In Practice

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To Achieve Purpose, Boards Must Embrace Integrated Reporting

By Robert G. Eccles and Helle Bank Jorgensen

Is integrated reporting the board's top priority? Of course not. Purpose is. But once purpose has been defined, integrated reporting is the way the company ensures it is being achieved and communicated to shareholders and all other stakeholders.

The pandemic shined a light on the fundamental question about the purpose of corporations: Do companies exist solely to make money for their shareholders, or should they have a broader purpose where profits come from successfully executing on that? In the case of the latter, companies have to understand who their key stakeholders are beyond shareholders and the impact the company's operations, products, and services have on them. They also need to understand and report on the material environmental, social, and governance (ESG) risks and opportunities. To do that with integrity, now more than ever, what companies need is integrated thinking. The board must take the lead and demand a truly integrated report that will enable and ultimately showcase integrated thinking by management. This will make the board more effective and benefit the company, its shareholders, other stakeholders, and the world itself.

History Lesson

Since the very first integrated report appeared in 2002—from the Danish biotechnology company Novozymes—there has been a steady increase in the number of integrated reports published by companies around the world, albeit with substantial variation by country. The Novozymes report was informed by ValueReporting, a PwC initiative that both authors of this article were involved in during the 1990s. The report was aimed at demonstrating the value creation from its environmental, social, financial, and stakeholder governance work. And it was grounded in the corporate governance of the company.

Seventeen years later, Novozymes' 2019 integrated report continues to provide lessons for other companies and their boards that are looking to adopt integrated reporting. For example, its "economic contribution" diagram shows how it has generated and distributed value to its suppliers, capital providers, community, employees, and reinvestment in Novozymes. The report explains how each of Novozymes' five business lines contributes to specific sustainable development goals. It also explains Novozymes' accounting policies for how it measures ESG performance. These are the basis for the "Statement of the Board of Directors and Executive Management" and the "Independent Auditor's Report."

Following the lead of Novozymes, Novo Nordisk, a Danish pharmaceutical company, produced its first integrated report in 2004. That same year, Natura, a Brazilian cosmetics and fragrances company, published its first integrated report. The fact that two companies in different industries and countries published their first integrated reports in the same year indicated then that the time for integrated reporting had arrived.

Since then, hundreds of corporations have issued integrated reports, and many reports have benefited from the International <IR> Framework, developed by the International Integrated Reporting Council (IIRC), including the six capitals (financial, manufactured, natural, human, intellectual, and social and relationship), to report on how companies create value over the short, medium, and long term. *(See sidebar, right.)* A good integrated report identifies the material ESG issues, often called nonfinancial issues, that matter to financial performance, and shows the relationships between them.

Status of Integrated Reporting

There is only one country that has mandated integrated reporting—South Africa—and it has done so on a comply-or-explain basis. Adoption in other countries varies. It is quite popular in Japan, where in 2010 fewer than 25 companies issued integrated reports and today more than 400 voluntarily do so. Only a handful of US companies issue integrated reports. The IIRC US community website lists 31 companies that are purportedly issuing integrated reports. No explanation is given for how companies get on this list, and many of them are self-labeled as "sustainability report" or "summary report."

Common reasons given by US companies as to why they don't want to practice integrated reporting are that investors don't care about ESG performance (demonstrably not true, as shown in "The Investor Revolution: Shareholders Are Getting Serious About Sustainability," *Harvard Business Review*, May-June 2019); it is too difficult and expensive to do so (the experience of companies in other countries belies this notion); and that it will invite litigation.

A First from Philip Morris

An interesting example to challenge the last point is the US tobacco company Philip Morris International (PMI). Tobacco companies are no stranger to litigation and are hardly looking for more reasons to be sued. Yet on June 30, PMI published its first integrated report, "Delivering a Smoke-Free Future: Progress Toward a World Without Cigarettes," along with a summary, "ESG Highlights From the Integrated Report." It also published an online supplement to the integrated report that provides additional information on PMI's approach to sustainability.

Materiality is obviously a foundational concept in integrated reporting. PMI explained the process it uses to determine its most material sustainability issues in a separate report produced a month earlier. PMI's first integrated report, published in its 2020 proxy statement, includes a statement of purpose signed by every member of its board.

This statement of purpose reinforces PMI's commitment to a fundamental business transformation—delivering a smoke-free future by aggressively cannibalizing its cigarette business in favor of reduced-risk products. To make its transformation measurable and transparent, the integrated report includes a set of bespoke business transformation metrics that shows the progress being made to replace cigarettes with less harmful (although not entirely risk-free) nicotine-containing products. Its integrated report contains 25 such metrics. For these

A framework developed by the International Integrated Reporting Council assists companies in identifying and quantifying nonfinancial issues that it recommends as these six forms of capital:

1. Financial: pools of funds obtained from sales or generated through operations

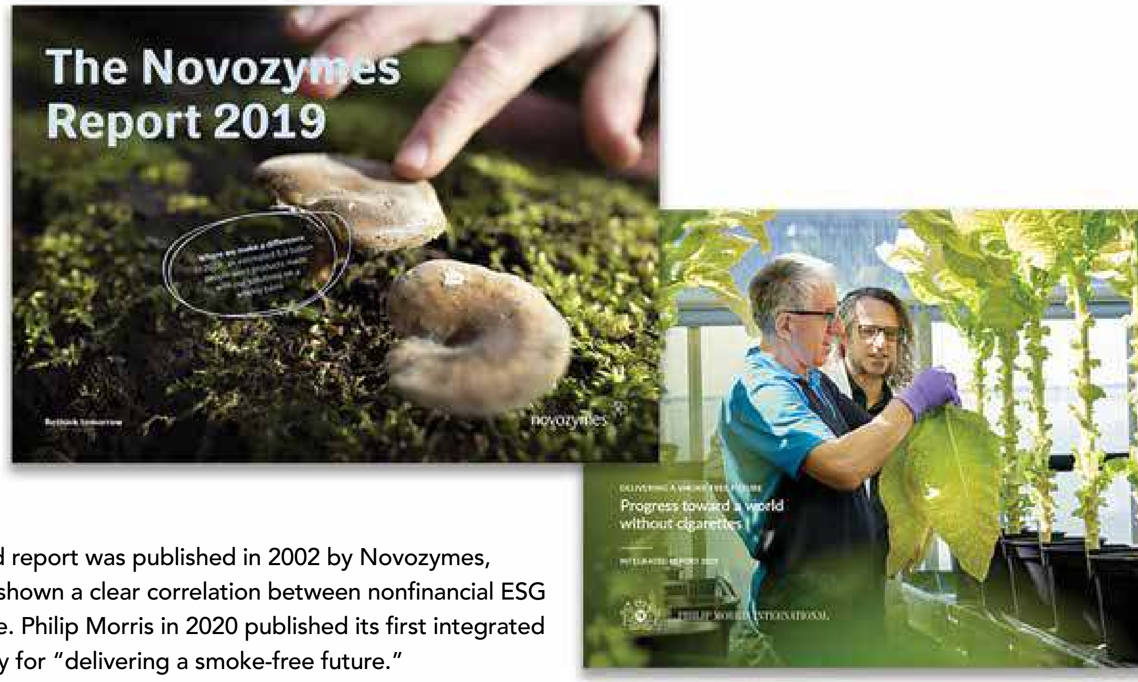
2. Manufactured: buildings, equipment, infrastructure

3. Natural: air, water, land, minerals

4. Human: people's competencies, capabilities, and experience

5. Intellectual: knowledge-based intangibles

6. Social and relationship: institutions, communities, groups of stakeholders that enhance individual and collective well-being



The world's first integrated report was published in 2002 by Novozymes, which each year since has shown a clear correlation between nonfinancial ESG measures and performance. Philip Morris in 2020 published its first integrated report detailing its strategy for "delivering a smoke-free future."

and other ESG metrics the company declared targets for 2025.

The quality of integrated reporting varies. A study of the quality of integrated reporting in 20 countries ranked South Africa first, closely followed by the Netherlands, where integrated reporting is done on a voluntary basis. This shows that regulation is not necessary for high-quality integrated reporting, although it is a factor in the quantity of reports. The United States was dead last, and by a wide margin. The reason why can be easily seen by a quick scan of the reports on the US community's website. Japan, where integrated reporting is quite popular, was third to last, showing that quality and quantity are independent variables. In general, quality was modest due to a variety of factors: poor materiality analysis, very little stakeholder engagement, the lack of a linkage to strategy and resource allocation, and the dearth of reporting on performance.

Most integrated reports, unfortunately, have nothing to do with how the company is managed. The report is typically put together at the end of the year by the sustainability and communications teams, perhaps with the help of outside public relations and design agencies. It does not show the relationship between financial and nonfinancial performance. At best, it is a useful marketing document for the general public, but offers little or no connection to the strategy or real value drivers of the business. Thus, it is largely irrelevant to investors, senior management, and the board—which has minimal input into it.

This needs to change. If a company is going to do integrated reporting, it needs to do it properly, lest the report become a mockery of the company itself. An integrated report needs to be the outcome of integrated thinking across the entire organization, where sustainability is not a separate strategy but core to the corporate strategy.

This, in turn, starts with the board. The board's first step is to agree to and publish a company-specific, stakeholder-inclusive statement of purpose. Integrated reporting is the mechanism by which the board ensures the integrated thinking necessary to accomplish the company's strategic objectives. The integrated report provides information to the board, management, investors, and other stakeholders about the extent to which the company is achieving its purpose. It should help the board in its oversight role and give long-term investors a view into the company and how it is creating and will continue to create value without misusing the resources at its disposal.

A well-discussed and thought-through integrated report will address governance; it will address ESG issues; it will address ethics and integrity; it will address the six capitals; it will discuss the company's purpose and tie that purpose to actual achievement both today and in the future. It will also be explicit about the relationships between ESG and financial performance, as well as between the different ESG performance measures themselves.

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SAP Details Cause and Effect

The German software company SAP provides a good example of this. In its online 2019 integrated report, a "connectivity" page shows the relationship between financial and nonfinancial performance measures. It shows four corporate objectives (growth, profitability, employee engagement, and customer loyalty), along with two environmental (carbon emissions and total energy consumed) and five social (capability building, social investment, women in management, employee retention, and Business Health Culture Index, or BCHI) indicators. Each of these indicators is represented by a small circle arranged in a larger circle. By clicking on any one of the circles, the user can see SAP's view of how it is related to the others. For example, women in management contributes to growth, profitability, and customer loyalty. Capability building contributes to the number of women in management, growth, profitability, and customer loyalty, and is related to the BCHI.

SAP provides evidence supporting these relationships and explains how it determines materiality for each of them. In some cases, the company is able to show the financial value of nonfinancial indicators. For example, in 2018, a 1 percent change in the BCHI affected operating profit by 90 million to 100 million euros.

While originally developed for its own internal management and reporting purposes, SAP is now embedding its logic into software solutions to help its clients practice integrated thinking and produce integrated reports.

"We believe that companies achieve higher profits—resulting from both greater cost efficiency as well as revenue growth—by addressing economic, social, and environmental considerations in a holistic and integrated manner," SAP states on its website about its Integrated Report 2019. "More importantly, these companies are better equipped to lead in the future, as they navigate the world's most pressing challenges and help to bring about long-term sustainable change."

Materiality of Stakeholders

A critical aspect that many boards do not discuss but should is who the key stakeholders are—those that are material to the company's purpose, resiliency, and sustainable long-term success. The board also needs to discuss the trade-off between stakeholder groups. All too often the board is afraid of setting priorities between stakeholders. However, that is exactly the board's role as stewards of the corporation and the resources it is impacting and the capital it is responsible for creating and deploying. If the board does not set the right tone and direction, it will be responsible for time and resources being wasted on the wrong activities for nonmaterial stakeholders.

Once clarity has been achieved about the relative importance of the company's stakeholders, including the many different types of shareholders, management should then determine the material issues related to the six capitals. This provides the foundation for the integrated report.

It will probably take at least a year, possibly two, for a company to produce its first quality integrated report. It may only want to share this first effort internally with the board. The board should provide rigorous feedback. Then, once the company starts publishing integrated reports, it should involve the full board in a substantive way without burdening it with excessive details. The board needs to be given a draft of the integrated report with enough time for a careful review. The board chair or lead director needs to make clear to all board members that this is an important task, and signal this by his or her own actions, such as sharing thoughtful comments with the other directors.

After the integrated report is published, feedback should be obtained from shareholders and other stakeholders. This is an ongoing process of continuous improvement. The goal needs to be an annual integrated report on which a positive assurance opinion is given, just as it is for the financial statement.

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