Integrated Reporting

Rising To The New Challenge

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What are your challenges in 2011 & 2012?

Introduction

The formal business environment in South Africa is certainly a highly challenging environment. This is not only due to the operational and financial issues and problems facing a company, but also due to increasing regulatory demands in the business environment. Compliance to laws, rules and regulations, while simultaneously keeping shareholders and other stakeholders happy, remains a huge challenge.

Corporate governance has become part and parcel of the South African business environment over the past two decades, mainly because of the King reports on Corporate Governance and the compliance thereof required by the JSE. By embracing the recommendqtions of the King reports South African businesses became global leaders in best corporate governance practices in many instances.

Of all the current regulatory challenges, the largest challenge is to produce a shorter version of the integrated report proposed in King III (King Code of Governance for South Africa (Institute of Directors, 2009).

Earlier challenges

Since the publication of the King II report in 2002, the process of integrating best corporate governance practices into the business model, has accelerated with some recommendations becoming legislation in 2007 (i.e. the requirements for audit committees). Over the past few years, many South African listed companies had to deal with the following changes (some companies had the foresight to embrace best corporate governance practices before being required to do so):

- Establishing a risk committee;
- Establishing an audit committee;
- Restructuring the board of directors, for example by finding a sufficient number of non-executive and independent non-executive directors with the appropriate background and expertise;
- Establishing risk-based internal audit departments;
- Preparing sustainability reports in line with the latest international best practices, for example complying with the GRI;
- Establishing nomination processes and committees;
- Determining how to be more transparent in reporting;
- Establishing stakeholder engagement processes; and
- Establishing ethical codes including whistle blowing.

With the publication of King III in 2009, the targets were once more set higher. A significant change was the requirement that a company should publish an integrated report, in which sustainability is essentially integrated, and not simply added, into the annual report.

Although this document deals with integrated reporting, the processes and policies underlying the reporting process must be revisited to ensure that the integrated report is based on the information provided by the business process.

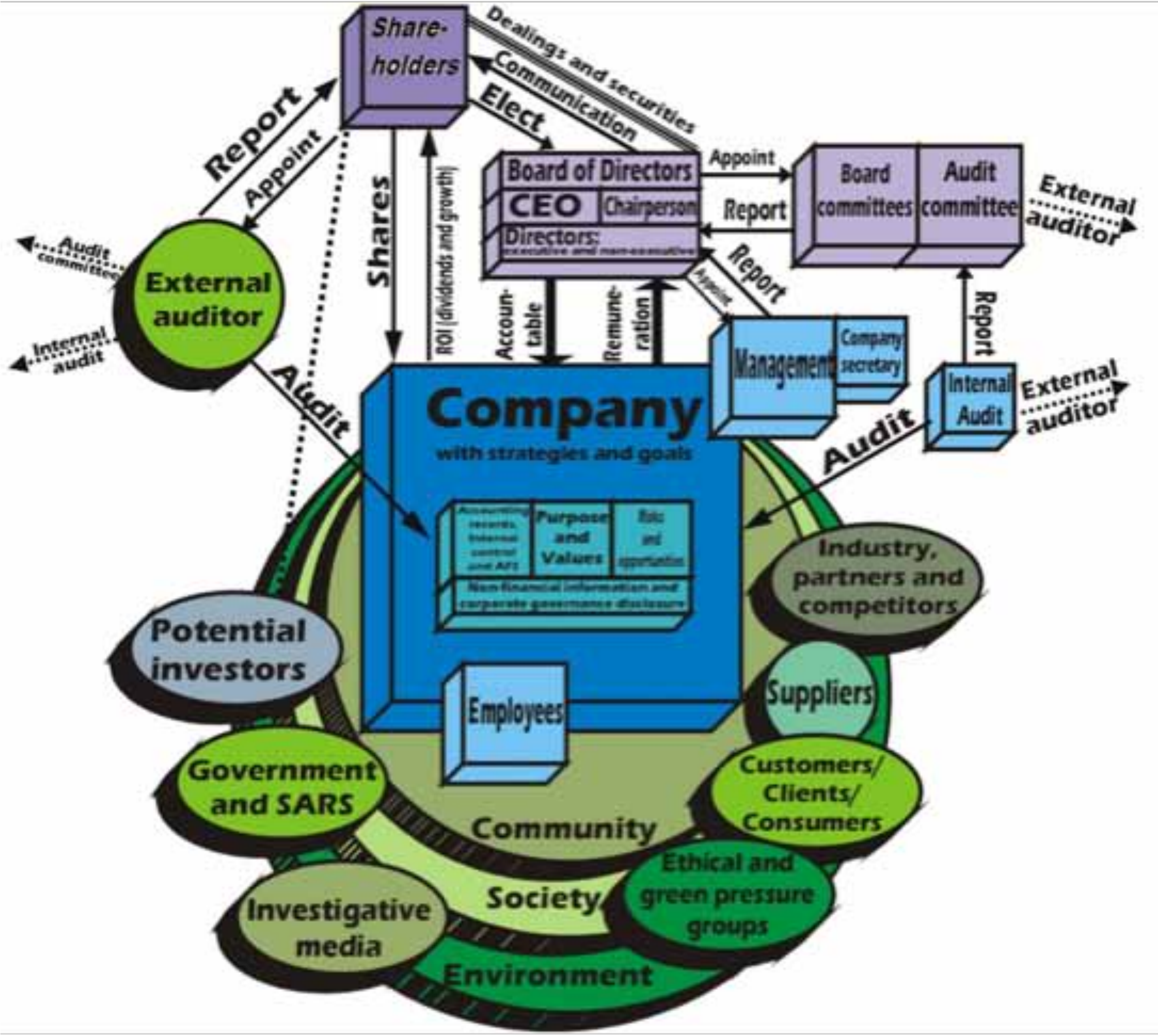
Current challenges

The South African listed companies generally attempted to adopt as much as possible of King III, even before they were required to do so. According to the JSE requirements King III became effective for listed companies in respect of all financial years commencing on or after 1 March 2010. In effect, it means that disclosure according to King III was not yet a requirement for most financial year-ends before 28 February 2011. Despite this, a large percentage of companies did produce integrated reports for the first time during the 14 months between the release of King III and 28 February 2011.

Many of the listed companies were already adjusting towards a fuller application of King III for their latest annual reports/integrated reports. Quite a number of these companies are still coming to grips with practical issues regarding not only disclosure, but also policy, processes and procedures. The following practical questions regarding the governance system emerged:

- How to integrate strategy, risk, ethics and sustainability? (Refer to a separate document in this series with the title "Is your Business Strategy aligned to Integrated Reporting Requirements?");
- How to measure the effectiveness of a compliance framework and processes for laws, codes, rules and standards?;
- How to involve the board of directors in setting the levels of risk tolerance and risk appetite once a year (instead of delegating it) and to receive and review a register of the company's key risks?;
- How to establish a framework for anticipating unpredictable risks?;
- How to establish an IT governance framework?;
- How the board can provide effective leadership in governance and in ethics and have relevant processes in place?;
- How to define the process or factors involved in assessing the independence of non-executive directors?;
- How to establish a process for capturing the number of and refusals of requests for information that were lodged with the company in terms of The Promotion of Access to Information Act, 2000?;
- How to measure, assess, monitor and report on adherence to ethical standards?;
- How to deal with resistance against aspects like King III, director training and formal director appraisals and evaluations (to mention only a few) from individual directors?;
- How to accommodate a risk committee separate from the audit committee?;
- How the charters of the board and committees can be aligned to King III?;
- How to evaluate IT systems to enhance the credibility and auditability of the Integrated Report?;
- How to ensure proper systems surround non-financial and sustainability information that will form part of the integrated report/annual report to ensure verifiability of information?;
- How the audit committee can start evaluating the Integrated Report?;
- How to integrate governance and IT governance in a group of companies with a diverse range of operations and subsidiaries?; and
- How to get proper and comprehensive stakeholder engagement processes going?. This involves more than social and health projects, aid projects to schools and communities and such. This is a dedicated approach to involve all stakeholders of a company (see figure 1 below).

The stakeholders of a company (adapted from Du Toit, 2006)



The practical issues regarding disclosure in the integrated report are:

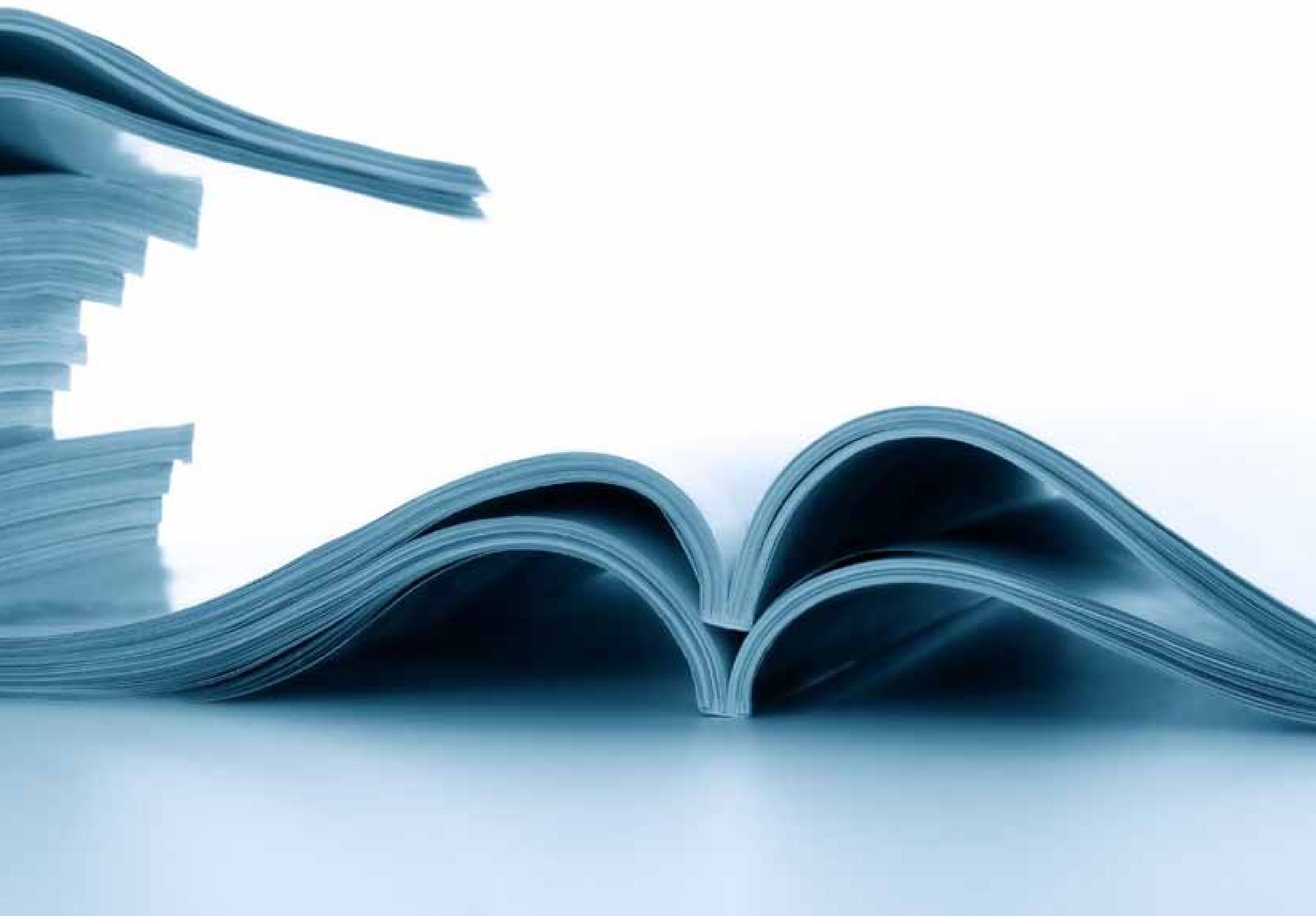
- How to report on adherence to ethical standards;
- How to obtain external independent assurance on non-financial and sustainability information;
- How to disclose the remuneration of the three most highly-paid employees who are not directors (individual, anonymous, aggregate?); and
- How to summarize the integrated report as proposed in Chapter 3 of the King III Report (not in-
- cluded in the King III Code).

All these questions and issues listed above are certainly important, but the problem is that the goalposts and criteria have been moved in the meantime. This creates new challenges amidst the current uncertainty of adapting to the known challenges of continuously enhanced governance practices.

New challenges

Many companies are experiencing the following recommendations as challenges for the 2011 and 2012 financial year-ends:

- To integrate strategy, risk, ethics and sustainability (refer to a separate document in this series with the title "Is your Business Strategy aligned to Integrated Reporting Requirements?");
- To establish a social and ethics committee, according to the Companies Act of 2008;
- To register a new memorandum of incorporation to comply with the Companies Act of 2008;
- Dealing with the new recommendations and regulations regarding Business Rescue, Fundamental and Affected Transactions and Alternative Dispute Resolution;
- To ensure internal audit is becoming even more risk-based integrated with the risk management processes and profiles;
- To perform a gap analysis, by analysing current company practices and disclosures against the King III Code recommendations and against the Companies Act, 2008, as amended to identify gaps. The gap analysis is often performed by an audit firm or by external consultants; and
- To ensure that advisory services in terms of sustainability and integrated reporting is not affecting the independence of neither the auditor of the company nor that of the assurance provider for the sustainability report or integrated report. The best advice is to have several auditing firms involved for the different roles.



The NEW integrated report - the largest challenge?

The business world had scarcely responded to King III, when a new document was published. This is the Framework for Integrated Reporting and the Integrated Report – Discussion Paper, released by the Integrated Reporting Committee (IRC) of South Africa in January 2011. The discussion paper followed in the wake of the publication of the ground-breaking work of Eccles and Krzus: One Report: Integrated Reporting for a Sustainable Strategy. An interesting and new dimension regarding integrated reporting is introduced in this discussion paper. Reading this document, one soon realises that an integrated report is not an integrated report!

This requires some explanation. Most of the listed companies clearly interpreted the King III Code as recommending one integrated report, in which the sustainability report is included in the annual report that would still contain the annual financial statements. Those who interpreted King III correctly also realised that integration is not merely combining the two reports, or simply inserting the sustainability report into the annual report to form an integrated report. They have appropriately made sure that sustainability is integrated into all the various components of the new integrated report. This led to very lengthy reports that integrated the existing annual report with sustainability in one comprehensive integrated report that could be up to 400 and more pages.

During 2010 and the beginning of 2011, very few companies have realised that there is a recommendation in the King III Report that is not included in the King III Code. This is the quest for summarised information of the integrated report, explained in paragraphs 41 to 45 of Chapter 3 in the King III Report.

It states that users benefit from a summary of the integrated report. "The company should therefore prepare a summarised integrated report in addition to the complete integrated report".

The objective of this summarised integrated report is to give a concise but balanced view of the company's integrated information, and should only contain key financial information (guided by IFRS standard IAS 34, with sufficient commentary to ensure an unbiased overview of the financial information) as well as key performance measures regarding sustainability information. There should still be an underlying complete integrated report to which this summary should refer. Furthermore, the summarised financial information should be assured by the external auditors. The last recommendation is that both the summarised and the complete integrated reports should be made available electronically and on the company's website. Should a large proportion of the stakeholders (not shareholders only!) not have electronic access to these, hard copies should be available from the registered office or the company secretary.

Let's go back to the new discussion paper mentioned above, as well as the statement that an integrated report is not an integrated report any longer. This is evident from the fact that this discussion paper calls the summarised integrated report, an integrated report in itself! This recommendation will require another more dramatic change as all companies should start producing this shorter version of the integrated report as the their integrated report in the new financial year. The challenge would be to produce a 50, 60 or 70 page report in addition to the "old" 300, 400 or 450 page integrated reports. Furthermore, the previously thick integrated report (complete integrated report) can now be more easily broken down into various reports, for example by having the financial statements, the sustainability report, the rest of the annual report, etc., as separate "clickable" documents on a website. This would not, however, do away with the King III requirements of integrating sustainability into all these, as well as in the summarised integrated report.

The following extract summarises a few main aspects covered in the discussion paper. As the document is still subject to change, the new, summarised integrated report will be referred to as the IRSV (Integrated Report Short Version) in Table 1 below.

Aspect	Contents/description
Objective of IRSV	To enable stakeholders to assess the ability of an organisation to create and sustain value over the short-, medium- and long-term. The users of the IRSV should be able to determine if the board of directors has sufficiently applied its mind in identifying the social, environmental, economic and financial issues that impact on the organisation's business, and whether these issues have been appropriately incorporated in its strategy.
What is included in the IRSV?	A concise overview of an organisation, integrating and connecting important information about strategy, risks and opportunities and relating them to social, environmental and financial issues. It is not, by its nature, a reporting by-product. It needs to flow from the heart of the organisation and it should be the organisation's primary report to stakeholders. (Mervyn King in the Foreword to the Discussion Paper)
Materiality in the IRSV	Having to shorten the integrated report, it is important to critically consider which matters are material. This will most certainly be the biggest challenge, as this would enable one to shorten the report. Materiality are used in two senses: the one is financial materiality, which would be an amount, while the other has to do with the non-financial information to enable one to decide which matters are important for the stakeholders (and thus be included) and which not.
The benefits of an IRSV to the organisation	✓ Leadership understands the strategy and its interaction with environmental, social, financial and economic issues better. ✓ Leadership demonstrates to all stakeholders that it fully understands the business and its challenges and will steer the organisation towards a long-term sustainable future. ✓ Holistic view of organisation provided to the stakeholder. ✓ Increased transparency, dealing with positive and negative issues and challenges. ✓ Risk management is enhanced because risk is integrated. ✓ Lower cost of capital to the organisation, due to leadership being able to demonstrate its effectiveness, and due to better transparency. ✓ Addressing the challenges of resource constraints, causing cost savings and improved products and services. ✓ It helps develop a culture of innovation in the organisation. ✓ More competitive, enhanced brand value, increased customer support and better positioned to exploit new business opportunities, due to the fact that external challenges are fully addressed.

Aspect	Contents/description
The elements (contents) of an IRSV	A description of the scope and boundary of the IRSV. A concise overview of the organisation and its activities, a statement of its business model describing how value is created, and an overview of its governance structure. A description of the risks and opportunities that are material now and in the future. All aspects and systems related to financial, social, environmental, economic and governance issues should be addressed, as well as a review of relationships with key stakeholders. A description of the strategic objectives and its relationship to risks, opportunities and sustainability issues. The report should give an indication of the organisational competencies required to realise strategic objectives, and a succinct list of the KPIs and KRIs that will track performance against the strategic objectives and competency requirements. This should cover short-, medium- and long-term periods. An account of the organisation's performance in terms of its strategic objectives, its material social, environmental, economic and financial impacts, its KPIs and KRIs. This should include the abridged financial statements and some related aspects. A statement of the anticipated activities and future performance objectives, informed by the assessment of recent performance and understanding of societal trends and stakeholder expectations. An overview of how the organisation remunerates employees and senior executives, including factors that could influence future remuneration. Separate disclosure for senior executives should be given. A brief analytical commentary that reflects the understanding of the organisation's governing structure and executive team of the nature of the current and anticipated performance in the context of the strategic objectives.
Characteristics of the IRSV	Relevance and materiality – what to include in the IRSV. Faithful representation. Completeness – include all material information. Neutral information that should have no bias as to the selection or presentation of information. Free from error. Comparability and consistency, internally and benchmarking to outsiders. Verifiability – the information should be verifiable (within the boundary that forward-looking information cannot always be verified). Timeliness – stakeholders should have sufficient time to respond to the IRSV in their decision-making. Understandability or clarity.
Assurance of the IRSV	As stated above, the financial statements summary should still be audited. A limited assurance report for the other information is recommended, as well as for the correct inclusion of more detailed reports into the IRSV.

New challenges

Concerning the recommendations in the King III Code, one should remember that the principle remain that a company should apply the Code or explain why not. It is not compliance-based as in the past. It is, however, a requirement of the JSE that a company follows the King III Code – that is not negotiable. But companies should then still either apply or explain.

Furthermore, a holistic approach to governance is required, as described in the Introduction to the King III Code. Each principle is equally important. The Code is applicable to all companies in South Africa. The only difference between a listed company and other companies is the fact that compliance to King III is a JSE requirement. Other companies have no such a requirement, but in that respect King III is also aspirational. Other companies should realise over time that applying the King III recommendations will be in the best interest of all companies and of business in South Africa and elsewhere in the long-term. The idea is that larger businesses will start to require their business partners, suppliers, retailers, manufacturers and others, to apply King III. If not, the business ties could be severed.

Nkonki Inc is a firm of Chartered Accountants and Registered Auditors that is ideally situated to assist clients at all levels (listed, public, private) with most of the issues identified above. Nkonki can, furthermore, provide sustainability assurance, integrated reporting assurance, and perform King III gap analysis.

Companies, in particular listed companies, often want to be seen as good corporate citizens, as companies with ethical leadership, as companies that are sustainable while caring for people, planet and profits, and some often want to be at the cutting edge of new developments. The latest news item on the www.sustainabilitysa.org website is an opportunity to become part of a pilot programme on integrated reporting:

> *"Is your company keen to join the international pilot programme for integrated reporting run by the International Integrated Reporting Committee (IIRC)? Or as an investor, are you keen to join the Investor group that will offer advice and feedback to the piloting companies and the IIRC? The IIRC is looking for 200 companies to participate in its pilot programme implementing its principles and framework for integrated reporting. The companies will have regular feedback sessions and will receive support during the piloting process. But note there is a cost – about 10 000 pounds – and after applying, the IIRC will select the 200 companies for the pilot programme."*

Conclusion

In the words of Mervyn King (2011) in the Discussion Paper on Integrated Reporting, integrated reporting is a journey. Organisations are unlikely to achieve perfection in the first year. Reporting will, however, improve. “Interactive communication with key stakeholders is fundamental to the success of integrated reporting as engagement leads to knowledge of the stakeholders’ legitimate interests and expectations”. Enjoy this journey! Convert the challenge into an opportunity, and also be aware that you need not be alone on this journey – Nkonki Inc is your partner in this process.

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