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Reporting that Matters: Emerging Best Practices for the Future of Global Corporate Reporting

Supporting paper:

The future of corporate reporting – An imperative for policymakers

Wednesday 14 March 2012, 10:30am – 12:00pm

Session with:

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- **Jessica Fries**, Executive Chairman, The Prince's Accounting for Sustainability Project & Board Director, The International Integrated Reporting Council
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Executive summary

We argue that corporate reporting can be *a major lever of policy change* capable of strengthening sustainable business success which can also help build trust in business by helping to explain the contribution it makes to social and environmental wellbeing. We believe that this can play an important part in achieving the future wellbeing of society and its future economic competitiveness, resilience and stability.

We are excited by the opportunity for corporate reporting agenda to make a significant step forward in the next few years but are concerned that this will require an alignment of many key initiatives which are taking place – such as Rio +20, the work of the International Integrated Reporting Council, national developments such as the support for narrative reporting in the UK and developments in South Africa.

If the whole becomes greater than the sum of the parts there is an opportunity for a significant step forward in the effectiveness and value of corporate reporting, and its wider contribution to both business and society; but it also follows that there is a real risk of disjointed activity, which adds to the burden of business, has unintended consequences, imposes a 'one size fits all' approach on businesses of different sizes, and creates a bigger gap between policymakers, regulators and business leaders.

We therefore argue for a *policy 'blueprint'* which facilitates the creation of a progressive information framework which can guide the evolution of reporting over the next few decades. Too often in the past reporting has evolved in a very piecemeal and reactive way. We believe there is a real opportunity and incentive for policy makers to help reset this underlying information framework on which others can build for mutual benefit.

To practically promote this positive influence and support this approach we propose the creation of *a new public/private innovation partnership* – to determine what 'good' looks like and share good practice, benefiting from such developments that are now starting across the world to create a new space for collaborative innovation.

The cumulative impact of these developments would, we believe, be important in tempering the exclusive focus on financial performance which all too often can fail to fully appreciate how this performance is achieved and of the significance of leadership, behavioural and cultural factors, and social and environmental value drivers; and in so doing takes into the wider implications and consequences for the whole of society.

We propose that any effective reform of corporate reporting must be guided by the key principles set out in *Tomorrow's Corporate Reporting* and will in summary promote, require and encourage:

> ***Bringing together material information, financial and non-financial; informed by a high level strategic narrative – or mandate – which clearly explains the organisation's purpose, business model, values, culture and risk appetite; to provide the information required to inform the boardroom, investors and other stakeholders of the success of the business; in order to achieve superior risk adjusted returns which delivers long-term and sustainable value.***

Introduction

This paper makes the case for the role of corporate reporting as a major lever of change through the way it influences both the behaviour of boards and the perceptions of investors. If carried out effectively, reporting has the ability to shape how business leaders and employees think, how organisations are structured and behave and how performance is assessed by investors and others.

For many decades academics and others have questioned the shortcomings and implications of a traditional corporate reporting model that focuses so heavily on financial performance, particularly in the short term. Should we be surprised that we have a capitalist system that is so driven by earnings and financial return and a personal recognition model so heavily focused on remuneration? This financial orientation is not superficial, it is hard wired into the DNA of the business world, how leaders lead, how capital is allocated, how employees make decisions, how they are incentivised and remunerated, its governance structures, through to the assurance process.

How different could this system be if the dominance of financial performance was tempered, if more focus was placed on how this performance is achieved and the wider implications and consequences for the whole of society?

In this paper we make the case for:

- **corporate reporting being a major policy lever,** capable of strengthening sustainable business success, by enhancing and accelerating businesses' ability to create wealth by responding to the changing needs and expectations of society. And for corporate reporting becoming a central mechanism for building trust in business by helping to explain the contribution it makes to social wellbeing

- **the importance of creating a policy blueprint** for the future of corporate reporting, a blueprint which facilitates the creation of a progressive information framework which can guide the evolution of reporting over the next few decades. Too often in the past reporting has evolved in a very piecemeal and reactive way, with one policy frame following the other, which perversely has reduced rather than increased transparency and user understanding

- **the creation of a new public/private innovation partnership** focused on creating the right conditions and mechanisms in which to foster innovation and best practices in corporate reporting. This partnership should provide forums to determine what 'good' looks like, to envision a future state of reporting, to determine key change principles and how new space for collaborative innovation can be created.

Understanding the corporate reporting system

In the report *Tomorrow's Corporate Reporting: A critical system at risk*, published in 2011, we describe the corporate reporting system as a 'jigsaw in pieces'. The various actors in the system mainly see only their own part, not the whole. They have different mindsets, different perspectives, different languages and different cultures.

We have established a number of principles upon which an effective reporting system should be based to:

- encourage innovation and change
- balance judgement and compliance by creating a system that give companies and professions flexibility to exercise and then explain their judgement without compromising accountability
- focus on the key drivers of long-term value for better alignment between external and internal reporting
- be accessible timely and relevant
- enable shareholders and investors to assess the long-term sustainability of companies and their wealth creating capabilities
- recognise the importance of those who have responsibility for the oversight of the system.

The report sets out a roadmap for change, emphasising the need for global consensus in the creation of a blueprint for the future of reporting in the rapidly changing business environment.

The case for rethinking reporting

New business environment

It is becoming clear that market forces are generating unsustainable outcomes.

A revolution in thinking is taking place in relation to our understanding of the role of business and the process of value creation. In the past the purpose of business was simply stated as the creation of shareholder value. Business success was measured by some metric of total shareholder return such as economic value added.

Today's progressive organisations understand that the purpose of any business is to create value for all their stakeholders - customers, employees, investors, suppliers and society, and that the interests of all these groups are inextricably linked. Therefore, sustainable value cannot be created for one group unless it is created for all of them.

They also understand that they operate within the triple context of interrelated economic, social and environmental systems. Value creation for the organisation's immediate stakeholders cannot be achieved in a sustainable way if, in the process of creation, the external impact on the wider economy, on society and the natural environment is damaging.

It is when an organisation thinks of itself purely as a financial engine whose purpose is to generate attractive financial returns that the company is least likely to maximise those returns in the long run. Often, such companies end up shuffling their portfolio of assets in a self-destructive quest for growth or 'superior returns' with no real understanding of the value-creation dynamics of the businesses they are acquiring and selling.

It is becoming increasingly understood that if companies do not provide an assessment of the broader Environmental, Social and Governance (ESG) risks and opportunities to which their business model is exposed, then how can the market assess the sustainability of that company's growth?

It is time to move beyond the concept of the triple bottom line which obscures the complex interrelationships between the economic, social and environmental aspect of a company's activities and to accept that 'people, planet and profit are inextricably intertwined'. There is only one bottom line, one which is a measure of a company's long-term sustainability, indicated by a market capitalisation that reflects the full understanding by the investment community of the real nature of wealth creation for shareholders and other stakeholders.

Given that reporting should move from its overemphasis on financial matters, there is an increasing demand for inclusion of a wider range of data, including ESG factors and other non-financial information relating to such factors as risk and business models. In consequence, integrated reporting has become the talked about vehicle of change. But it is important to emphasise that integrated reporting is not simply a case of combining the traditional annual and sustainability reports into one document. Instead, the report should demonstrate how the organisation has reviewed its strategy in the context of societal issues.

Corporate reporting – A critical change catalyst

The frame of corporate reporting has the ability to shape the future by influencing and informing human thinking and ultimately how organisations behave. It is therefore a major policy lever that needs to be understood and exploited.

Recent research by the Harvard Business School and others highlight that the shape and scope of the corporate reporting model (which can extend to issues around governance, business models, risk and remuneration in addition to sustainability matters) can drive new forms of thinking and behaviour which, if channelled properly, should result in:

- **better managed companies** – more fully orientated to the needs of society and the conflicting challenges of wealth creation in all its forms. Companies who manage by looking at the world through the integrated reporting framework can only do so if their thinking and decision making is also integrated. This shift will result in companies that are better engaged with the changing dynamic of business and that are more responsive to the needs and expectations of their key stakeholders. This engagement will be reflected by the type of individuals who will emerge as leaders, the way governance is conducted, the types of measurement systems used to assess both corporate and individual performance

- **improved relationships and trust between business and society** created by the introduction of a more balanced assessment of value creation in the day-to-day decision making of business, through a greater understanding of the resources used and in increased transparency around the total contribution of business to s social wellbeing

- **better investment decision making and asset allocation** by ensuring that both the risk and return parameters of the decision process are properly sensitised to a changing world where resource usage needs to be decoupled from growth and where the impacts and performance of business need to take account of human, intellectual, natural and social capital and not just financial capital.

However, in using corporate reporting as a tool of change, policymakers need to be careful not to undermine its power through the wrong type of regulatory intervention. In particular policymakers have to create the right environment that can enhance behavioural change and minimise negative unintended consequences.

Policy blueprint

Putting the pieces of the jigsaw together

At the time of writing there are many regulatory and market initiatives and consultations in various parts of the world focused on different aspects of reporting and of the reporting system (for example, the European Commission has recently adopted a new Corporate Social Responsibility strategy). Although it is important to keep the momentum around these initiatives going, there is a danger of overload unless what we say in the paper is taken seriously. While these consultations are all well-intentioned, the very fact they are addressing separate elements of the model and the system is indicative on a lack of understanding of how the system operates, its interdependencies, and most critically, how proposed actions will impact the desired behavioural response.

As a specific example, a model that involves companies reporting on their supply chain performance would have a significant impact on the organisation's overall mindset and how it thought about its business. This difference in focus is but one element of change being proposed by the International Integrated Reporting Council (IIRC) in its Discussion Paper on integrated reporting.

Furthermore, there are many companies that are reacting to the changing dynamic of business and whose actions should be informing policymakers about the direction of travel and ways in which reporting might lend behavioural change.

- Puma, the German sports apparel business has recently calculated and reported on the cost of carbon and water in its entire supply chain which indicates an additional business cost of approximately 100 million euros as against the established measurement model we have today

- there is also a growing number of other companies that have started to produce 'socio-economic impact' reports which attempt to present their total footprint, both positive and negative, from employment across the supply chain, to knowledge creation, to total tax contribution, impacts of local communities and the environment.

Yet at this time the scope and quality of mainstream corporate reporting of most public companies remains extremely variable. This is so in respect of companies' explanation of their strategies, business models, key risks and relationships through to their environmental and social performance. 75 per cent of the companies covered by Bloomberg do not currently disclose their sustainability performance, let alone integrate environment, social and governance issues into their mainstream explanations of strategy and financial performance.

There are clearly many other levers of change which policymakers, national governments and intergovernmental organisations can use alongside the reporting model. These include developing more effective incentives that reward long-term performance such as fiscal policy, corporate governance guidelines and professional education and standards. And it goes without saying that real momentum around this business change agenda will be achieved when all these levers are used in unison.

There is also a huge educational task in helping the investment community develop an understanding of sustainability and its critical importance in the assessment of a company's future prospects. We cannot ignore the fact that standing in the way of such understanding is a system, particularly in the Anglo-American space, that encourages short-term behaviours and a predominant focus on financial rewards.

The role of regulation

Regulation has a central role to play in the development of the right corporate reporting model which can enable business to flourish and meet the needs of society in the current century. But rather than it being a drag on change, a throwback to a past, we need to turn its focus towards the future and to the needs of the world in 2050 and beyond.

We need to challenge the historic and largely negative view of what regulators do. We must recognise that they have a critical role and responsibility to act as architects of change, creating the blueprint, the framework in which reporting can evolve, providing the mechanisms that encourage and support innovation and change, and most critically, working with policymakers to understand and shape the behavioural drivers which the reporting model can unleash if thoughtfully constructed.

Most critically, we must recognise that just because an element of reporting is made mandatory does not guarantee that it will affect the internal mindset of business, the company's strategy, how it is run and the information it uses to make day-to-day decisions. Often mandatory reporting encourages passive compliance with regulatory requirements but does not get to the heart of the matter, which is to do with changing business practice, people's mindsets, values and business cultures.

We strongly believe that policymakers and regulators have an enormously important role to play as sponsors of the blueprint for the future of reporting, and once achieved, to effect a series of actions that can 'nudge' companies and investors towards a new integrated mindset and approach to reporting. This nudging process can be accelerated through other mechanisms, such as new incentives, adjustments to guidelines and through actions to promote best practice.

The creation of a new public/private change initiative

This paper also argues that policymakers should use a forward-looking corporate reporting framework to help drive a sustainable growth agenda, decoupled from increased consumption and resource usage. This action alone would have a significant impact on many of the core issues which underpin the sustainability agenda. We believe there is a programme of actions which could help secure this opportunity at a time where there is significant interest in reporting and how it should develop. Central to this programme is the formation of new public/private partnerships, between government, business and the investment community aimed at creating the architecture for change and the innovation space needed to encourage meaningful collaboration.

Through collaboration between companies, investors, auditors and regulators we believe a consensus needs to be built on the following:

- **determine what good looks like today** – identify the best reporting practice today which business and key stakeholders agree should set the minimum standards for all public company reporting in the short term (say three years)

- **envisage the future** – catalogue and piece together all the forward-looking reporting initiatives, whether regulatory or business-led. This patchwork of initiatives should provide a view of the direction of travel in which reporting is moving and should help identify areas of commonality, potential dispute and most importantly area of omission

- **determine key change principles** – build an international consensus around the principles that need to be central to the process of change. Given the different stages of development of corporate reporting around the world it may be difficult for national governments to reach a common view on the future reporting framework (including its scope and content). The IIRC's Discussion Paper on integrated reporting is a case in point. However, this paper does provide a strong directional indicator of where the world of reporting is moving and should provide a view against which national governments could agree a series of change principles. The purpose of these change principles would be to encourage convergence of thinking around the globe to help ensure reporting moves broadly in the same direction.

Set out below are the issues where international agreement should be sought:

- segmentation by size – reporting needs to be proportional to the size of business, recognising that many major multinational companies are larger than many sovereign states, whereas the majority of wealth is driven through SMEs
- avoiding piecemeal and stand-alone additions to existing the reporting model which clutter rather than inform
- making reporting more forward-looking by enhancing the quality of contextual information and the reporting of strategic milestones
- focusing on all the resources and relationships critical to long-term business survival (including elements which may be considered free goods today e.g. carbon and water)
- ensuring reported information goes beyond the legal entity and span of control to all aspects, both positive and negative, of a business's supply chain
- developing the concept of materiality beyond financial impacts
- improving user understanding and access, here the role of electronic information needs to be centre stage.

Establish new change processes

At the same time regulators around the world should be considering how they can harness behavioural change. Examples are emerging. One comes from the UK Financial Reporting Council which has recently launched its 'reporting lab'. A virtual space which offers the environment where corporates and investors can come together to develop pragmatic solutions to today's reporting needs. Priorities in the lab will be determined in large part by its participants focusing on finding pragmatic solutions to known problem areas.

Policy proposition

We propose that any effective reform of corporate reporting must be guided by the key principles set out in *Tomorrow's Corporate Reporting* and will in summary promote, require and encourage:

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