INTEGRATED THINKING

The next step in integrated reporting
Two of the world’s most prestigious accounting bodies, AICPA and CIMA, have formed a joint venture to establish the Chartered Global Management Accountant® (CGMA®) designation to elevate and build recognition of the profession of management accounting. This international designation recognises the most talented and committed management accountants with the discipline and skill to drive strong business performance. CGMA designation holders are either CPAs with qualifying management accounting experience or associate or fellow members of the Chartered Institute of Management Accountants.
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INTRODUCTION

Globalisation, technological development and rapid population growth are causing fundamental change to the business world. Traditional financial reporting has not kept pace with the seismic shift in macro-economic value experienced over the last 30 years, and this is reflected in balance sheets.

The value of intangible assets has now grown to over 80% of total market value for S&P 500 companies. That is a massive proportion of an organisation’s true value not being recognised by current financial accounting standards (see figure 1). At a time when many of the practices and processes that account for a company’s assets do not adequately capture value, we urgently require a reality check for business reporting.

Reporting must evolve to address the information needs of business decision makers within this changed business dynamic. Reporting plays a fundamental role in determining both corporate and investor behaviour. Both the American Institute of Certified Public Accountants (AICPA) and the Chartered Institute of Management Accountants (CIMA) advocate a new corporate reporting initiative, Integrated Reporting, which is championed by the International Integrated Reporting Council (IIRC).

Integrated reporting (<IR>) brings together material information about an organisation’s strategy, governance, performance and prospects in a way that reflects the commercial, social and environmental context within which it operates. It provides a clear, concise representation of how an organisation demonstrates sustainability and creates value. The International Integrated Reporting Framework sets out the guiding principles and content elements of an integrated report. Effective integrated reporting requires integrated thinking and decision making based on an information set that is much broader, more interconnected and more forward-looking than traditional financial analysis. The IIRC’s goal is for integrated thinking to become a fundamental business practice in both the public and private sectors, facilitated by <IR> as the reporting norm.

**FIGURE 1: Components of S&P 500 market value**

<table>
<thead>
<tr>
<th>Year</th>
<th>Intangible Assets</th>
<th>Tangible Assets</th>
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<tbody>
<tr>
<td>1975</td>
<td>17%</td>
<td>83%</td>
</tr>
<tr>
<td>1985</td>
<td>32%</td>
<td>68%</td>
</tr>
<tr>
<td>1995</td>
<td>20%</td>
<td>80%</td>
</tr>
<tr>
<td>2005</td>
<td>20%</td>
<td>80%</td>
</tr>
<tr>
<td>2010</td>
<td>20%</td>
<td>80%</td>
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Source: Ocean Tomo

**What is an integrated report?**

An integrated report should:

- Make the allocation of capital more efficient and productive through improvements in the quality of information available to providers of financial capital.

- Identify and communicate the full range of financial and non-financial factors that materially affect the ability of an organisation to create value over the short, medium and long term.

- Recognise the importance of a broad range of capitals (financial, manufactured, intellectual, human, social and relationship and natural) to a thorough understanding of the organisation’s business model.

- Focus on the core concept of the business model to support integrated thinking and decision making with a view to sustainable value creation.
REPORTING ON WHAT MATTERS

The greater the degree of integration included within the organisations’ reporting, the more long-term investors comprise their investor base, according to research by George Serafeim at Harvard Business School\textsuperscript{3} into the relationships between US firms and their investor base.

This research, which included not only those organisations that prepared integrated reports but also those that reflected broader, more interconnected and longer-term thinking in their published reports, demonstrates the link between integrated reporting principles and more long-term investment.

Stakeholder engagement remains vitally important. It has enabled corporations to question, and challenge assumptions. The Italian energy company Eni, for example, has developed its reporting to respond to the demands of its key stakeholders (see case study).

As well as improving relationships with stakeholders, integrated reporting has helped many organisations reassess the way they work across the different elements of their business, use technology to integrate information and change their reporting to reinforce the connectivity of information.\textsuperscript{5} This helps to emphasise the interdependency between strategy, the business model and value creation.

Integrated reporting is gaining international momentum but despite strongly held beliefs about the benefits of integrated reporting amongst its proponents, the journey is far from complete. CGMA designation holders have an important role to play to advocate a much broader information set for decision making. This more holistic consideration of outcomes and impacts will assist organisations to report more effectively and act as a tool to help refine their value creation process.\textsuperscript{6}

CASE STUDY

Improving stakeholder communications at Eni

Eni, a major integrated energy company headquarterd in Italy, noticed a disconnect between their reporting and the needs of their stakeholders. Sabina Ratti, Eni’s Sustainability Senior Vice President, said “After having issued a series of environmental and then sustainability reports Eni realised that, although the numbers were allowing a true and fair review of the company’s performance, operations and management, they were not necessarily relevant to the stakeholders.”\textsuperscript{4}

So how did Eni respond? By contextualising its reporting to focus on the interests of key stakeholders.

Ratti goes on to say that “What was missing was a broader process of analysis and communication able to put performance in context, able to represent the strategic leverages the company was using to build and maintain its ability to produce value in the long term. Stakeholders’ demands for greater transparency have, in time, been coupled with an internal reflection on what the company considered its strategic drivers: nowadays, our integrated reporting aims to respond to this challenge.”
HOW INTEGRATED REPORTING HELPS BUSINESS

Companies who adopt integrated reporting practices benefit from a greater understanding of their business, the business environment and their ability to create value. A greater understanding of the business enables companies and investors to make better decisions for long-term success.

Integrated reporting helps a company tell its story

More disclosure does not equate to better reporting. The focus has to be on disclosing not just a broader set of information but the relevant and interconnected information needed by investors, employees and other stakeholders to assess the organisation’s long-term prospects in a clear, concise, connected and comparable format. This will enable those organisations, their investors and others to make better short, medium and long-term decisions. <IR> helps organisations tell their story in their own words.

Benefits of <IR> for stakeholders

A company’s relationships are interconnected. Communicating in a coherent way that meets their different needs is key to creating and sustaining value.

FIGURE 2: The benefits of <IR> for stakeholders

<table>
<thead>
<tr>
<th>For investors</th>
<th>For employees</th>
<th>For other stakeholders</th>
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<tbody>
<tr>
<td>Many investors still struggle to integrate all relevant risk factors that contribute to value creation over time into investment decisions, because the information that is often presented is insufficiently strategic, comparable and sector specific. As a result, there is the risk that capital is not being directed efficiently towards those companies that have robust business models.</td>
<td>Those investors that disconnect non-financial factors from financial performance are missing what most CEOs and boards already know well – that these two are not isolated, but interconnected. For example, labour standards, employee satisfaction, customer feedback, community relations and government regulatory track records are fundamental to the success of the business and its “licence to operate”. &lt;IR&gt; provides the necessary framework to enable all the relevant information about a business to be put into context alongside its strategy and business model and provide a more holistic view of performance.</td>
<td>Integrated reporting benefits all stakeholders interested in a company’s ability to create value over time including customers, suppliers, business partners, local communities, legislators, regulators and policy-makers. What all stakeholders wish to know is the relevant issues that are impacting (and will impact) the performance of the business over time.</td>
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Basis for effective communication leading to better engagement and motivation. | A company’s ability to compete and create value is critically dependent on its people. It is well known that employee engagement is correlated with higher levels of employee motivation and customer satisfaction, which in turn leads to increased customer loyalty. Being clear about communicating the story of the company is therefore vital. Integrated reporting provides the framework to help companies engage more effectively with employees. |
Integrated reporting helps a company create value

Value is not only created within the traditional boundaries of a company. The value creation process crosses organisational and geographical boundaries through connecting numerous value drivers, many of which are now intangible. This requires good information to inform good decision making and a clear strategy and business model – all of which rely on internal cohesion created through a clear understanding of what the organisation is seeking to achieve and how.

Integrated reporting promotes integrated thinking

Integrated reporting emphasises conciseness, future orientation and a firm focus on strategy, the business model and value creation. The connectivity of information will help to improve the information available to enable a more efficient and productive allocation of capital, both between businesses and within businesses. This greater cohesion and efficiency in the reporting process promotes integrated thinking as a way of breaking down internal silos, reducing duplication and driving positive behaviours focused on long-term success.

But what are the core building blocks that support integrated thinking? It starts with a thorough understanding of the business model within the context of the external environment (see figure 3). This understanding creates a more robust basis for identifying risks and opportunities.

Our members are increasingly embracing the value of the Integrated Reporting Framework from the perspective of internal communication and co-ordination across departments and divisions to improve strategic planning and decision making.

Susan S. Coffey CPA, CGMA, Senior Vice President Public Practice and Global Affairs, AICPA

FIGURE 3: How <IR> helps achieve a resilient business model

<table>
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<tr>
<th>BETTER UNDERSTANDING OF THE VALUE CREATION PROCESS AND CRITICAL BUSINESS RELATIONSHIPS</th>
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<tbody>
<tr>
<td>Integrated reporting helps a company better understand its value creation process and connect the information, value-creating activities and relationships through which the value is created, both inside and outside the organisation.</td>
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<tr>
<th>FOCUS ON EXTERNAL BUSINESS ENVIRONMENT</th>
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<td>Changes in strategy may be driven by internal activities, but are more often driven by changes in the external environment such as changing demographics, or resource and energy limitations. These changes can be risks, but they can also be opportunities if they are identified, assessed and managed effectively and used to create competitive advantage. The &lt;IR&gt; focus on the external business environment helps this identification, assessment and management process.</td>
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<th>FORWARD-LOOKING ORIENTATION</th>
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<td>Companies need to learn from the past, act in the present, but plan for the future. The forward-looking orientation fundamental to integrated reporting promotes thinking over the short, medium and long term across the full value creation process and so is an invaluable management tool.</td>
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AT THE CORE: THE BUSINESS MODEL

The International Integrated Reporting Framework defines an organisation’s business model as its “system of transforming inputs, through its business activities, into outputs and outcomes that aim to fulfil the organisation’s strategic priorities and create value over the short, medium and long term.”

So what are inputs, business activities, outputs and outcomes?

• **Inputs** are the resources, relationships and other capitals that the organisation depends upon or which provide a source of differentiation. Integrated reporting describes those inputs that are material to understanding the robustness and resilience of the business model.

• **Business activities** are what the organisation does, how it goes about creating value for itself and its stakeholders (including society).

• In an integrated report, **outputs** include an organisation’s key products and services as well as any by-products, waste or emissions that need to be discussed, depending on materiality relative to an understanding of the robustness and resilience of the business model.

• **Outcomes** can be both internal (employee morale, revenue) and external (customer satisfaction, tax payments), as well as either positive or negative.

It is this need to identify and describe outcomes, particularly external outcomes, that drives an organisation to consider the capitals more broadly than those that it owns or controls. And it is this broadening of the range of factors to be taken into account in business decision making that underlies integrated reporting and provides its more holistic, long-term foundation.

**FIGURE 4:** The business model, sitting at the heart of the organisation, within the context of the external environment
Business model analysis

The need to understand the business model exists at both the tactical and strategic levels within an organisation. At the tactical level the focus is on an almost forensic analysis of the mechanics of the business model. At the heart of this detailed analysis, which spans the entire organisation, are the imperatives of improved customer experience, cost leadership, management of external resources and limiting the effect of competitor activity. Faced with this increasingly complex business environment, the focus should be on value creation leading to long-term business success through the optimisation of value-creating opportunities and the minimisation of value-limiting factors (see figure 5).

At the tactical level the organisation’s business model needs to be viewed through a variety of lenses specifically designed to filter different aspects of the model such as cash flows, profit generation, dependence on external relationships, technological reliance, operational processes and the impact on the organisation's reputation and risk exposure.

These lenses should be focused on the long term. However, pressure persists on business leaders to deliver financial results in the short term. According to a McKinsey Quarterly survey7 nearly 80% of executives feel most pressure to deliver financial results within a time frame of two years or less. Nevertheless, the importance of reputational risk is clear. Over three quarters (76%) of finance leaders recently surveyed by CGMA8 indicated that their company was prepared to lose profit in the short term for the sake of protecting long-term reputation, and the same number are putting more focus on reputational risk now than in previous years.

At the strategic level, the analysis is driven by the need for the board to understand how their organisation creates value through its chosen business model and the risks it faces. Airmic’s Roads to Ruin9 identifies a number of cases where board failure to understand the business model contributed to a major crisis. For example, neither the board of Northern Rock nor AIG appeared to have appreciated the potential impact of the financial markets on which their business models depended. A thorough understanding of the business model therefore needs to be at the heart of the boardroom conversation for a number of reasons:

- The business model focuses on inputs, activities, outputs and outcomes helps the board identify whether the activities of the organisation are effectively aligned to the achievement of strategic priorities and the creation of long-term value.
- The business model analysis provides a robust framework for identifying risks, weaknesses, opportunities, key relationships, supply chain and external environment issues upon which the long-term success of the business depends.
- Strategic discussions are more likely to be grounded in reality when there is a thorough understanding of all the factors contributing to or limiting the success of the business. This should lead to strategic priorities being more effectively framed in the context of the business.

As a consequence, there should be increased unity of purpose within the boardroom and more coherent and attainable strategic plans.

FIGURE 5: Business model optimisation – a tactical approach

VALUE-CREATING OPPORTUNITY

<table>
<thead>
<tr>
<th>Meet customer needs</th>
<th>Drive process</th>
</tr>
</thead>
<tbody>
<tr>
<td>Focus on value creation</td>
<td>Long-term business success</td>
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VALUE LIMITING FACTORS

| Resource constraints | Competitor activity |
Such integrated thinking has a broader base than traditional business decision making which has tended to focus on relatively short-term financial outcomes. Together with best practice protocols, integrated thinking helps frame reporting to boards and promotes better quality, decision-relevant management information necessary for effective decision making. The top slice of this board reporting provides an ideal basis for effective external reporting.

A thorough understanding of the business model supports better integrated thinking and decision making – leading to better governance, better performance management and better reporting; in other words, better business.

CGMA designation holders are ideally placed to encourage deep consideration of the process of reporting, not just the report itself and by doing so will help their organisations secure the full benefits of integrated reporting. Developing integrated thinking to support business decision making will not only present the opportunity for competitive advantage but also contribute towards global financial stability.

For CIMA, implementing integrated reporting has led to closer alignment of the P&L account and business model, as well as improved short and long-term planning processes. It has helped us focus on the same (and the right) targets across the business, and create better links between teams and with management.

John Windle FCMA, CGMA, Chief Financial and Operating Officer, CIMA

Further Reading

The Extended Value Chain
The global trends affecting business generally and how these issues are impacting extended value chains.

Building Resilience – an introduction to business models
How business models function and the factors that contribute to their success and failure.

Business Models – A Background Paper, CIMA/IFAC/PwC for the IIRC
This paper explores and reconciles divergent approaches in business model reporting.

Tomorrow’s business success
How integrated reporting helps create value and effectively tell the organisation’s story.
References

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