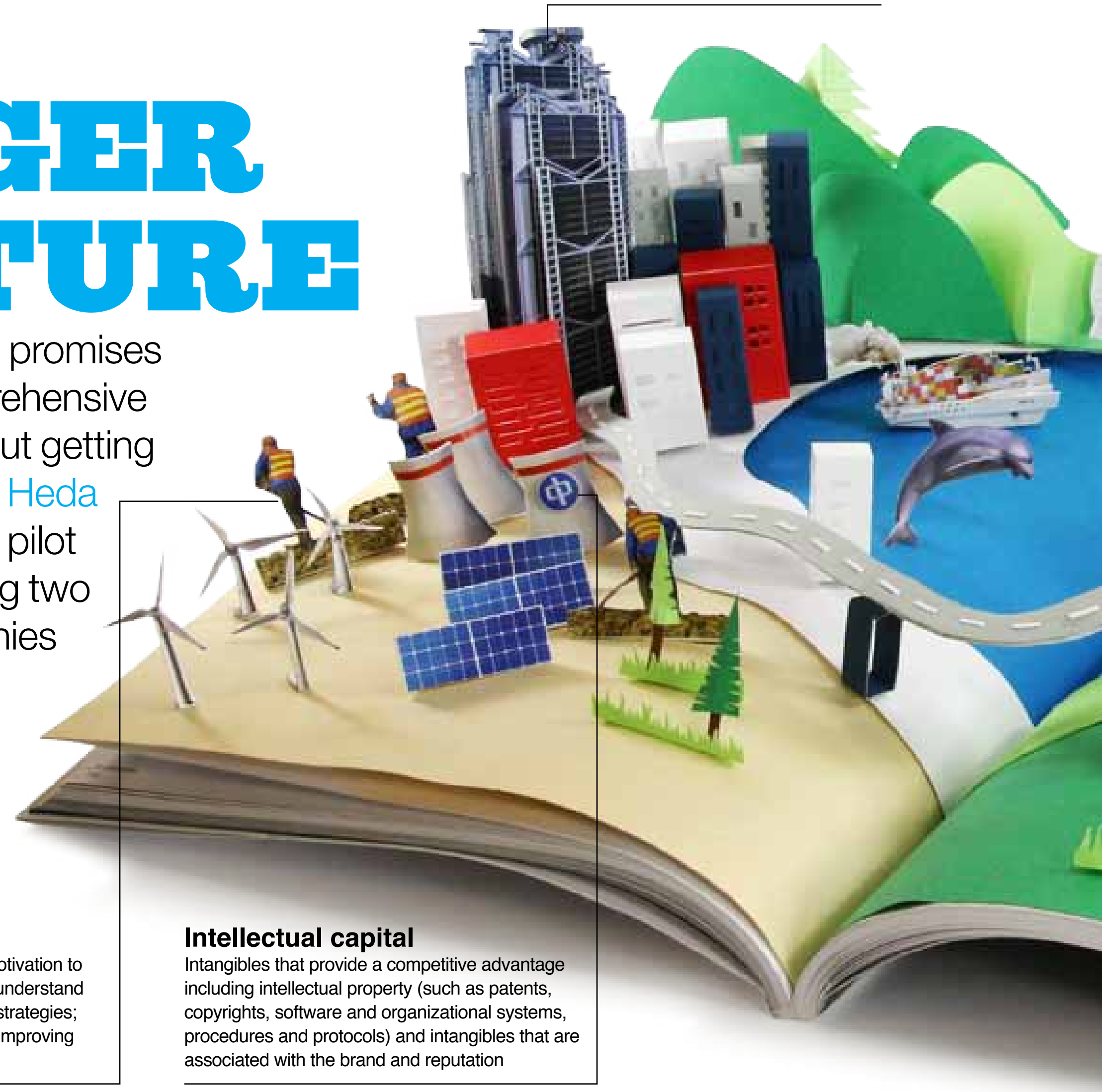
THE BIGGER PICTURE

Integrated reporting promises to produce a comprehensive corporate picture, but getting there is a challenge. Heda Bayron reports on a pilot programme involving two Hong Kong companies



When floodwaters from an unusually heavy rainy season submerged Honda Motors' factories in Thailand in October, the Japanese carmaker had to halve car production in the United States and Canada and delay introducing a new vehicle because it lacked the necessary parts.

The disruption of Honda's global supply chain prompted shareholders to dump the stock at a time when it could least afford it – the company had recently announced a significant drop in profit. "To put it bluntly, we're in a really tough spot," Fumihiko Ike, Honda's chief financial officer, told a media conference on 31 October.

That flooding in a Southeast Asian country could disrupt the global operations of one of the world's largest car makers underscores the vulnerabilities and dependencies that companies deal with today.

These seemingly out-of-nowhere business disruptions have forced CFOs and other executives to view company viability beyond the financials and evaluate the impact of factors such as climate change, resource scarcity and political risk. In hindsight, Honda Motors management and shareholders could have benefited from information about the risks to its global supply chain from the shutdown of factories in one country.

This is where integrated reporting can step in, say proponents of the system of reporting developed in the 1990s that demonstrates linkages between a company's strategy, governance and financial performance and the social, environmental and economic context in which it operates.

Annual reports have grown thicker as companies have struggled to include supplementary material in the hope of plugging information gaps and meeting stakeholders' expectations. Companies have accounted for their nonfinancial performance, such as

Manufactured capital
Manufactured physical objects (as distinct from natural physical objects) that are available to the organization for use in the production of goods or the provision of services, including buildings, equipment, infrastructure (such as roads, ports, bridges and waste and water treatment plants)

Natural capital
The raw materials used as inputs for the goods or the provision of services; an organization's activities can also impact (positively or negatively) on its natural capital, including water, land, minerals, forests, biodiversity and the health of the ecosystem

Social capital
The institutions and relationships established to enhance individual and collective well-being, including common values and behaviours, and the trust and loyalty that an organization has with customers, suppliers and business partners

Source : International Integrated Reporting Council
Artwork by Jennifer Choy, Crystal Fung, Jasmine Hu and William Tang

The company capitals measured in an integrated report

whether they meet environmental, social and governance standards.

"It's no longer just enough to report on financial performance," says Gayle Donohue, audit partner at PricewaterhouseCoopers in Hong Kong. "Investors want to know what the drivers of the business are. They focus not just on the sustainability of economic capital but also on environmental and social capital."

Yet stakeholders are still left hanging. They say companies aren't adequately connecting all these pieces of information and explaining how they affect the ability of the company to create and sustain value in the short to long term.

The holy grail for fans of integrated reporting is a single report that combines financial and nonfinancial information. By issuing an integrated report, companies are supposed to benefit from better engagement with shareholders, better resource allocation and better risk management.

In September, the International Integrated Reporting Council, a group comprised of business leaders, regulators, standard setters (including Hans Hoogervorst, the International Accounting Standards Board chairman), academics and investors, published a discussion paper on integrated reporting.

In the following month, CLP Group and HSBC became the first Hong Kong participants of a two-year integrated reporting pilot programme involving more than 40 companies worldwide.

Change of mindset

Integrated reporting is not just about combining a sustainability report with the traditional annual report. It requires companies to connect strategy, risk, remuneration, key performance indicators and other components. And for many Hong Kong companies, that's a totally new accounting experience.

Content elements

The International Integrated Reporting Council set down a framework for covering the different aspects of a company, and how they are fundamentally linked with one another. The IIRC recommends that reports contain the following components:

Organizational overview and business model covers the nature of the company in question, and its plans to create and sustain value in the short, medium and long term.

Operating context including risks and opportunities encompasses the circumstances, resources and relationships involved in the operation, and how these present uncertainties.

Strategic objectives and strategies to achieve those objectives focuses on the aspirations of the company, and the methods it plans to employ to reach those desired ambitions.

Source : International Integrated Reporting Council

"In terms of reporting practices, at the moment, information from different departments is compiled into a report with little or no connection among the different aspects of the company's performance, such as the business, community and environmental aspects," says Yvonne Wu, an enterprise risk partner at Deloitte in Hong Kong.

"The report also has little connection to creating long-term value," she adds. "Integrated reporting requires a comprehensive mindset and it is also a transformation from an information compilation exercise to a process for understanding how all these different factors complement each other and contribute to long-term sustainable growth."

April Chan, CLP Group's company secretary and an Institute member, says integrated reporting would help the regional utility drive performance within the company and improve its relationship with shareholders. "Through the reporting process we can actually create some internal and external pressure to [create] an integrated thinking process, aligning policies and systems to the expectations of our shareholders," she says.

Last year, the Johannesburg Stock Exchange became the first bourse to require listed companies to issue integrated reports, but research by Deloitte assessing the first year of implementation found that "many companies still do not yet see the relevance or value of integrated reporting."

Deloitte also found that companies are grappling with setting measurable nonfinancial targets. Their data showed that South African companies performed particularly badly in terms of "demonstrating a commitment by management to synthesizing environmental, social and governance standards into strategy and ensuring that suitable structures are in place to ensure execution."

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In Hong Kong, the adoption curve may be steeper. Few listed companies are reporting on nonfinancial performance, such as sustainability or corporate social responsibility reports. "I believe the principle of connectivity of information is a challenge that would apply to most companies," says Chan.

Executives say linking financial and nonfinancial elements is a difficult process. "When you describe the strategy, performance and outlook, that's a lot easier, you can tell the story," says Chan. "But if you also tie [those] with the impact of business on the climate, on the community and others, you need measures at the outset, and, based on those measures, you collect the relevant information and then disclose it within each business unit. That is a challenge."

Another obstacle is the lack of a single standard for sustainability reporting, which makes comparability among companies a hard task. "The entire sustainable investment industry suffers from the fact that there are not enough standard methodologies and metrics for environmental, social and governance factors," says Alexandra Tracy, chairwoman of the Hong Kong-based Association of Sustainable and Responsible Investing in Asia.

Step by step

Companies may have to take a step-by-step approach to integrated reporting, which includes gathering information across the entire business and determining details relevant to stakeholders. This could mean companies need to look at how they gather data internally and how reliable these are.

At CLP, where a system is already in place to collect information for its annual report and sustainability report, Chan says it's a matter of making the process more structured. She says CLP might need more time to collect information and develop its method.

Governance and remuneration refers to the internal structure of the organization, and how this factors in to strategic objectives and to the company's approach to compensation.

Performance gauges the organization's achievements and failures in relation to the company's objectives and strategies, and includes both qualitative and quantitative data.

Future outlook covers the opportunities, challenges and uncertainties the organization expects to come across in attempting to achieve its predetermined strategic objectives.

Source : International Integrated Reporting Council

Wu at Deloitte says senior management's acceptance of integrated reporting is critical because they have a top-down view of the company and can decide which data should go into the report. "Top management has the power to visualize the long-term value of integrated reporting and conduct a conscientious assessment," she says.

Datasets will vary among industries, at least in the early stages of integrated reporting. For example, investors looking to put their money into an airline with good environmental practices may want to compare carbon emissions before making a decision. Experts expect agreed-upon standards to emerge eventually.

"Over time, industry practices will emerge, which will drive comparability, making integrated reporting a bit more structured," Wu says.

Selling the benefits

Some fear that integrated reporting may be burdensome, especially now that regulations are tighter. "Ideally, an integrated report should be smaller than the traditional annual plus sustainability report," says Tracy. "Many small- and medium-sized enterprises that do not currently produce a sustainability report will have to progress slowly towards integrated reporting."

Tracy is concerned that such businesses do not have the internal systems and capabilities to measure and report environmental, social and governance data. "They will need help," she says. "Strong insistence on global reporting initiative or IIRC standards may scare them away from the whole exercise."

Chris Joy, executive director of the Hong Kong Institute of CPAs, says the IIRC proposal does not appear to add to the reporting burden, but he acknowledges that there could be challenges in adopting integrated reporting. "There is no way the existing reporting frameworks and regulatory reporting demands are going to be dropped overnight in favour of something else," he says. "So I think it has to be very, very carefully done to ensure that they are not just putting another layer to the reporting requirements."

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The Institute has been organizing forums in recent weeks to introduce integrated reporting to its members and the business community, and to encourage submissions to the IIRC discussion paper due this month.

The success of the pilot programme is expected to drive the mainstream adoption of integrated reporting.

Right now, only a few big companies, such as Denmark's Novo Nordisk and United Technologies in the United States, undertake integrated reporting.

With few case studies to review and benchmark against, many Hong Kong companies are likely to wait and see.

"The pilot programme provides much-needed examples to Hong Kong companies on how to mimic successful integrated reports," says Donohue at PwC. "Bigger companies have more resources and smaller companies can piggyback on their experiences."

Experts say getting Hong Kong companies on board boils down to demonstrating commercial benefits from integrated reporting. A company may find that cost savings from reduced water consumption also translates into sales growth and thus, a rise in its share price. Or a company may find that failing to account for climate change-related risks to its global supply chain draws wrath from the market.

"This is not just a touchy-feely thing," Joy insists. "It actually has commercial imperatives behind it. I think once people pick up on this and understand it, then integrated reporting will be much more readily embraced." A