INTEGRATED REPORTING

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Recently, quite often we come across the Integrated Reporting (IR) term/concept.

Integrated Reporting (IR) is a relatively new concept and as such not well-known to many. This article intends to introduce to the reader the concept of IR and to discuss its applicability and potential benefits. The article is based on the materials published by International Integrated Reporting Council (www.integratedreporting.org) and International Federation of Accountants (www.ifac.org)

So, what does IR mean? It is a new form and rather a new level of corporate reporting. As we know, the traditional form of corporate reporting represents financial statements which provide past (historic) information about the entity's financial position and performance that are expected to be useful for the users in assessing the entity's ability to generate future cash flows.

It is currently widely recognized that such financial statements, even though prepared in accordance with IFRSs, have inherent limitations and do not meet the information needs determined by the current level of development of, and challenges faced by the society. Particularly, they do not refer to the personnel, social, environmental, and sustainable development issues. They also do not reflect customer and supplier relationships, human capital, and brand and reputation, which are of key importance for value creation.

In response to the above mentioned corporate reporting "gaps," many organizations realizing their role in the society as a corporate citizen, voluntarily undertake certain responsibilities, introduce environmental standards (ISO 14000), prepare and publish environmental and social reports.

As a result, such organizations prepare a number of reports or communications that are often isolated from each other, and do not take into consideration internal organic links and communication channels.

It is expected that, over time, IR will become the corporate reporting norm and no longer will an organization produce numerous, disconnected and static communications.

However, IR is much more than simply a reporting. It is a process based on integrated thinking that results in a periodic integrated report by an organization about value creation over time and related communications regarding aspects of value creation.

An integrated report is a concise communication about how an organization's strategy, governance, performance, and prospects, in the context of its external environment, lead to the creation of value over the short, medium and long-term. It demonstrates the linkages between an organization's strategy, governance and financial performance and the social, environmental and economic context within which it operates.

So, in order to be able to prepare IR it is necessary to get a good understanding of all of that, and such an understanding is a part of integrated thinking. Integrated thinking is described in the IR Framework as "the active consideration by an organization of the relationships between its various operating and functional units and the capitals that the organization uses or affects."

IR is seen by the International Integrated Reporting Council (IIRC) as the basis for a fundamental change in the way in which entities are managed and report to stakeholders.

The aim of IR, as stated in the IIR Framework, is to support integrated thinking and decision making.

The primary purpose of an integrated report is to explain to providers of financial capital how an organization creates value over time. However, an integrated report brings benefits not only to the providers of financial capital, but to all stakeholders interested in an organization's ability to create value over time, including employees, customers, suppliers, business partners, local communities, legislators, regulators, and policy-makers.

The Value Creation Process

As IR is about value creation, it is necessary to have a closer look to the value creation process.

The value creation process is depicted in the figure below which is taken from the IIR Framework (see on the next page).[1]

As we can see from the figure, for IR purposes, apart from financial capital, five additional types of, so called, sustainable capitals are considered, from where we derive the goods and services we need to improve the quality of our lives. These other capitals (sometimes collectively referred to as "multiple capitals") are:

Manufactured Capital: tangible goods such as tools, machines, and buildings and infrastructure that organizations own, lease, or have access to be used in the provision of goods or services.

Intellectual Capital: knowledge, intellectual property, systems, and processes that an organization has at its disposal that provide it with a competitive advantage and positively affect its future earning potential e.g. gaining new customers, creating new products.

Human Capital: skills, experience, health, and motivation that employees and management in an organization possess that provide the foundation for future development and growth. Enhancing human capital through education and training is central to a flourishing economy.

Social and Relationship Capital: An organization's brands and reputation, including its relationships with the community in which it operates (such as schools, trade unions, voluntary organizations), its customers, and business partners and others in its value chain, like various government agencies.

Natural Capital: An organization's access to environmental resources that it can use to provide a return and/ or that it affects through its activities or the goods and services it creates. The value that nature provides, the natural assets that society has are therefore not only the basis of production but of life itself. It includes resources of a renewable and non-renewable materials e.g. land, water, energy and those factors and processes that absorb, neutralize, or recycle wastes-e.g. climate regulation, climate change, CO_2 emissions.

Different Types of Capital, on the one hand, are used in the business model as inputs (resources) and, on the other hand, they are affected by the outputs derived through business activities.

The External Environment, including economic conditions, technological change, societal issues and environmental challenges, sets the context within which the organization operates.

The Mission and Vision encompass the whole organization, identifying its purpose and intention in clear, concise terms.

Those charged with **governance** are responsible for creating an appropriate oversight structure to support the ability of the organization to create value.

At the core of the organization is its **business model**, which draws on various capitals as **inputs** and, through its business activities, converts them to **outputs** (products, services, byproducts and waste).

The organization's activities and its outputs lead to **outcomes** in terms of effects on the capitals. The capacity of the business model to adapt to changes (e.g., in the availability, quality and affordability of inputs) can affect the organization's longer term viability.

Business activities include the planning, design, and manufacture of products or the deployment of specialized skills and knowledge in the provision of services. Encouraging a culture of innovation is often a key business activity in terms of generating new products and services that anticipate customer demand, introducing efficiencies and better use of technology, substituting inputs to minimize adverse social or environmental effects, and finding alternative uses for outputs.

Outcomes are the internal and external consequences (positive and negative) for the capitals as a result of an organization's business activities and outputs.

Continuous monitoring and analysis of the external environment in the context of the organization's mission and vision identifies **risks and opportunities** relevant to the organization, its strategy, and its business model.

The organization's **strategy** identifies how it intends to mitigate or manage risks and maximize opportunities. It sets out strategic objectives and strategies to achieve them, which are implemented through **resource allocation** plans.

The organization needs information about its **performance**, which involves setting up measurement and monitoring systems to provide information for decision making.

The value creation process is not static; regular review of each component and its interactions with other components, and a focus on the organization's **outlook,** lead to revision and refinement with the purpose to improve all the components.

In creating value for itself, an entity creates, and may sometimes destroy, value for others. Value is almost always co-created. Like two sides of a transaction, neither party will close the deal unless it perceives there is value in it for itself. For example, excessive usage of water by fish-farmers in Ararat valley may lead to not only the lack of water for fishery, but also for the general life activity in the region.

The International Integrated Reporting Council (IIRC) published the International IR Framework in December 2013. In addition to fundamental concepts, IR Framework establishes also Guiding Principles and Content Elements that govern the overall content of an IR, and explains the fundamental concepts that underpin them. The volume and nature of this article does not allow to consider

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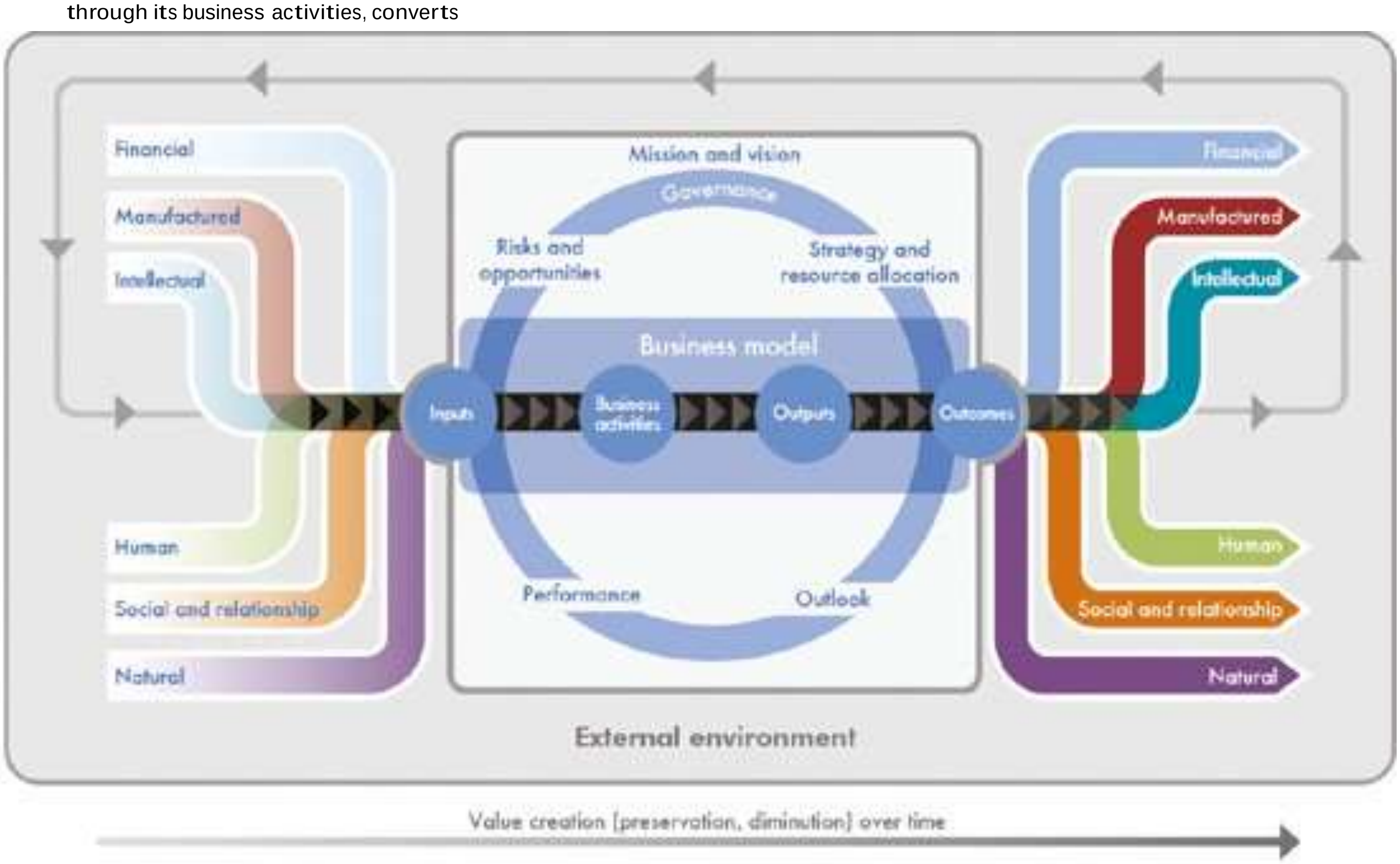

those in details, so short descriptions are provided below.

The following Guiding Principles underpin the preparation and presentation of an integrated report, informing the content of the report and how information is presented:

A **Strategic focus and future orientation:** An integrated report should provide insight into the organization's strategy, and how it relates to the organization's ability to create value in short, medium and long term, and to its use of and effects on the capitals.

B **Connectivity of information:** An integrated report should show a holistic picture of the combination, interrelatedness, and dependencies between the factors that affect the organization's ability to create value over time.

C **Stakeholder relationships:** An integrated report should provide insight into the nature and quality of the organization's relationships with its key stakeholders, including how and to what extent the organization understands, takes into account, and responds to their legitimate needs and interests.

D **Materiality:** An integrated report should disclose information about matters that substantively affect the organization's ability to create value over short, medium, and long-term.

E **Conciseness:** An integrated report should be concise.

F **Reliability and completeness:** An integrated report should include all material matters, both positive and negative, in a balanced way and without material error.

G **Consistency and comparability:** The information in an integrated report should be presented: (a) on a basis that is consistent over time; and (b) in a way that enables comparison with other organizations to the extent it is material to the organization's own ability to create value over time.

An integrated report includes the following eight Content Elements:

1) **Organizational overview and external environment:** What the business does and the circumstances under which it is operating.

2) **Governance:** How the governance structure supports the business's ability to create value in short, medium, and long term.

3) **Business model:** The business model, including an identification of its key elements, which may include a simple diagram showing business input, activities, outputs, and outcomes.

4) **Risks and opportunities:** The specific risks and opportunities that could affect the business's ability to create value over short, medium, and long term, and how it is dealing with them.

5) **Strategy and resource allocation:** The direction in which the business is heading and how it plans to get there.

6) **Performance:** The business's journey in achieving its strategic objectives for the period and what the outcomes are in terms of the effects on the various capitals.

7) **Outlook:** The challenges and uncertainties that the business has encountered in pursuing its strategy, and the implications for the business model and future performance.

8) **Basis of preparation and presentation:** How the business determines which matters are to be included in the integrated report and how such matters are quantified or evaluated.

The Content Elements are fundamentally linked to each other and are not mutually exclusive. In preparing an integrated report they should not be treated as an end in itself, rather they intend to help better to present the value creation process.

As shows a research conducted by ACCA (Insights into Integrated Reporting: Challenges and Best Practice Responses), many reports included good discussions in relation to each IR content element, but over half fail to link the content elements to value creation.

Organizations often struggle to identify what their stakeholders perceive as "value." Further, many seasoned preparers are still on a quest to find the most effective way of articulating how non-financial value is created or destroyed-qualitatively or quantitatively.

Given the complex nature of IR, from a first glance, one can think, that IR is solely for big companies. However, it is not the case. Through integrated thinking, IR can help an SME build a better, more concrete understanding of the factors that determine its ability to create value over short, medium, and long term. It enhances an SME's business planning and development by taking a fully connected, holistic view, including its use of, and effect on, all capitals or resources that are important to its business model and future. IR is an effective way to help an SME better understand and manage how it creates value, as well as report on that value creation. More integrated information and thinking should lead the organization to make better decisions about the key areas that affect its ability to create value that can then be communicated through an integrated report, which demonstrates a compelling business case to providers of finance, and others interested in the business.

IR also provides a significant opportunity to establish, or enhance processes and systems for identifying, measuring, and analyzing essential data in various capitals. Important areas driving value creation can then be built into setting objectives and targets, managing opportunities and risk, undertaking project and investment appraisals, and aligning performance to objectives with relevant performance measures.

IR is applicable and can be of benefit for organizations of different size, different nature (including not-for-profit and public sector), different stage of development and their stakeholders, including providers of financial capital, such as shareholders, venture capitalists, crowdfunding, banks, grant donors, etc.

Finally, while concluding this article, I thought that the Armenian Institute of Directors can be a suitable body/ structure to initiate the translation of the International Integrated Reporting Framework into Armenian. Also, I wonder to see who will be the integrated reporting pioneer among Armenian organizations.

Find out more: http://www.amcham.am/pdf/147da7c4d8b5303779c407f0b4d1eb96.pdf