



# H A R V A R D | B U S I N E S S | S C H O O L

ROBERT G. ECCLES |  
PROFESSOR OF MANAGEMENT PRACTICE

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To: Integrated Reporting Committee (IRC) of South Africa

From: Harvard Business School Integrated Reporting Team

The Harvard Business School Integrated Reporting Team, whose members have signed this letter, are pleased to submit our comments regarding the “Framework for Integrated Reporting and the Integrated Report Discussion Paper” which was released on January 25, 2011. We are very impressed with and grateful for the work of the IRC of South Africa. Our comments are below. If you would like any clarification and/or elaboration on our thoughts, please let us know and we will respond as quickly as possible.

## **The role of the corporation in society**

*Recommendation:*

*An integrated report should include a discussion of management’s perspective about the role of the corporation in society.*

An integrated report should reflect a company’s understanding that it operates in a multi-dimensional world; the global economy, the environment, and the society on which the business relies to create value. This is a concept far beyond the simple combination of a financial report and a sustainability report into a single document. The process of implementing integrated reporting is a continuum, rather than an objective to be achieved at a fixed point in time. A contextual narrative about management’s views on the relationship between a company and the society in which it operates, supported by relevant quantitative environmental, social, and governance (“ESG”) metrics, provides the reader with a progress report on the integrated reporting journey.

The envisioned discussion could address, among other things, the following questions, which have been adapted from Corporation 20/20, “New Principles for Corporate Design.”<sup>1</sup>

- Who are the stakeholders in the company?
- How does the company harness private interests to serve the public interest?
- How is the objective of providing a fair return on shareholders’ investments balanced with the interests of other stakeholders?
- What processes and controls are in operation to ensure that the company’s use of human, financial, and natural resources does not compromise the ability of future generations to meet their needs?
- How does the company ensure that profits are distributed equitably among those who create value?
- What processes and controls are in operation to ensure that the company and its supply chain are governed in a manner that is transparent, ethical, and accountable?
- What processes and controls are in operation to ensure that the company neither impairs the right of people to govern themselves, nor infringes on other universal human rights?
- What metrics—backward-looking to evaluate past performance and forward-looking to establish targets and objectives—are in place with respect to the foregoing questions?

Greater clarity about the company’s role in society should emerge with each successive integrated report. The better management understands the corporation’s role in society, the more likely that capitalism can continue to create jobs and generate wealth for all stakeholders in the years to come.

### **Governance, risk tolerance, and remuneration**

*Recommendation:*

*An integrated report should include a discussion about how the board of directors oversees management’s execution of the imperative for long-term viability—of both the entity itself and the world it relies on to create economic value—with the demands for short-term competitiveness and profitability.*

The underlying questions to be addressed are whether the corporation is managed for the next fiscal quarter or for the next century and what information does the board use to oversee progress towards strategic objectives. These questions will provide insights into whether the company seeks to maximize earnings today,

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<sup>1</sup> Corporation 20/20. “New Principles for Corporate Design.” Accessed March 21, 2011, <http://www.corporation2020.org/>.

with disregard for the long term. In addition, dependency on often short-term financial information alone raises questions about the quality of management insight and suggests that it is failing to engage effectively with stakeholders.

Ideally, management and the board should have an unwavering commitment to create value over the long-term. This perspective might be reflected in several ways, for example, as loyalty to those who have “invested” in the company with capital, work, or granting a real or implied license to operate, or as an eye towards continuous development of products or services that will generate revenues in the future.

Answers to the following questions might better inform the reader of an integrated report about whether management believes it has an imperative for long-term viability. It should be noted however, that this list is illustrative, not exhaustive.

- How are priorities established to balance the need to allocate and use capital for research and development as opposed to simply increasing dividends?
- To what extent does management use accounting adjustments, or adopt accounting principles, solely to accelerate revenue or delay recognition of expenses in order to inflate current earnings?
- What are the policies regarding the use of debt to finance company expenses and projects—which increases leverage, thereby inflating returns on equity as long as the company is doing well and the market is trending up—but increases exposure to insolvency if the market goes down?
- How does the board ensure that compensation arrangements do not create incentives to prioritize the satisfaction of short-term financial goals as opposed to rewarding a long-term orientation?
- How often does the company cut employment to generate cost savings and what considerations are given to the trade-offs of decreased employee satisfaction and loss of talent?
- What processes and controls are in place to mitigate risks related to environmental (e.g., scarcity of water or other resources); social (e.g., human rights and supply chain labor); and financial (e.g., incentives linked to high-risk activities) matters?
- What metrics for compensation schemes have been established to ensure that decision-making is geared towards the corporation’s value as seen through the eyes of not only shareholders but also other stakeholders?

Governance may be defined as exerting a guiding influence—a demonstration of a fierce commitment to integrity and a demand for excellence in all efforts. Ultimately, rules, regulations, laws, principles, and frameworks are of no value unless people act with integrity. What really matters is people doing the right thing and holding themselves accountable for the consequences of their actions.

### **Web 2.0**

*Recommendation:*

*Additional guidance on stakeholder engagement, specifically regarding the use of the Internet and Web 2.0<sup>2</sup> technologies, should be provided.*

Stakeholder engagement is a core component of an integrated reporting process. Just as an integrated report is not simply a paper document or PDF file, meaningful engagement is more than a focus group or a presentation to analysts. Effective engagement can present a formidable challenge for all companies; this is especially true for small- and mid-sized entities that are constrained by limited financial and human resources.

Web 2.0 technologies enhance the effectiveness of communication with on a wide range of topics. Moreover, the Internet and its associated Web 2.0 tools and technologies make it possible to shift from a one-way push of information to an ongoing dialogue between a company and its shareholders, employees, NGOs, civil society, and all other stakeholders.

There are several questions management and stakeholders can ask to evaluate the effectiveness of a Web-based stakeholder engagement process. How does the company use the Internet to engage stakeholders and what are the results of the dialogue with respect to the following?

- Meeting the needs and expectations of analysts, investors and a wide range of other stakeholder groups for information about how nonfinancial performance is related to financial results
- Identifying material risks and opportunities
- Facilitating better engagement with current and prospective employees, the supply chain, and customers

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<sup>2</sup> For a definition of the term “Web 2.0” see: McKinsey & Co., “How businesses are using Web 2.0: A McKinsey Global Survey,” *The McKinsey Quarterly*, 2007.

- Receiving feedback from stakeholders on the company's objectives and about how to improve reporting and engagement processes
- Helping investors and other stakeholders understand whether and how externalities are identified and managed
- Providing insights into how materiality for nonfinancial information is determined and applied

In a robust engagement process, shareholders gain a more holistic perspective of a company; realizing that an organization's ability to earn profits over the long term will require investments that come at short-term costs or even transfer value from shareholders to other stakeholders as measured by traditional financial metrics. Conversely, other stakeholders will learn that companies must make a profit in order to survive and grow.

### **Materiality and risk assessment**

*Recommendation:*

*Preparers of an integrated report should be encouraged to include either a "materiality matrix," which identifies the potential impact of various risks as seen through the eyes of the company as well as its stakeholders, or a narrative about materiality and risk assessment.*

In the absence of a globally accepted definition of materiality for nonfinancial information, it will be more important for companies to focus on disclosure about the process used to determine materiality and risk prioritization rather than on quantitative materiality measures. The more information provided, the more informed an evaluation a stakeholder can make about whether all material issues are addressed.

Rather than prescribe specific methodology, we urge the Integrated Reporting Committee to refer preparers to make disclosures similar to the approaches used by two well-respected integrated reporting companies.

1. In consultation with stakeholders, companies might prepare a "materiality matrix" similar to BASF, see <http://www.basf.com/group/corporate/en/sustainability/management-and-instruments/global-materiality-matrix>, accessed March 21, 2011.
2. In the alternative, Novo Nordisk uses a narrative to provide a definition of "materiality," see <http://annualreport2010.novonordisk.com/stakeholders-and-reporting/reporting/integrated->

[reporting.aspx](#), accessed March 21, 2011, and an overview of its risk management approach and process, see <http://annualreport2010.novonordisk.com/governance/risk-management.aspx#Risk%20mgmt.%20process>, accessed March 21, 2011.

Either one of these two approaches will provide the reader of an integrated report with the information necessary to evaluate whether the “right things” are being reported and whether the organization is responsive to the interests and expectations of its stakeholders.

### **Assurance**

*Recommendation:*

*The Integrated Reporting Committee should establish a specific date after which assurance on integrated reports would be required.*

Investors have come to view an independent auditor’s report as enhancing the credibility or reliability of financial information. Similarly, assurance on nonfinancial information, or perhaps on the processes and controls over nonfinancial reporting, would reduce the risk that such information is incorrect.

The obstacles inherent in this recommendation cannot be lightly dismissed. There are no generally accepted standards for nonfinancial information. There are concerns about the robustness of the international assurance standards (ISAE 3000). Also, accounting firms face challenges related to availability of skilled talent and the financial resources necessary to develop assurance tools and methodologies for nonfinancial information.

Corporate reporting is evolving. It is moving from a focus solely on historical financial information to the integration of financial and sustainability information. In addition, reporting is moving from printed paper annual reports, to “documents” in a Word or PDF format, to Web-based environments. If conventional wisdom about the very nature of a “report” is being challenged, then why not challenge current thinking about assurance?

Perhaps the South African integrated reporting experiment could also explore the concept of continuous assurance. The more reporting moves to the Internet, the more it will be necessary to provide continuous

assurance over processes rather than content. Continuous assurance might be envisioned as monitoring procedures that provide continuous evidence that system controls are operating effectively or, in the alternative, notify the assurance provider that controls may have broken down. By definition, this will require development of intelligent “agents” or software components that automatically monitor controls.

If the accounting firms know that assurance will be required after a certain date, then they will make the investments necessary to meet the requirement and deliver high quality assurance.

### **Improved definitions**

*Recommendation:*

*An appendix of defined terms should be added.*

Among the terms that should be more clearly defined are

- Financial
- Economic
- Governance
- Monetize
- Collective mind
- economic, social, & environmental
- Financial, economic, social & environmental *systems*
- Financial, economic, social & environmental *issues*
- Financial, economic, social & environmental *trends*
- Stakeholder Engagement
- Integrated reporting
- Integrated report; One Report

### **Additional references**

*Recommendation:*

*Research references should be expanded.*

A reference to DVFA Society of Investment Professionals in Germany in conjunction with EFFAS European Federation of Financial Analysts Societies, *KPIs for ESG: A Guideline for the Integration of ESG into Financial Analysis and Corporate Valuation*, Version 3.0 should be added.

**Errors**

Page 22. The correct spelling of One Report co-author is Michael P. Krzus, not Krzuz.

Sincerely yours,

Kyle Ambrester

Beiting Cheng

Tiffany Clay

Robert G. Eccles

Michael P. Krzus

Daniela Saltzman

George Serafeim