle 4, which brings all corporate reporting within the realm of director oversight. We explain the investor's interest and role in developing a corporate reporting environment which is better aligned with the information they need for their assessments of stewardship and business prospects. We believe that investors and directors investing in long term business prospects have a common interest in reporting that addresses this.

We note current director concerns regarding potential director liability for forward-looking statements, and the need for them to engage with investors to support change. We discuss the opportunity to evolve the annual report into the 'flagship' report, at the centre of the portfolio which explains how the company has created value to date, and importantly how it is set up to deliver future value for shareholders in the short, medium and long term.

The flagship report, which could be the Operating & Financial Review (OFR) in the Australian context, would be based on the International Integrated Reporting Council's (IIRC) International Integrated Reporting <IR> Framework (<IR> Framework). According to the IIRC's research, elements of the <IR> Framework are already being adopted by over 1,000 global companies, and the trend is growing. Although this is not an education paper on integrated reporting (more information is available at www.kpmg.com/betterbusinessreporting), we do explain what integrated reporting is and is not.

We also explain how integrated reports can improve the quality of engagement between companies and their providers of financial capital, as well as the quality of the information provided by the company to assist investors and analysts refine their models and make capital allocation decisions. We also look at why this is the case, and to what extent assurance could be provided to support confidence over the reliability of a flagship report.

Corporate reporting, and especially an integrated report, is prepared by organisations for their providers of financial capital. Investors have the opportunity to use the recent changes in the corporate reporting environment to support and encourage companies to refine their corporate reporting portfolios to better address their information needs.

This paper is one of a series of three being issued by KPMG. The other two papers cover corporate reporting reform from a CFO and a director perspective.

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In brief

- **Investor interest in integrated reporting <IR> is gaining momentum, driven by the need to align the information companies report more closely with the drivers of their value**
- **The <IR> Framework was developed to support more informed interactions between organisations and their providers of financial capital, focusing reporting on what is material and strategically important to long-term value creation**
- **The broader perspective provided by an Integrated Report can help investors better assess both stewardship and business value**
- **Investors and analysts should work with companies as they review their corporate reporting portfolios, as required under the revised ASX Corporate Governance Principles**

The case for reforming corporate reporting to meet investors' needs

There is at times a disconnect between how public companies report on corporate performance and the information needs and interests of investors and other stakeholders.

Corporate reporting is becoming ever more voluminous and complex as a result of a range of pressures and requirements (accounting standards, mitigation of legal risks and a widening range of stakeholder demands). There is a cost to this in terms of clarity and succinctness of information, but is the information being provided any more relevant? While acutely aware of these problems, directors are also concerned about potential personal liability for forward-looking statements made in corporate reports as well as about the level of assurance required to support the integrity of the information published.

Investor needs are often on the flipside of these matters – getting fast access to key company information (both from the company and other sources) in a reliable, accessible form to help them make reasonably informed and more precise decisions about capital allocation.

Companies and investors alike therefore share a frustration with today's corporate reporting model. They share common interests. They have seen corporate reporting 'improvements' come and go, but are still left with a sense that things could and should be better for both report preparers and report users.

From an investor's perspective, previous reporting initiatives have not delivered the step change needed to help them make significantly better capital allocation decisions (particularly regarding long term investments) nor reduced reporting volume and complexity. Investors have become skeptical about new reporting initiatives, and this understandably applies to <IR> which is not yet widely understood[1].

It is time for a more meaningful dialogue on corporate reporting between investors and the companies they invest in. Both would benefit from working together to improve capital market information flows via a continuing process of corporate reporting reform, focused on a common objective.

1 Integrated Reporting (<IR>): A process founded on integrated thinking that results in a periodic integrated report by an organization about value creation over time and related communications regarding aspects of value creation. 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 in the short, medium and long term. The International Integrated Reporting Council (IIRC) issued its International Integrated Reporting <IR> Framework in December 2013 (www.theiirc.org).

The role <IR> could play in corporate reporting reform

<IR> has the potential to support corporate reporting reform. However, the uptake of <IR> has so far been sporadic:

- <IR> remains a relatively new concept. The <IR> Framework was only released in December 2013 after a 3-year trial. It is still in early adopter territory.
- Misunderstandings persist around the concept of <IR> – what it is and is not. For example, a common misconception is that an integrated report is simply about communicating sustainability matters. Another misconception is that <IR> may add another layer of corporate reporting.
- There is a lack of awareness of how the <IR> Framework could assist organisations to explain to their investors how they create value.
- The application of the <IR> Framework has been of mixed quality to date.

Nevertheless, investor interest in, and demand for <IR>, is growing as evidence emerges of its capacity to provide more complete information (strategic, balanced, forward-looking, concise and focused on material value drivers and risks).

In South Africa, investors have been receiving integrated reports for 3 years under local corporate governance rules. We outline later in this report some of the initial challenges and lessons learned from the South African experience, as well as some of the benefits now being realised.

Investors in the IIRC's investor network[2] have reported that the early integrated reports they received were useful in communicating a more holistic view of performance objectives and results than was the case with traditional financial reports. Compared with conventional reporting, integrated reports also allowed greater insight into issues such as strategy, risk management, governance and the future outlook. Investors felt that the integrated reports provide a contextual foundation for interpretation and analysis, enabling them to make more precise and forward looking capital allocation decisions based upon better analysis of estimated future (risk-adjusted) cash flows.

The IIRC has recently established the Integrated Reporting Pension Fund network working closely with the Australian Council of Superannuation Investors (ACSI) and the Australian Institute of Superannuation Trustees (AIST) in Australia and several industry funds. This group is reaching out globally to major funds throughout the world, with an initial focus on preparing their own integrated reports.

In the absence of widespread adoption of the <IR> Framework, the case for investor and analyst interest can also be built at a sector level, especially those sectors needing significant capital investment such as the infrastructure sector.

One of the biggest economic challenges facing governments around the world is how to meet the growing demand for infrastructure development[3]. It has been estimated by McKinsey and Standard and Poors that US $3.2 trillion will be needed each year for the next 15 years to fund infrastructure development. However, the shortfall in available funds is significant – estimated at $500 billion annually.

In an Australian context, the need for significant investment in infrastructure is well established although questions regarding the sourcing of the finance necessary for these developments remain a critical issue.

The Business 20 (B20), which brings together business leaders from the G20 countries, in 2013 asked the six largest international accounting networks to analyse the issue and develop practical recommendations that would promote more long-term investment from non-government sources in infrastructure.

In June 2014, the B20 Panel of six international accounting networks released a paper entitled *Unlocking Investment in Infrastructure – Is current accounting a barrier?* within which the Panel recommended that the B20 make the following actionable recommendations to the G20:

"Encourage corporate reporting innovations and initiatives that provide investors with a longer-term and broader perspective on shareholder value creation to complement the historical financial performance and current financial position perspective provided by financial statements. The B20 notes the particular relevance of integrated reporting as an example in this respect. Each G20 Finance Minister should assess and address any practical, legal or statutory barriers in order to make corporate reporting more conducive to infrastructure and other long-term investment."

Each G20 nation will need to find its own pathway to adoption of integrated reporting within their own legislative framework. For Australia, we note that a non-mandatory model, similar to the Johannesburg Stock Exchange's 'apply or explain' rule and aligned with the current Corporate Governance Principles of the ASX Corporate Governance Council, may work well.

Integrated reports can help investors (and financiers) gain a more meaningful understanding of the business model supporting an infrastructure or investment proposition.

Barriers to better corporate reporting

For widespread adoption of <IR> to occur in Australia, two key matters require clarification.

1) **Director liability** and the current impediments for forward-looking statements.

   At this stage investors remain to be convinced of the need for director liability reform, and yet for many directors resolving this issue is an essential prerequisite in enabling more forward-looking material to be included in OFRs and full application of the <IR> Framework.

   To this end, the Chairman of the Australian Business Reporting Leaders Forum (BRLF) recently wrote[4] to the Federal Government asking that it bring company directors and investor groups together so that a framework for legislation that would provide an 'honest and reasonable' defence for individual director liability could be implemented. This change is a critical pre step to enable a fully developed <IR> regime.

2) **Development of an assurance** framework for integrated reports.

   An important issue raised by a number of investors as well as directors is the underlying quality of the broader information set provided in the integrated report, and the potential need for a high quality <IR> assurance framework. It is, after all, a common investor complaint that companies tend to emphasise the good news in their communications. Companies have some way to go before they would be ready for assurance over an integrated report but it is certainly possible to assure both the accuracy and range of information being communicated if there is demand.

   We expect that assurance on integrated reports, including both limited and reasonable assurance, will be possible as demand for it develops, along with the quality of the underlying reporting practices. The IIRC are working with the International Auditing & Assurance Standards Board on how to bring <IR> assurance within the international auditing and assurance standards framework.

2 The IIRC's Investor Network includes AMP Capital Investors, Colonial First State Global Asset Management ACSI and Financial Services Council from Australia, and Goldman Sachs, Hermes, Deutche Bank and CFA Institute internationally. Refer www.theiirc.org/companies-and-investors/pilot-programme-investor-network/for full details.

3 McKinsey Global Institute Report – Infrastructure productivity: How to save $1 trillion a year, 2013 www.mckinsey.com/insights/engineering_constructioninfrastructure_productivity.

4 Paper available on the BRLF website at www.ske.org.au/BRLF

What <IR> is and is not

Many investors and other capital market participants misunderstand the underlying purpose of <IR> which at the highest level is to provide more meaningful information to investors about a company's ability to create value now and in the future. It is important to not only know what <IR> is, but also what it is not.

The <IR> Framework (released in December 2013) incorporates several key characteristics:

- **The <IR> Framework does not require the creation of a new report.** The integrated report should be a separately identifiable communication, but one which can be subsumed into an existing report such as the OFR, or in an annual review (the approach used by IIRC pilots, NAB and Stockland).
- **<IR> is not another form of sustainability report.** It is the primary report on how the company creates and sustains shareholder value over time for its providers of capital. Sustainability reporting, if undertaken by an organisation, will be relevant[5] to the integrated report only to the extent that it addresses issues that materially affect shareholder value. An integrated report is not therefore a substitute for communication to other stakeholder groups.
- **Forecasts and projections do not need to be included in the integrated report.** An Integrated Report should provide the information needed for investors to form *their own* assessments of business prospects. Future-oriented information included in an integrated report can include strategic objectives and strategies to achieve them, descriptions of future risks and opportunities, challenges and uncertainties that the organisation is likely to encounter, estimates of the effects of known matters scheduled to occur in the future (e.g. enacted regulations that will be effective in a future period), targets and, although not required by the <IR> Framework, business forecasts and projections.

It is important to not only know what <IR> is, but also what it is not.

- **Using the 'capitals'[6] approach in the <IR> Framework will not add to the volume and complexity of corporate reporting.** An <IR> should address the 'capitals' – i.e. those resources, such as customer base and intellectual property that the future success of the business depends on. The <IR> Framework identifies six categories of capital but the integrated report should only talk to those that are material drivers of business value. <IR> is all about relevance not volume. It is also important to note that the report should focus on how those capitals are being developed and protected, rather than assigning a valuation to each individual capital.
- **The <IR> Framework already reflects significant practical experience.** Listed companies in South Africa have been preparing integrated reports since 2011, and the 100 plus IIRC pilot program organisations and investors have been testing out the concepts included in the <IR> Framework throughout its development. In addition the IIRC produced a discussion paper and consultation draft for public scrutiny and feedback, and addressed issues raised in developing the <IR> Framework. All of this experience and feedback has been captured in the <IR> Framework released in December 2013.
- **Materiality can be applied to an integrated report.** The term 'material' is on balance well understood in the reporting community and its application is central to integrated reporting and preparation of an integrated report. In the context of an investor focused integrated report, materiality should ensure that only matters that are relevant to an investor's assessment of business value are covered in the report.
- **The <IR> Framework is designed to deliver an integrated report that is tailored to the circumstances of each reporting organisation.** For example integrated reports for Australia's many small-cap listed companies are not expected to be onerous or long, but most likely short and clearly aligned to internal management and board reporting. They will be concise and focus on explaining the vital few material value drivers and risks.

5 As are the <IR> and financial reporting frameworks.

6 The 'six capitals', financial, manufactured, social and relationship, natural, human and intellectual, are one of the fundamental concepts of the Integrated Reporting Framework.

The <IR> Framework is 'Investor-Friendly'

The <IR> Framework has been developed specifically for the providers of financial capital. It has been developed to deliver more insights into the resources and relationships that drive business success today and into the future. There is more focus on the operational performance of the organisation including its use and development of its people, intellectual property, resources and scarce resources, as well as its financial capital and assets. It aims to assist investors understand how the company's own board and management assess the ability of the organisation to create value over the longer term to inform their own assessments and models.

The <IR> Framework is principles-based, and consists of fundamental concepts, guiding principles and content elements. It encourages greater engagement with report users. Therefore investors and analysts have a role in supporting each organisation in determining what is strategically material that needs to be reported regularly; and when changes are required as a result of actions taken or likely future events. This is an important component of effective investor stewardship.

In practice, integrated reporting should lead to:

- **more operationally focused measures of performance**, with the aim of helping users to understand progress in implementing strategy, developing business assets and creating new income streams – i.e. leading indicators of performance, rather than lagging ones
- **greater focus on explaining key business assets** – e.g. customer base, intellectual property and reputation – with the aim of explaining how these assets 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** – including risks and opportunities – so that users can form their own views on how they might impact on future performance.

This should lead to reports that are 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 to assess the substantial element of value that is typically locked up in the 'terminal value' element of their models.

Content of an Integrated Report

Integrated Reporting is built around seven key components of content:

- business model
- organisational overview and external environment
- opportunities and risks
- strategy and resource allocation
- performance
- outlook
- governance.

The <IR> Framework does not require the content elements to be discrete sections in the report. Rather, they should be seen as a high-level check to ensure that the report covers all of the relevant aspects of the business story.

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 will provide a foundation 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 will help to determine what should and, importantly, what should not be included in the report. For example, if a central part of the business strategy involves developing a particular market, then the logic of Integrated Reporting implies that the company should report on its 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 investors' decision-making.

<IR> Theory

Although the <IR> Framework is not prescriptive, it provides guiding principles for preparation of an integrated report. Many of the principles are similar to those underpinning good reporting today, but there are three noted below that are fundamental in providing investors and analysts with a clear understanding of what the company believes its value creation story to be and how it is set up to deliver long-term value.

Connectivity – provides clear connectivity throughout the integrated report using the business model, strategic objectives or six capitals to connect content and explain the value creation story.

Materiality – requires disclosure of the process to determine materiality, so that users understand what the board determines to be material to value creation across all time dimensions.

Conciseness – often drives more concise disclosures 'on a page' that link business model, strategic objectives, KPIs, and risks, with more detail. Although the integrated report should stand alone, references can be used to other sources e.g. for standing data provided on-line.

This is achieved through three fundamental concepts in the <IR> Framework:

1. Value creation for the organisation and for others. The <IR> Framework was developed on the basis that Investors are interested in the value an organisation creates for itself and the value an organisation creates for others *to the extent that the organisation is subsequently able to capture it in the form of future cash flows*.
2. The 'six capitals'. Financial, manufactured, intellectual, human, social and relationship, and natural capitals make up the 'six capitals' underlying <IR>. Companies are not obliged to adopt this categorisation in preparing an integrated report.
3. The value creation process or business model. Value created by an organisation over time manifests itself in increases, decreases or transformations of the six capitals caused by the organisation's business activities and outputs (i.e. its business model).

The table below sets out how each of the fundamental concepts in the <IR> Framework maps to an integrated report. This is then compared with relevant elements of the current corporate reporting portfolio, namely the OFR in the Directors' Report[7], a typical sustainability report[8], and implicitly the IFRS and Australian Accounting Standard based financial reports underpinning the OFR. The comparison in the final column may provide some indication as to how each report may help investors and analysts to understand and model the organisation's strategy, performance and prospects.

Fundamental concept	<IR> Framework	OFRs under RG 247	Sustainability reports	Comparison
Value creation	Focus on short, medium and long term, with an **emphasis** on value an organisation creates for itself and the value an organisation creates for others **when it affects** the ability of the organisation to create value for itself.	Focus on 'how we did last year' with some insight on the outlook, with an emphasis on **financial** value the organisation creates for **itself.**	Focus on the value an organisation creates for **others.**	An integrated report presents an **integrated depiction of value creation**. OFRs (including financial reports) and sustainability reports are less integrated and more 'special purpose' or limited in coverage of the six capitals.
The 'six capitals'	**Integration** across **'six capitals'** (financial, manufactured, intellectual, human, social and relationship and natural).	Mainly focuses on **financial** & **manufactured** capitals.	Mainly focuses on **social** and **relationship** and **natural** capitals.	An integrated report is integrated across all 'six capitals', including **human** and **intellectual** capital. OFRs and sustainability reports focus mainly on specific capitals.
The business model	**Central** to the integrated report.	**Some** focus, with more being placed on strategic objectives and business risks.	**Peripheral** to the report.	The business model is **not central** to an OFR or a sustainability report, though there is some coverage of the business model in an OFR.

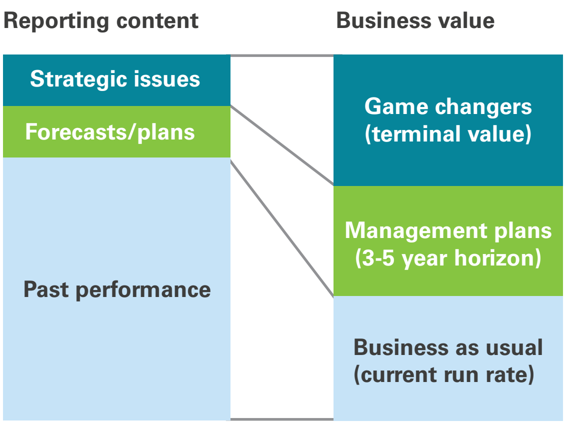
7 Which now should include material information on the business model, strategy, risks and outlook following release of ASIC's Regulatory Guide RG247 in 2013.

8 May be prepared under the GRI ('Global Reporting Initiative') G4 Guidelines.

"Can I model this?"

Accounting pronouncements have declared that the purpose of reporting is to 'meet user needs'. However, reporting developments, and report preparers themselves have tended to focus on balance sheets rather than earnings or earnings prospects. Accounting practices have been tweaked and refined but bigger questions around the overall scope of information provided in reports has not been addressed. The result is a gap between what is reported and the drivers of business value.

The Reporting Gap



Closing the gap

Cash flow models of business value typically have three components of value – 'business as usual', the value added from management's plans and expected changes in the business environment, and assumptions about the ability of the business to generate returns over the long term.

The focus of traditional business reporting on past performance creates a gap between the information reported and the information needed to assess business value. The danger is that this reporting gap creates uncertainty which must be priced as a risk premium into the organisations's cost of capital.

There are of course, many different approaches to business valuation. Report preparers cannot be expected to address each approach, but they can approach the question of what to report by looking at the drivers of intrinsic business value – i.e. the factors that they consider are relevant to an assessment of future business cash flows.

In other words, rather than working through a compliance checklist of disconnected disclosures, report preparers should be thinking about how the information they are providing (or not providing) might shift the assumptions, discount rates and cash flow estimates used by investors and analysts in relation to the future.

By telling a company's value creation story, an integrated report should align with the information the board and management would use themselves in assessing past performance and valuing future prospects. The result should be information that management considers relevant to an assessment of the intrinsic value of the organisation, which taken into account with other external research, should inform a more robust valuation model.

In particular high quality integrated reports should enable investors and analysts to better assess future risk for the purposes of estimating future cash flows and selecting discount rates to use in conjunction with their own research and judgements, in building and improving such models, shifting assumptions, discount rates and cash flow estimates.

The example below uses a simplified NPV model as a proxy for demonstrating how an integrated report is better aligned to support capital allocation decisions. This enables investors to go beyond how they use traditional corporate reports in investment analysis, and helps them refine their decision-support models and so make better capital allocation decisions.

We first visualise how the corporate model and internal reporting can drive the content of an integrated report, following the broad timelines considered by management – the current earnings run rate; the business plan, covering known operational plans and known external factors; and the long term ability of the business to continue in its current form – its terminal value.

The idea is that even if it is not actually modelled in detail, 'value' can be thought of within a company as being driven by the strategy, expected cash flows over the short, medium and long term and a discount rate.

Corporate Model and Internal Reporting						Integrated Report
	Actual	**Budget**	**Business Plan**	**Terminal Value**	**Total**	
Strategy	• 6 Capitals and Value Creation for Short, Medium and Long Term • Strategic Objectives & KPIs • Business Model: Inputs, Activities & Outputs/Outcomes + Value Drivers & Risk Mitigation + KPIs					
Key inputs	Last Year	Next Year	1-5 Years	5+ Years		
Cash Inflows	Known	Budgeted KPIs	Planned KPIs	Target KPIs	$X	Precise KPIs based on implementation of strategy as planned KPIs
Cash Outflows	Known				$X	
Net Cash Flows	Known	$X	$X	$X	$X	
Discount Rate	Known	Risk – free adjusted for 'company' factors				KPIs on risk management performance – enable judgementon ability to execute strategy
Net Present Value	**Known**	**20**	**100**	**1,000**	**1,130**	**Scenarios & Sensitivities**

Direct cash flows might include the revenue and cost impact of customer churn, impact of voluntary and regulated carbon abatement; whereas KPIs impacting on the discount rate could include dependency on key customers or products, ability to adapt to technology changes, likelihood of additional regulation.

Next we turn to how much of what is known and modelled and reported internally can and should be reported externally in an integrated report. A key question to ask is whether investors and analysts will be able to use an integrated report to improve their decision making?

The following diagram visualises how the integrated report may confirm or improve the investor's own discounted cash flow model.

Corporate Model and Internal Reporting	Actual	Budget	Business Plan	Terminal Value	Total	Integrated Report
Strategy	• 6 Capitals and Value Creation for Short, Medium and Long Term • Strategic Objectives & KPIs • Business Model: Inputs, Activities & Outputs/Outcomes + Value Drivers & Risk Mitigation + KPIs					
Key inputs	Last Year	Next Year	1-5 Years	5+ Years		
Cash Inflows	Known	Budgeted KPIs	Planned KPIs	Target KPIs	$X	Precise KPIs based on implementation of strategy as planned KPIs
Cash Outflows	Known				$X	
Net Cash Flows	Known	$X	$X	$X	$X	
Discount Rate	Known	Risk-free adjusted for 'company' factors				KPIs on risk management performance – enable judgement on ability to execute strategy
Net Present Value	Known	20	100	1,000	1,130	Scenarios & Sensitivities

<IR>
Integrated Report

Investor and Analyst Models	Actual	Budget	Business Plan	Terminal Value	Total
Strategy	• Limited Capitals and ShorterTerm Value Creation • Assumptions about Strategy and External Environment				
Key inputs	Last Year	Next Year	1-5 Years	5+ Years	
Cash Inflows	Known	Guidance	'Next year + 10%'	Extrapolate on current factors	$X
Cash Outflows	Known		'Next year + 10%'		$X
Net Cash Flows	Known	$X	$X	$X	$X
Discount Rate	Known	Risk-free adjusted for 'industry' factors			
Net Present Value	10	20	100	1,000	1,130

The investor's assumptions can more closely reflect the strategy and business model, cash flow estimates can be more closely aligned to the value drivers, KPIs and time dimensions.

Investors will be able make more informed selections of discount rates based on reported information about key company-specific risk profiles and mitigation performance and plans.

Later, investors will be able to better estimate future cash flows in three key time buckets (the current budget, the business plan, and the longer term).

The level of detail provided together with their own research enables investors to have better dialogue with the company on complex issues, both informing assumptions supporting their model, as well as supporting their assessment of management's stewardship.

Companies will need to educate their investors and analysts about their integrated reports, so that they better understand how to use the integrated report.

Connecting with investors – work in progress – the experience of South Africa to date

It is recognised that even in South Africa and among the IIRC pilot businesses, further evolution of the practical application of the <IR> Framework is required, particularly in terms of the 'Connectivity' principle (for example, further improving the selection and disclosure of KPIs related to key value drivers)[9].

In South Africa there has been some initial disappointment that <IR> has not made more of an impact with the investor community. However, this experience reflects the way in which <IR> has evolved in South Africa, rather than evidence that it will not ultimately deliver better reports for investors. The three main reasons are:

1. The initial discussion paper produced by the Integrated Reporting Committee of South Africa placed a strong emphasis on reporting to a broad range of stakeholders (in contrast to the IIRC's <IR> Framework, which is focused on reporting to the providers of financial capital). The result has been that many reports do not attempt to provide the performance information that would be needed to support an investor assessment of value creation.
2. There is a lingering assumption among many report preparers that investors are only interested in current financial performance. It is therefore taking time for <IR> practice to extend to the most important operational aspects of the business.
3. Businesses have needed to develop their reporting systems to the point where they are able to report operating measures of performance externally.

It is therefore important to see current practice in South Africa as one step in the evolution towards fully investor-focused integrated reports. We believe that many of the reports now being produced in South Africa provide a strong foundation for explaining progress in managing the key drivers of shareholder value.

Once the final piece of the reporting jigsaw is added – the KPIs measuring the performance of value drivers (e.g. brand, channel, IP and efficiency) – we expect that investor interest will increase[10]. It should be noted that South Africa has now adopted the IIRC's <IR> Framework as the basis for future integrated reporting.

Over time a performance track record will be built up and there will be an ability to track correlations between reported KPIs and value created, including within sectors and countries, and between capitals (e.g. lack of staff engagement leads to poor customer service/delays in IP development leads to reduced returns, etc). We are already seeing academic institutions around the world starting to undertake empirical research on a number of <IR> related topics including its impact on investor decision making.

9 'The KPMG Survey of Business Reporting', 2014 www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Pages/kpmg-survey-business-reporting.aspx From page 5, "…it is striking how few companies report performance measures over the most commonly identified drivers of business value." The most frequently cited value driver was operating efficiency. Only 21% of companies reported a KPI on this. Only 7% of companies reported a KPI on customer focus, the second most common value driver.

10 *The KPMG Survey of Business Reporting*', 2014 www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Pages/kpmg-survey-business-reporting.aspx

Incorporation of <IR> into ASX CGC Principles

While some momentum in investor demand for <IR> has begun to build, the level which would be required for the ASX Corporate Governance Council (ASX CGC) in Australia to adopt a more formal path to 'if not, why not?' adoption of <IR> in the ASX Corporate Governance Principles and Recommendations (ASX CGC Principles) has not yet been reached.

With the IIRC having a key strategic goal of building investor demand in 2014, this momentum could build quite quickly. Impetus will also be added if the B20 and G20 adopt the recommendations in the June 2014 report by the B20 panel of six international accounting networks, *Unlocking investment in infrastructure – Is current reporting a barrier?* which includes implementation of <IR> across G20 nations as a part of the solution .

If director liability issues can be resolved, the overall quality of <IR> continues to improve, and investor demand gathers momentum, there may be the required public groundswell that the ASX CGC can use as the litmus test for change to the ASX CGC Principles as early as for the 2016 financial year. <IR> could then be explicitly positioned as the flagship report supported by the financial report and other information on the corporate website through the ASX CGC Principles.

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