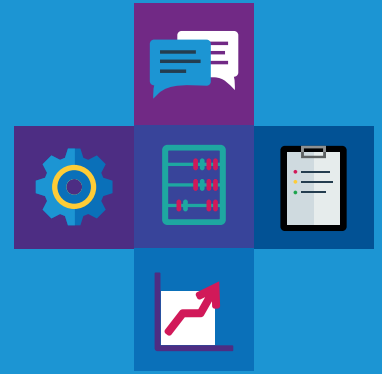


Six capitals

Five steps to a new risk approach



Internal Audit has a key role helping organisations identify, understand, measure, manage and report new dimensions of business integrity – such as social impact and reputation. The key is to evaluate performance against all six capitals in order to get a holistic view of an organisation that helps drive change.

Is there such a thing as a ‘traditional’ approach to risk management? If there ever was, the sheer variety of threats and opportunities in this much-vaunted era of change and unpredictability have forced internal audit (IA) teams to start questioning it.

By focusing on areas not traditionally within its remit, IA can help promote new ways of measuring value and assessing potential liabilities even in areas like business integrity – where long-standing issues such as fraud and bribery have been augmented by fuzzier drivers of reputation, brand and long-term sustainability.

It’s a natural extension of the still-developing principle of integrated reporting – the approach that offers investors greater context for performance data with a longer-term perspective. Applying some of the same ideas – in particular, a more holistic view of the enterprise – to risk management and decision-making within the business is a compelling approach.

Capital appreciation

A good starting point for IA, then, is a more rounded view of the inputs, or capitals, that help an organisation create value. These are human; social and relationship; intellectual; financial; manufactured; and natural.

Businesses, to varying degrees, impact and depend on these capitals: increasing, decreasing or transforming them. A traditional view of the way an organisation creates value has an internal focus. It looks mainly at the three types of more readily quantifiable capital – financial, manufactured and intellectual capital – and even narrows what it looks at within these capitals to those that are on the organisation’s balance sheet.

But to really understand whether the whole business is acting responsibly and with integrity, IA needs to consider all its impacts and dependencies. This means expanding its work beyond what’s included in the balance sheet for financial, manufactured and intellectual capital as well as bringing in the other three capitals: human, social and relationship, and natural.

These three ‘softer’ capitals, often considered together as ‘sustainability capitals’, are not owned by the organisation that uses or affects them. But their availability, quality and price can affect the ability of an organisation to create value over time.

Looking outside for answers

That means IA has to look outside the organisation to assess its true level of integrity. For example, increasing sustainability pressures – such as ecosystem decline, population growth, or pressure on natural resources – are driving major change around the world. Businesses that anticipate these changes and turn them to their advantage are well positioned for growth.

Smart businesses do not just respond to these mega forces – they develop a forward-looking strategy to achieve sustainable growth and performance improvement based on a solid understanding of their impacts and dependencies on the sustainability capitals.

Other external factors are also important. For example, business is increasingly expected to make a net positive contribution to society. After all, profit is only one measure of success. Stakeholders are interested in, involved with and have increasing influence over business reputation and licence to operate.

In other words, societal value is increasingly linked with shareholder value. That puts the more holistic six capital dimension firmly in IA's sights. In each case, we are getting a much clearer idea of the diversity of drivers that affect their contribution to the organisation; what the interconnections between them are; and how their contribution to sustainable value creation is evolving. Understanding how a business affects and depends on these capitals is therefore crucial to explaining its risk profile.

Integrity as a value driver

Hence the connection to business integrity. It can no longer be assessed purely in terms of adherence to accounting rules, bribery laws or operating standards. It is now measured and valued against a much wider set of benchmarks.

IA professionals are perfectly placed to help define, protect and enhance this value. By understanding and communicating how the business interacts with the capitals, and gaining a deeper understanding of those drivers and interconnections between them that shape risk, IA can help with measuring and reporting on sustainability in a way that both society and the capital markets increasingly expect.

The resulting picture of corporate value not only allows society and markets to understand the business's risks better – it also drives longer-term and more holistic decision-making from management.

A new framework for assessing sustainability capitals

We propose a five-step plan to help IA move towards a risk approach based broadly on all six capitals.



Step 1 **Familiarity**

Companies need to understand the full range of material sustainability issues. Often, the expertise to do so will be close to home. There will be people in the organisation who spend a good deal of time thinking about sustainability already. In our experience? This person is rarely a risk specialist. Finding this sustainability expertise and marrying it to IA risk approaches can be very powerful.

Consider the different stakeholders: employees, customers, shareholders, local communities and NGOs. Consider what sorts of things they would be interested in or worried about. (Ask them, if possible.) The idea is not to come up with a complete or fixed list of all the important sustainability issues, but to become more familiar with the sort of topics that might be important.



Step 2 **Boundaries**

The objective of financial reporting is relatively straightforward: record everything over which you have financial control, do the arithmetic right and apply the accounting standards. At a minimum, you have to evaluate the risks and opportunities that sit at the heart of your business – the things you have direct control over.

Sustainability needs a different approach; its risks and opportunities are often external.

So where do you place the boundaries? Will it be in the supply chain? Or only in your direct activities? What about your customer impacts? Will you consider how your actions can affect society more broadly? Will you just focus on a particular part or aspect of your business – a particular product, market or division? Defining the playing field makes the task manageable and helps IA – and the business – be consistent in both measurement and management.



Step 3

Impacts and dependencies

Most large businesses already have a good idea of their key sustainability impacts. They know how much carbon dioxide they emit, how much waste they send to landfill, and how much water they use and so on. But those impact measures are only one side of the coin.

On the other side, the dependencies are a different challenge. Businesses rely on sources of human, social and relationship and natural capital for their day-to-day operations. Understanding the dependence on these inputs is key to managing the organisation's long-term success.



Step 4

Change-drivers

What about the broader environment in which the business operates? Which impacts or dependencies are likely to be under threat in the future by changing external factors?

Governmental policy, security of supply, price shifts, reputational no-go areas – these are just some of the changes that could be driven by environmental or social pressures over which the organisation has little or no control. IA has to find ways of articulating these drivers in ways that make the risks both credible and capable of being managed.



Step 5

Measurement

Any organisation ought to have a clear idea of the extent of its impact or dependency. Its leaders need to make informed business decisions based on a more objective understanding of the drivers of change; and how its impacts and dependencies are evolving over time.

So all six capitals need to be measured consistently and reliably. That starts with a disciplined measurement of current impacts and dependencies. And it requires tools and techniques to evaluate any changes in order to monitor performance.

My tip on which KPIs to use and methodologies to apply? Do not simply run with what is being done elsewhere. I see many organisations with great ambitions in the area of sustainable business – but too many of them use the wrong KPIs to measure their performance as they blindly follow others in their sector.

'Business integrity', even using the six capitals and our frameworks, will be expressed uniquely for each business. IA must tailor its approach to new risks while sacrificing none of its rigour and discipline. It's a fascinating, and essential, challenge.

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