

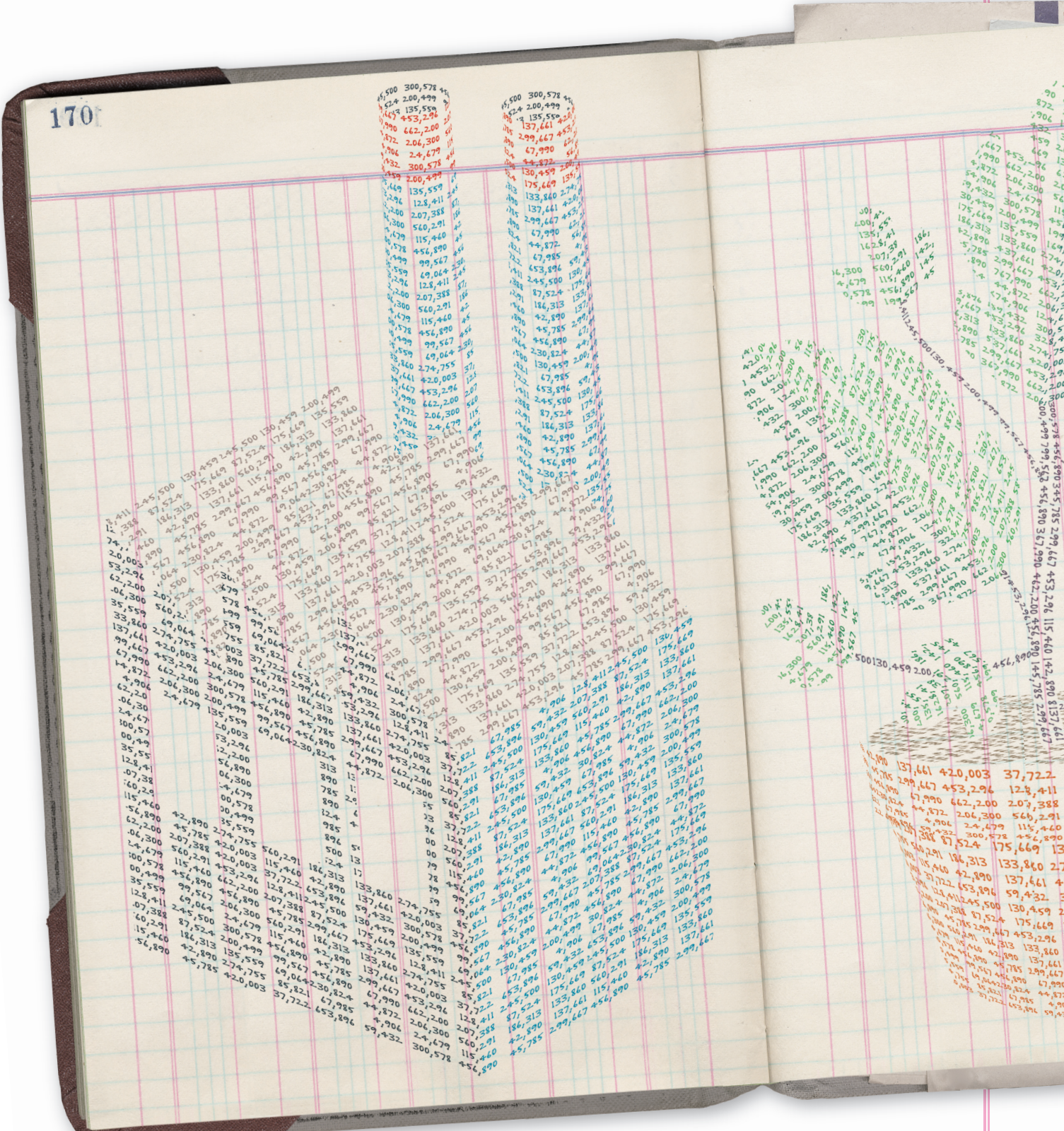
**Achieving Sustainability Through Integrated
Reporting**

By Robert G. Eccles & Daniela Saltzman

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Integrated reporting—the combination of a company’s financial and nonfinancial performance in one document—is a crucial step to creating a more sustainable society. It is being practiced around the globe by companies as varied as Philips, Novo Nordisk, PepsiCo, and Southwest Airlines. **By ROBERT G. ECCLES & DANIELA SALTZMAN**



ACHIEVING SUSTAINABILITY THROUGH INTEGRATED REPORTING



On Jan. 25, 2011, at a press conference held at the Johannesburg Stock Exchange, the world's first guidance document for companies practicing integrated reporting was issued. This was precedent-setting, as only a handful of the world's top 30 stock exchanges provide guidance on nonfinancial reporting. The Johannesburg Stock Exchange went a step further. As of March 1, 2010, it has been requiring companies to submit integrated reports or list elsewhere.

An integrated report is a single document that presents and explains a company's financial and nonfinancial—environmental, social, and governance (ESG)—performance. The impetus behind issuing this document was the *King Report on Governance for South Africa 2009 (King III)*, written by University of South Africa professor Mervyn King, which recommended that companies and other organizations produce integrated reports connecting material financial and sustainability information. *King III* was created to maintain South Africa's leadership in standards and practices for corporate governance. It also reflects the country's intention to be “at the forefront of governance internationally,” as the report states. “We believe this has been achieved because of the focus on the importance of conducting business reporting annually in an integrated manner, i.e., putting the financial results in perspective by also reporting on how a company has, both positively and negatively, impacted on the economic life of the community in which it operated during the year under review; and how the company intends to enhance those positive aspects and eradicate or ameliorate the negative aspects in the year ahead.”¹

South Africa's integrated reporting requirement is an important step toward creating a more sustainable economic, social, and environmental society. King hopes it will cause a worldwide domino effect. “Companies,

investors, and other stakeholders in South Africa are very supportive of integrated reporting and excited about the opportunity we have to help lay the foundation for spreading this practice on a global basis,” he said. But companies cannot be the only force behind integrated reporting. “All of us are responsible for creating a sustainable society,” said King, “and I think NGOs have a critical role to play as representatives of civil society.”

This article explores the strengths and challenges of integrated reporting and how the public, private, and nongovernmental sectors can collaborate to create a worldwide movement that requires organizations of all kinds to act more sustainably.

THE STATE OF CORPORATE REPORTING TODAY

Every company listed on a stock exchange is required to issue on at least an annual basis a financial performance report. These reports are based on a set of accounting standards—typically International Financial Reporting Standards or US Generally Accepted Accounting Principles—that define the information reported in a company's income statement, balance sheet, and notes to the financial statements. High-quality and transparent financial reporting that presents an accurate view of a company's financial condition is one of the bedrocks for fair and efficient capital markets. Companies, their external auditors, standard setters like the Financial Accounting Standards Board in the United States and the International Accounting Standards Board, and regulators such as securities commissions all make substantial efforts to ensure high-quality financial reporting by listed companies. In 2010, the total market value of these 45,517 companies was about \$52 trillion, with revenues of some \$46 trillion and total employment of nearly 200 million people, according to the World Federation of Exchanges and

PHOTO ILLUSTRATION BY DAVID HERBICK, LEDGER PHOTOGRAPH BY CHERYL GRAHAM/ISTOCKPHOTO

Capital IQ, respectively. By comparison, global GDP that year was \$58 trillion, illustrating how significant corporations have become. Given the large amount of financial, natural, and human resources controlled by these companies, it is important that investors have accurate information when making their resource allocation decisions. Similarly, other stakeholders, such as employees and customers, need this information to decide where to work and from whom to buy.

Financial reporting has institutional legitimacy, thanks to a variety of factors. They include measurement, reporting, and auditing standards; effective enforcement mechanisms, including courts of law for redress of fraud in the financial statements; sophisticated internal control and measurement systems; and information technologies that enable rapid capture and aggregation of data. But financial reporting also has its critics, who cite its increasing complexity, making it hard for all but the most sophisticated users to understand the reports. There is also the difficulty of finding the most relevant information, the time lag in issuing reports, the paucity of information about the risks being taken by the company to create value for shareholders, and the backward-looking nature of the reports. Questions about whether a financial report presents a “true and fair view” of a company cannot be adequately answered, because the reports do not contain information on nonfinancial performance that can determine a company’s long-term financial picture.

As a result, an increasing number of companies are voluntarily starting to produce sustainability or corporate social responsibility reports. Typically, they contain information on a company’s environmental (e.g., energy and water usage and carbon emissions), social (e.g., labor practices, employee turnover, and workforce diversity), and governance (e.g., independence of the board and approach to risk management) performance. In some cases, they also include information on the company’s philanthropic and community activities. Frameworks and standards for the information in these reports are not nearly as well established as they are for financial reporting. Nevertheless, investors are increasingly interested in nonfinancial information. In July 2009, Bloomberg added ESG data to its information offerings that cover thousands of public companies. Now Bloomberg’s 300,000 customers see ESG data, such as toxic discharge, water usage, and more than 100 other indicators, from companies like General Electric and Deutsche Bank. In the second half of 2010, customers in 29 countries accessed more than 50 million ESG indicators.

There are also several important nonfinancial reporting initiatives. The NGO Global Reporting Initiative’s G3 Guidelines are a good start for a set of reporting standards. And the NGO AccountAbility has issued the AA1000 Assurance Standard, which provides assurance on nonfinancial information. Also relevant is the Climate Change Reporting Framework issued by the Climate Disclosure Standards Board. The percentage of companies publishing reports on their nonfinancial performance varies by country, with European

countries, Australia, Brazil, and Japan being more active than China, India, and the United States. The European Commission is considering making ESG disclosures mandatory. Currently, Australia and Brazil have the highest number of companies publishing nonfinancial performance reports. In 2009, there were approximately 1,400 companies issuing nonfinancial reports using the G3 Guidelines, a 29 percent increase from 2008. In 2012, the NGO Global Reporting Initiative will release its G4 Guidelines, which will be a stepping-stone for signatories to produce integrated reports.

Although the original intention of nonfinancial reporting was to provide information of interest to stakeholders, shareholders are paying increasing attention. For example, a representative of Aviva Investors, an international coalition of large institutional investors facilitated by the U.N.-backed Principles for Responsible Investment, sent a letter in January 2011 to the CEOs of the world’s top 30 stock exchanges asking them to encourage their listed companies to improve disclosure on sustainability performance and strategy. The letter calls for stock exchanges to “consult with companies on how they should be integrating sustainability into long-term strategic decision making—e.g., highlighting risks and opportunities within the existing business model on their website and in their financial report. This includes encouraging companies to undertake integrated reporting.”² Steven Waygood, head of sustainability research and engagement at Aviva Investors, said he sent the letter because “we need this data in order to assess the wider risks and opportunities associated with a company. Without it, we cannot properly integrate these issues into valuation models.” Waygood believes that stock exchanges and their regulators have a crucial role in fostering integrated reporting. “Integrating sustainability into valuation helps to ensure that capital flows in the direction of more sustainable companies,” he said. “This can only be a good thing for long-term investors and the broader economy, and we believe that exchanges have a responsibility to help.”

THE EMERGENCE OF INTEGRATED REPORTING

The Danish company Novozymes, whose core business is industrial enzymes, microorganisms, and biopharmaceutical ingredients, is generally considered the first company to issue an integrated report, which it did in 2002. The first US company to issue an integrated report was the diversified manufacturing company United Technologies in its 2008 annual report. The next year these companies were joined by American Electric Power, PepsiCo, and Southwest Airlines. Other early adopters include the Danish diabetes care company Novo Nordisk (2004), the Brazilian cosmetics and fragrance company Natura (2008), and the Dutch health care and lighting company Philips (2008). Given the industry and geographical diversity of these companies, it is unlikely that they knew about each other’s efforts. But their reasons for issuing integrated reports are similar. They include a commitment to sustainability, defined broadly in financial and ESG terms; a belief that an integrated report is the best way to communicate to shareholders and other stakeholders how well a company is accomplishing these objectives; and a recognition that integrated reporting is an important discipline for ensuring that a company has a sustainable strategy.

The earliest corporate adopters of integrated reports, sometimes

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referred to as One Reports, did so before any literature existed on the topic, showing how practice often leads theory in new management ideas. Although some of the seeds for integrated reporting go back as far as John Elkington's concept of the triple bottom line in 1994 and to work by this article's co-author Robert G. Eccles and PricewaterhouseCoopers on ValueReporting in 1999, the first use of "integrated" in this context is Allen White's discussion of Novo Nordisk's "integrated, balanced, and candid reporting" in a June 20, 2005, Business for Social Responsibility brief titled "New Wine, New Bottles: The Rise of Non-Financial Reporting."

In August 2005, Solstice Sustainability Works published a 16-page white paper called "Integrated Reporting: Issues and Implications for Reporters," sponsored by Vancity, Canada's largest member-owned and -directed credit union. This paper was ahead of its time—too far ahead of its time—and largely disappeared from view. Eccles and Michael P. Krzus were not aware of it until after the publication of their 2010 book, *One Report: Integrated Reporting for a Sustainable Strategy*. Since then, a number of articles, papers, and blogs have been written on integrated reporting, as well as a free e-book, *The Landscape of Integrated Reporting: Reflections and Next Steps*, published in November 2010 following an integrated reporting workshop at Harvard Business School. Companies now have the benefit of an increasing body of literature on integrated reporting, and those writing about it have the benefit of an increasing number of companies that are practicing it.

Although South Africa is the only country that has mandated integrated reporting, Denmark, Norway, and Sweden require sustainability reporting to varying degrees, and the Grenelle II legislation in France will require "all major French listed and non-listed large companies to disclose in their annual reports how they take into account the environmental and social impacts of their activities as well as their contributions to developing a sustainable society." The legislation also requires this information to "be verified by an independent third party."³ These efforts may soon become Europe-wide. According to a January 2011 report of the European Sustainable Investment Forum, "After years of engaging in dialogue with industry stakeholders, disclosure of nonfinancial information by companies is poised to move from a voluntary to a mandatory basis."⁴

Complementing these regulatory and legislative actions is the Sustainable Stock Exchanges Initiative, which is studying how exchanges can work with investors, regulators, and companies on ESG reporting. Australia, Italy, Japan, Korea, and New Zealand are exploring the formation of national organizations to advocate for integrated reporting. They all plan to coordinate with the International Integrated Reporting Committee (IIRC), formed in July 2009, and with the Prince's Accounting for Sustainability Project, which in 2007 proposed the creation of a Connected Reporting Framework. The IIRC plans to release a draft framework in June 2011 and is working to get integrated reporting on the agenda of the G-20 meeting hosted by France in November 2011.

THE BENEFITS OF INTEGRATED REPORTING

Integrated reporting begins with a single report on a company's financial and nonfinancial performance. An integrated report is not intended to be a compendium of every single piece of performance

information. Rather, it brings together material information on financial and nonfinancial performance in one place. Ideally, it also shows the relationships between these material financial and nonfinancial performance metrics, although this is uncommon, even among the most sophisticated companies practicing integrated reporting today. Examples of the kind of information that would be included in an integrated report are: How much water does a company use per unit of production compared to its competitors? To what extent do energy-efficiency programs reduce carbon emissions and lower the costs of production? What is the impact of training programs on improved workforce productivity, lower turnover, and greater customer satisfaction? How do improvements in customer satisfaction lead to greater customer loyalty, a larger percentage of the customer's spending, and higher revenue growth? How is better management of reputational risk through good corporate governance contributing to the value and robustness of the company's brand?

Although integrated reporting is still in its infancy, it is possible to identify three classes of benefits. The first is *internal benefits*, including better internal resource allocation decisions, greater engagement with shareholders and other stakeholders, and lower reputational risk.⁵ The second is *external market benefits*, including meeting the needs of mainstream investors who want ESG information, appearing on sustainability indices, and ensuring that data vendors report accurate nonfinancial information on the company.⁶ The third is managing regulatory risk, including being prepared for a likely wave of global regulation, responding to requests from stock exchanges, and having a seat at the table as frameworks and standards are developed.⁷

Of course, integrated reporting is not a panacea for improving resource allocation decisions or a silver bullet for solving contemporary problems with financial and nonfinancial reporting, particularly as it is so young. Companies interested in implementing integrated reporting face a number of challenges, beginning with the fact that no globally accepted framework specifying what goes into an integrated report exists. But there are a growing number of examples of integrated reports from which companies can learn. A closely related problem is that there is no globally accepted set of standards for measuring and reporting nonfinancial information. Although the G3 Guidelines can be useful, they may not be entirely appropriate to a company's circumstances. As a consequence, few companies have internal control and measurement systems for nonfinancial information that are of the same quality as for financial information. Simply gathering all the nonfinancial and financial information to issue an integrated report is a formidable challenge in most companies.

Users of integrated reports also face constraints that limit the value of integrated reporting to them today. The lack of a framework and standards for nonfinancial information makes it difficult to compare the performance of different companies, a core feature of investment analysis. Another limitation is the small number of companies practicing integrated reporting, and the fact that it will likely be adopted across industries and countries to varying degrees. Questions exist about the reliability of the information reported by companies. For the most part, having any type of third-party assurance on nonfinancial information in the report, let alone on the entire integrated report, is voluntary. And even when assurance is provided, it is not done with the same degree of rigor as the audit of a financial report.

Although these challenges are significant, they can and must be overcome, and quickly. A sustainable society requires that all of its companies practice integrated reporting, so that resources used today do not jeopardize access to resources for future generations. There really is no alternative to integrated reporting. This still infant idea needs to grow into a strong and robust management practice. Doing this requires a cross-sector approach that involves the public and private sectors, and civil society as represented by NGOs.

PHILIPS: AN EXAMPLE OF INTEGRATED REPORTING

Headquartered in Amsterdam, Royal Philips Electronics is a diversified company focused on the health care, lifestyle, and lighting sectors. Philips first streamlined its financial and sustainability reports into an integrated report for its 2008 annual report. It continues to do so because the company considers “sustainability to be a driver of growth and an integral part of the Philips DNA.”⁸

The adoption of integrated reporting at Philips can be attributed to three motivating factors: increased efficiency, reduced cost, and improved communication. Pierre-Jean Sivignon, former chief financial officer of Philips, said integrated reporting started as an exercise in streamlining. “The goal with producing the annual report,” he said, “was threefold: Do it in a cost-effective manner and quickly, so as to get the finance team focused back on this business as soon as possible.” To expedite the creation of the financial report and the sustainability report, while meeting US and international legal requirements, an integrated paperless document made most sense. From the perspective of Henk de Bruin, global head of corporate sustainability at Philips, the impetus behind integrated reporting was transparency and a one-channel communication on company performance. “There are synergistic elements between the finance discipline and sustainability discipline. The finance discipline has learned to be high-quality data oriented, while the sustainability discipline emphasizes communication and a stakeholder approach toward multiple audiences, such as financial and sustainability analysts in the investor world and governmental and nongovernmental organizations. Sustainability reminds finance that we don’t communicate just for legal reasons to meet statutory obligations and inform shareholders, but that one-channel communication can be used for so much more.” De Bruin notes that the integrated report serves as a business card for the company both externally and internally. “It highlights to employees what is going on around the organization in a clear and easily accessible format. ... It increases their pride in the company knowing Philips takes sustainability seriously.” Externally, the benefit of the online integrated reporting model is that Philips can better understand what users care about and improve the annual report going forward.

The roots of integrated reporting at Philips can be traced to 1998, when it produced its first environmental report. In 2008, the company issued its first integrated report and accompanying website. Sustainability issues were woven into the report in both quantitative and qualitative form, and received limited assurance coverage by the company’s auditors, KPMG. The 2008 integrated report showcased ESG metrics such as the net promoter score, which measures customer satisfaction and loyalty to the Philips brand; employee engagement information, including perceptions and attitudes related to employee

satisfaction, commitment, and advocacy; sales of green products; and operational carbon footprint. The website offered a tool for creating individualized reports and a user survey for stakeholder engagement.

Although the 2008 integrated report and website set the foundation for Philips’s new reporting initiatives, the 2009 and 2010 integrated reports and their websites show deeper linkages between and analysis of financial and ESG information. Starting in 2009, the annual report website included economic indicators in sustainability performance and identified the opportunities and risks related to sustainability, linking them to other relevant sections. Unique to the 2010 annual report website is a feature that allows users to select the role of “sustainability analyst,” “financial analyst,” or “employee” to see different views of the data. The website also offers the report in Mandarin. The 2010 home page features interactive charts with both financial and ESG information under performance highlights, reinforcing the link between the two. Users see that in 2010 Philips invested more than €450 million in green innovations, achieving the 2012 target of €1 billion invested in green innovations two years ahead of schedule; and that the company aims to invest a cumulative €2 billion during the coming five years.

Although opportunities still exist for Philips, integrated reporting has been an important catalyst in bringing sustainability to the forefront of the management team agenda. Critical to this goal will be ongoing stakeholder engagement. Simon Braaksma, senior director at Philips’s corporate sustainability office, commented: “These collaborations get board-level attention within the company. Stakeholder engagement is a key part of our business operations, expanding our knowledge of markets and improving our products as we balance our financial and ESG goals.” As an example, Philips is involved with the Dutch Sustainable Trade Initiative (IDH), which creates multi-sector partnerships to achieve the United Nations Millennium Development Goals. Philips is participating in the IDH Electronics Program to improve working conditions for 500,000 workers in China’s Pearl River Delta. This form of stakeholder engagement enables Philips to create a more sustainable society while expanding its presence in a growing market. The approach also highlights the integrated nature of business results and sustainability as well as the role integrated reporting can play in fostering multi-sector partnerships.

THE ROLE OF CIVIL SOCIETY

Although most of the current focus on integrated reporting is on companies, the concept applies equally well to many types of organizations. Virtually any organization that uses financial, natural, and human resources should practice integrated reporting. The U.S.-based National Association of College and University Business Officers is exploring integrated reporting, and Dean Nitin Nohria of the Harvard Business School plans to produce a One Report on the school. Living PlanIT, the high technology start-up for sustainable urbanization, is developing an application of integrated reporting for cities along with its partners Microsoft and Cisco Systems.

As representatives of civil society and in collaboration with the public and private sectors, nongovernmental organizations have a major role to play in promoting integrated reporting, particularly through their advocacy role and what Waygood calls “capital market

campaigning.” This is based on two complementary techniques, argues Waygood, of “first, pressuring investors to invest capital in one company or sector rather than another; and, second, using the rights and influence associated with share ownership to voice concerns directly with company directors and senior management.”⁹

NGOs can act at a more strategic level through formal partnerships with institutional investors. An example of an NGO working with investors is the Oxfam Better Returns in a Better World Project, facilitated by the Principles of Responsible Investment (PRI), which is assessing the potential for investors to contribute to poverty alleviation. The project made two recommendations for institutional investors. The first is “develop, implement, and report on their responsible investment strategies, with a particular focus on how they will address poverty.” The second is that “asset owners explicitly demand and reward investment managers that take particularly proactive responses to responsible investment.”¹⁰ Another example of NGO investor engagement is the Access to Medicine Index. Developed by a group of prominent institutional investors with the help of the PRI, the index is designed to encourage pharmaceutical companies to develop, implement, and report on policies that give people in developing countries access to affordable medicines. Twenty-seven investors, managing a total of \$3.3 trillion in assets, signed an Investor Statement that, among other things, commits them to “take into account the analysis generated from the index as appropriate in the ESG analysis we conduct on the companies we invest in.”¹¹

NGOs can direct investor groups to influence industry associations, stock exchanges, standard setters, regulators, and legislators to encourage and require integrated reporting by companies. NGOs also can use their public policy advocacy muscle to argue that the current structure of capital markets acts as a constraint against sustainable development for two main reasons: short-termism and market failure. Focusing on short-term financial targets clearly creates a disincentive to make investments that produce positive economic and sustainable returns, such as reducing a company’s carbon emissions and waste and improving its working conditions. NGOs can advocate for a longer-term orientation by investors, just as they can by companies. They also can lobby government entities to require companies to internalize the environmental and social costs they create by placing these liabilities on their balance sheets, thereby addressing the market failure problem. Obviously, NGOs cannot do any of this unless ESG performance information is available from companies. One hopes the desire for this information will create an incentive. And as time goes on, investors will be in a position to compare the performance of their portfolio companies practicing integrated reporting to those that are not.

Similarly, NGOs can pressure government, in its many levels and functions, to practice integrated reporting. Focusing solely on GDP is no different from focusing solely on quarterly earnings. British Prime Minister David Cameron has made this distinction part of his Big Society campaign. In a November 2010 speech he said, “It’s time we admitted that there’s more to life than money and it’s time we focused not just on GDP but on GWB—general well-being.” Citing recent market failures, Cameron continued: “Governments have failed to sufficiently internalize companies’ environmental and social costs such that the consequent economic development

is fully sustainable. ... As a result of government’s failure to internalize these costs on company balance sheets, the capital market does not incorporate companies’ full social and environmental costs.”¹² But if governments were practicing integrated reporting, they would have incentives to address this market failure. Requiring companies to put financial and nonfinancial externalities on their balance sheets will improve the management of natural, human, and financial resources at the company level. It also, in the aggregate, will improve performance at the country level.

NGOs have an important role to play in the creation and enforcement of frameworks and standards for integrated reporting. They can engage with the IIRC and support its efforts. They also can help ensure the proper practice by companies and use by investors and other stakeholders of integrated reporting by monitoring public and private sector entities that have an enforcement role. In doing so, they will be the “watcher of the watchers,” representing the interests of civil society, to ensure that those responsible for the application of integrated reporting frameworks and standards are doing their job.

Finally, if NGOs expect companies and investors to put their self-interest in a broader social and longer-term context, they must do the same. NGOs advocating for integrated reporting must practice it themselves. Like all organizations, NGOs use financial, natural, and human resources to accomplish their objectives—admittedly at smaller levels than large corporations and governments. They need to disclose their use of these resources, practicing the same level of transparency they want from companies, investors, and the government.

The clock is ticking for creating a sustainable society. In some areas, such as climate change, there are those who believe it has already struck midnight. But we must get on with it, starting with each and every one of us as citizens of the world, whether we represent public, private, or nongovernmental interests. Now is the time for all three sectors to acknowledge and act before it is too late. ■

Notes

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