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An Integrated Reporting approach to communicating business value

The article considers fundamental concepts of "The International Integrated Reporting Framework". A number of problems concerning adequate quantitative reflection of changes in the amount of different types of capital are outlined, as well as the impact of such changes on the company's business value.

Keywords: *Integrated Reporting, value creation, <IR> fundamental concepts, financial capital, forms of capital.*

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Інтегрована звітність як механізм підвищення вартості бізнесу

У статті розглянуті фундаментальні концепції «Основ підготовки Інтегрованої звітності». Позначений ряд проблем, пов'язаних з адекватним, кількісним відображенням змін величини різних видів капіталів і впливу таких змін на вартість бізнесу компанії в цілому.

Ключеві слова: Інтегрована звітність, створення вартості, фундаментальні концепції ІЗ, фінансовий капітал, види капіталу.

Табл. 1. Рис. 1. Літ. 10.

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Интегрированная отчетность как механизм повышения стоимости бизнеса

В статье рассмотрены фундаментальные концепции «Основ подготовки Интегрированной отчетности». Обозначен ряд проблем, связанных с адекватным, количественным отражением изменений величины различных видов капиталов и влияния таких изменений на стоимость бизнеса компании в целом.

Ключевые слова: Интегрированная отчетность, создание стоимости, фундаментальные концепции ИО, финансовый капитал, виды капитала

Introduction. A new stage in the corporate reporting development is the emergence of the **Integrated Reporting** (IR), which is a consolidation of financial and non-financial information and reflects the organization's ability to create and maintain its value in the short, medium and long term. The visible result of the IR is short, periodic integrated report.

The appearance of this kind of reporting was not accidental. The gap between the needs of investors to recreate a more complete picture of the company's value and the information currently contained in the financial statements increases.

IR is designed to fill this gap by offering a basis for companies to explain how the value creation process affects the capital markets. IR can also help users to look beyond the short-term results of the companies, to form a clearer outlook on the long-term value of the company.

Literature analysis. Currently, the generally issues of an integrated reporting model that was developed by foreign, Russian and Ukrainian researchers: sustainable development problems (Michael E. Porter and Mark R. Kramer,2011), creation of an Integrated Reporting model (P. Drukman; R. Martin 2012)(Cristiano Busco, Mark L. Frigo, Paolo Quattrone, Angelo Riccaboni, 2013) and setting up of the companies value issues was researched: (K. O. Sorokina,2010; O. V. Solovieva, 2013; R. O. Kostyrko, 2012; N. A. Lokhanova, 2013; T. V. Davyduk, 2012) and many others.

Problem statement. Topical issues of research are development of an integrated reporting model, elaboration of the financial statements to reflect the increase or decrease in business as a whole, Integrated reporting data validation by independent experts.

Results and discussion. The world first integrated reports began to appear in the mid-2000s. In 2007 by the Prince of Wales initiative "Accounting for sustainability" was presented a document named *Connected Reporting Framework* (Connected Reporting Framework,2007). In 2009, same organization released another paper – *Connected Reporting "how to" guide*. Later all the groundwork were passed to the newly initiated International Integrated Reporting Council (IIRC).

The International Integrated Reporting Council (IIRC) was created in 2010, under the aegis of A4S and GRI to develop a unified approach to the integrated reporting. All A4S research in integrated reporting was transferred to IIRC, which focused on the International Standard elaboration. In 2011, the Council issued a document "*One step closer to integrated reporting. New approach in the XXI century*" defining an IIRC approach to integrated report format.

IR concept is supported by over 90 global companies and more than 50 institutional investors, members of the IIRC pilot program. Among them are Danone, Deloitte, HSBC, KPMG, Microsoft, Coca-Cola, Unilever, Volvo etc. Russian companies participants of the pilot program: State Corporation "Rosatom", OJSC "NK Rosneft", OJSC "NIAEP" FC "Uralsib". In Ukraine, integrated reporting issues just started to be discussed by financiers of major domestic corporations, who have the first experience in the formation of sustainable development reporting due to inclusion of their companies in the pilot projects of formation of such reports ("DTEK" company, "Metinvest" Group, FIG "SKM", "Obolon" corporation) (DTEK corportate website,2013).

In December 2013 an official document *The International Integrated Reporting Framework* (The international IR framework, 2013).

A considerable part of *IR Framework* is devoted to the company "value creation".

The basis of preparation of Integrated Reporting rests on two fundamental concepts:

1. Value creation
2. Categories of the capital

The value creation process in question is based on seven elements: organizational overview and external environment, governance, opportunities and risks, strategy and resource allocation, business model, performance, and future outlook.

Let us consider in more detail fundamental concepts mentioned above.

Value creation

The main idea is that the company value cannot be created by or within an organization alone. The value can vary over time: influenced by the external environment or through relationships with stakeholders, as well as depending on the access to various resources.

Therefore, an Integrated Report should focus on:

- the external environment that affects a company;
- the resources and the relationships used and affected by the company;
- how the company interacts with the external environment and the capitals to create value over the short, medium and long term.

Corporate reporting discloses the value which is created directly for the company, and enables financial returns to the providers of financial capital. Integrated reporting includes also the value an organization creates for others – stakeholders and society at large.

Moreover, the ability of the company to create value for itself is linked to the value it creates for others. This happens through a wide range of activities, interactions and relationships:

1. Company operations (business activities results);
2. Relations with concerned parties (customer satisfaction, suppliers' willingness to trade with the company, the terms and conditions upon which they do so)
3. Interactions with external environment (legal requirements, company reputation etc.)

When these interactions, activities, and relationships are material to the company's ability to create value for itself, they are included in the Integrated Report.

Forms of capital

All organizations depend on various forms of capital for their success. *The International IR Framework* address capital categories stated in *Table 1* below, though organization preparing an integrated report is not required to adopt this categorization. It is included in *Framework* as a guideline to ensure the company does not overlook a capital that it uses or affects.

Table 1 **The capitals**

	Categories of the capital	*Definitions*	*Examples*
1	Financial capital	The pool of funds that is available to a company for use in the production of goods or the provision of services, obtained through financing.	Debt, equity or grants, or generated through operations or investments.
2	Manufactured capital	Manufactured physical objects (as distinct from natural physical objects) that are available to a company for use in the production of goods or the provision of services	Buildings, equipment, infrastructure (roads, ports, bridges etc.)
3	Intellectual capital	Organizational, knowledge-based intangibles	Intellectual property: patents, copyrights, software, rights and licences; "organizational capital" such as tacit knowledge, systems, procedures and protocols.
4	Human capital	People's competencies, capabilities and experience, and their motivations to innovate	Alignment with and support for a company's governance framework, risk management approach, ethical values, ability to understand, develop and implement an company's strategy, loyalties and motivations for improving processes, goods and services, including ability to lead, manage and collaborate.

5	Social and relationship capital	The institutions and the relationships within and between communities, groups of stakeholders and other networks, and the ability to share information to enhance individual and collective well-being	Shared norms, and common values and behaviors, key stakeholder relationships, and the trust and willingness to engage that a company has developed and strives to build and protect with external stakeholders, intangibles associated with the brand and reputation that a company has developed.
6	Natural capital	All renewable and non-renewable environmental resources and processes that provide goods or services that support the past, current or future prosperity of a company.	Air, water, land, minerals and forests, biodiversity and eco-system health.

(Source: “THE INTERNATIONAL <IR> FRAMEWORK,” the International Integrated Reporting Council, December 2013)

The overall stock of capitals is not fixed over time. There is a constant flow between and within the capitals as they are increased, decreased or transformed. For example, when an organization improves its human capital through employee training, the related training costs reduce its financial capital. The effect is that financial capital has been transformed into human capital.

The value creation process

The value creation process is depicted in *Figure 1*

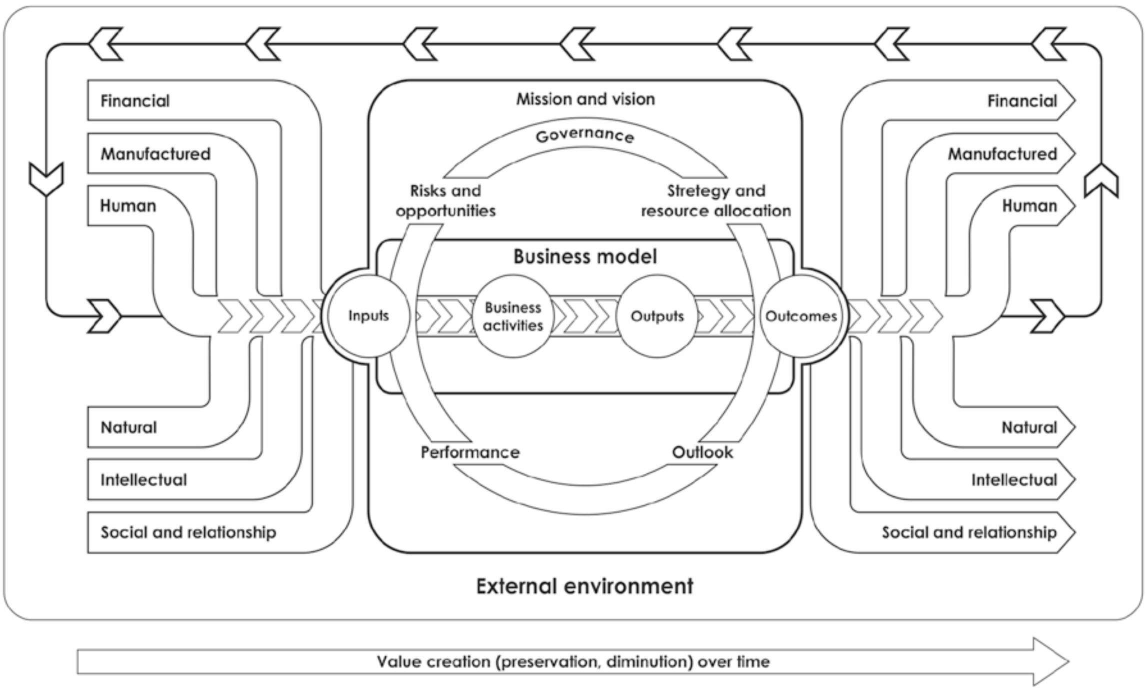

Fig. 1 **The value creation process**

(Source: “THE INTERNATIONAL <IR> FRAMEWORK,” the International Integrated Reporting Council, December 2013)

As we can see an Integrated Report includes the following seven elements: organizational overview and external environment, governance, business model, opportunities and risks, strategy and resource allocation, performance, and future outlook.

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.

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, by-products 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.

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 to improve all the components.

Considered fundamental concepts of value creation are certainly innovative and designed to respond to the requests of stakeholders on the creation of value over the short, medium and long term.

However, it is clear that the development of integrated reporting model raises a number of problems. As noted by the researcher K. V. Sorokina "One of the main issues is how much in detail is it possible to define the information necessary to disclose, for it to be useful." (K. O. Sorokina, 2010). According to the *IFRS Conceptual Framework* (Conceptual framework of financial reporting, 2010) to the financial information to be useful, it must be relevant and authentically represent what it is meant to represent (item *QC4* of *IFRS Conceptual Framework*). Relevant financial information can affect the decisions made by users (see item *QC6* of *IFRS Conceptual Framework*). To be *faithful* representation should be *complete*, *neutral* and *free from error* (see item *QC12* of *IFRS Conceptual Framework*).

Usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable (item *QC4* of *IFRS Conceptual Framework*).

Information is material if its omission or misstatement could influence the decisions made by users on the basis of financial information on a particular reporting entity - materiality is a specific for the organization aspect of relevance (see item *QC11* of *IFRS Conceptual Framework*).

But the *IFRS Conceptual Framework* concerns financial performance, is given judgment applicable to non-financial indicators? Sometimes even executives do not know what specific indicators has to be analyzed and disclosed in the IR as "a lead to success".

Also according (Sorokina, 2010) it seems to be reasonable to disclose *success drivers* to business. However, a major obstacle to the practical application of this approach is that, although this relationship is intuitively clear, distinctly define the contribution of each of the drivers (which can be numerous) to the success and financial performance of the company is very difficult. The effect can be cumulative, i.e., from a few drivers together, to estimate the contribution of each driver in the financial statements is quite subjective.

A number of IR problems are outlined in the N. A. Lokhanova’s publication (Lokhanova, 2013). In particular, four groups of unresolved issues:

- providing materiality of information, presented in IR;
- balancing a necessary but not excessive information, that could endanger economically sustainable development of the enterprise;
- balancing of economic interests in relation to sustainable development and disclosure of relevant information;
- reliability of indicators used in the preparation of Integrated Reporting.

And yet still a major problem, in author's opinion, is adequate, objective, quantitative assessment of the business value, what was the main purpose of the

Integrated Reporting model developers. At the same time, according to item 4.53 of the *Conceptual framework of the International Integrated Reporting* (The international IR framework, 2013) quantitative indicators are allowed and even encouraged, in particular some guidelines were issued regarding that matter.

It is unclear however, how to practically assess the impact of certain capital category on the business in general? Is there any correlation between changes in e.g. social capital and the company business value and how to keep track of it? For example, if the company has financed during the year two social events (help to the kindergartens and so on) more than the last year, will it increase the total company value (with a noticeable and measurable reduction of financial capital)?

It is quite obvious that the measurement and evaluation of the impact of changes in one or another form of capital on the company value - is a methodical challenge. At first, the indicators have to be developed, the methodology have to be determined for calculating the impact on value, and only then widespread introduction of this Integrated reporting model is possible.

Corporate financial reporting presented by companies (which provide useful information for existing and potential investors to make decisions about providing resources to the organization) certainly has some limitations. In particular, in the present model of corporate reporting not enough attention is paid to some factors, such as risk, strategy, supervision and stability of enterprise business model. Certainly reporting should evolve as there is a need to reflect changes in business, information technologies, and consumers' needs – but should the changes be so revolutionary?

Prospects for further research are studies of a number of issues:

- Theoretical (problems of terminology in *Conceptual framework of the International Integrated Reporting*, IR status, scope, purpose, users problems etc.).
- Methodological (the process of Integrated reporting as a product of the integral accounting system, qualitative, quantitative indicators that measure the value of the company business, elaboration of the methodology of Integrated reporting model generation, etc.)

Conclusions: Value created by an organization has two interrelated aspects: value created for the organization itself, which brings financial benefits to the providers of financial capital, and the value created for other stakeholders and society at large. Therefore, an Integrated Report is intended to disclose information about the external environment affecting the organization, resources and relationships used in the company and how the organization interacts with the environment and capitals to create value in the short, medium and long term.

1. All organizations depend on various forms of capital for their success. *Conceptual IR Framework* reckons such capital categories as financial, manufactured, intellectual, human, natural, social and relationship. The capitals are stocks of value that are increased, decreased or transformed through the activities and outputs of the organization.
2. The value creation process is based on seven elements: organizational overview and external environment, governance, opportunities and risks, strategy and resource allocation, business model, performance, and future outlook.
3. Building a model of Integrated Reporting raises a number of problems, including the following:
   - whether it is possible to define in detail the information, required for disclosure in the IR, to make it useful;
   - to reach the balance of necessary but not excessive information, which could jeopardize economically sustainable development of the enterprise;
   - to balance economic interests with respect to sustainable development and disclosure of relevant information.
4. The main problem is the lack of adequate, objective, quantitative assessment of the business value, which was the purpose of the developers of Integrated Reporting model.
5. Estimation and evaluation of the impact of changes in one or another form of capital on the company value as a whole – is a methodical challenge. First, indicators have to be elaborated, than methodology for calculating the impact on value have to be developed, before the widespread introduction of this Integrated Reporting model.

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