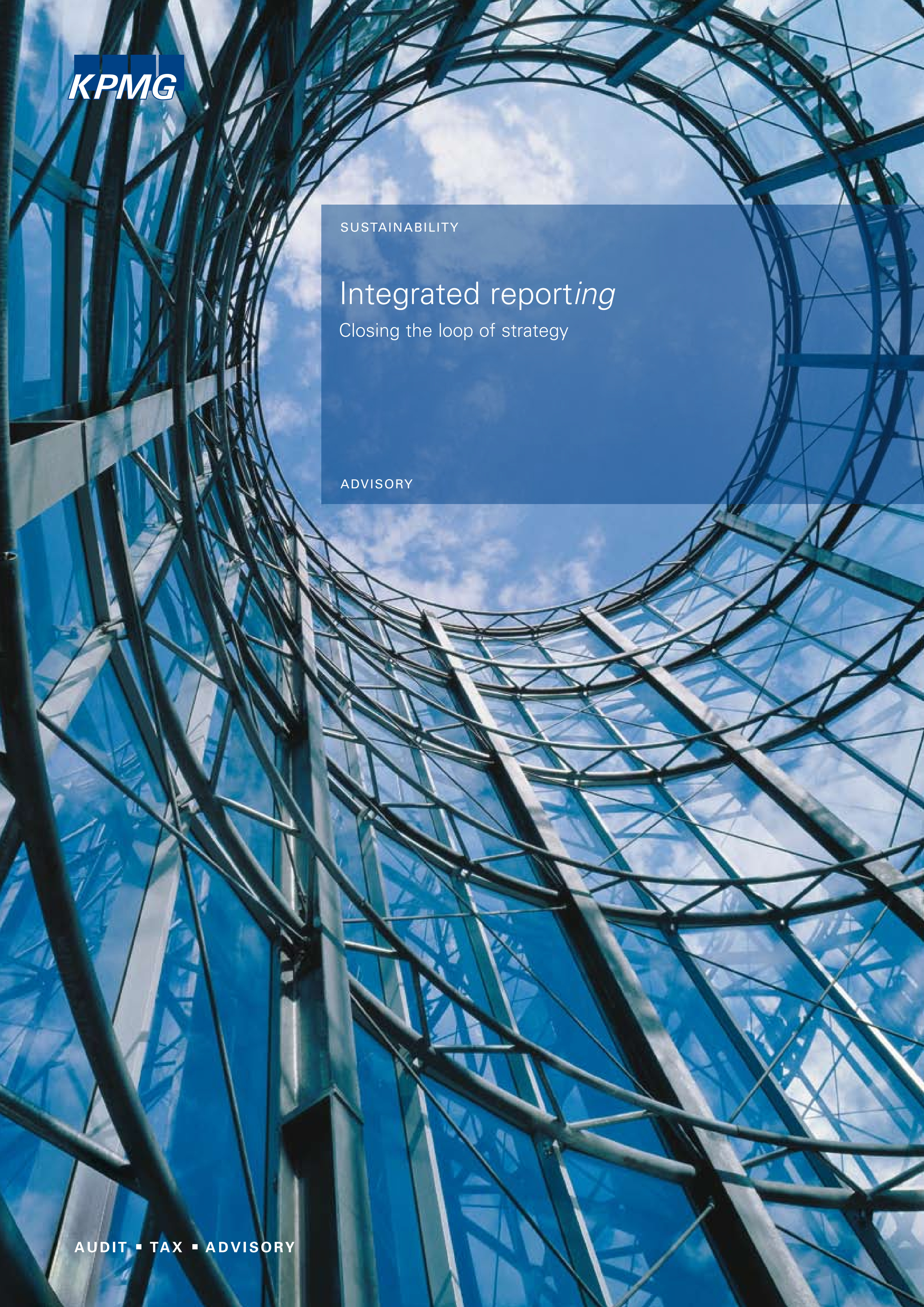


KPMG

SUSTAINABILITY

Integrated report*ing*

Closing the loop of strategy

ADVISORY

AUDIT ▪ TAX ▪ ADVISORY

A transformation in corporate reporting

"Integrated report*ing* is part of the shift in business responsibility"

We are at the start of an era of convergence in reporting.
Traditionally company reporting primarily consists of financial information. The balance sheet, the profit and loss account and the accompanying directors' report together outline the company's performance. In the past decades a shift has occurred in how companies report on the impact they have on their stakeholders. By the end of the last century trendsetting companies started to explain their impact on the environment and wider society in CSR (Corporate Social Responsibility) reports and a growing number of companies are now following their example. Over the last decade CSR reporting has grown significantly – from 35 percent in 1999 to 80 percent of the companies listed in the Global Fortune 250 in 2008[1].
Over the last years, a selected number of companies have started to integrate CSR reporting into the annual report. As of today, only 3 percent of the companies worldwide are reporting on an integrated basis[1]. However, this figure is increasing.

Moreover, there is a shift in integrating corporate responsibility into the business. For an increasing number of leading companies corporate responsibility starts to be at the heart of the business – in the company strategy, in governance and values and in the products. No longer is corporate responsibility only about managing reputation risk, it is seen by many as a means to value creation for shareholders, employees and other stakeholders.

Finally, regulatory and other reporting initiatives are embracing the concept of integrated report*ing*. The EU Directive on Transparency requires companies to report on relevant CSR information, as does the King III Code for South African companies[2]. The Global Reporting Initiative and sustainable investors associations such as EUROSIF are also supporting the concept. XBRL reporting incorporates other-than-financial business-impacting information into the model and frameworks are being developed to connect annual reporting and CSR reporting, such as the Connected Reporting Framework developed by the Prince of Wales' Accounting for Sustainability Project[3]. The basic assumption behind these initiatives is that reporting on CSR performance should be part of mainstream reporting, as a logical outcome of the integration into daily business.

It seems time for a transformation in corporate reporting: from a focus on financial information to a concept where all types of relevant information for assessing and evaluating a company's quality, performance, value and impact are reported in a comprehensive way.

At KPMG we believe there is a clear need for this transformation. However integrating report*ing* 'for the sake of integrating' is set to fail and disappoint stakeholders. In our view only companies with a profound connection of their sustainability efforts with their strategy and the management cycle should start taking steps towards integrated report*ing*. Companies should also ensure that the needs of all relevant stakeholder groups who use the information are satisfied. In this publication we refer to these as the management perspective and the communication perspective respectively, which should fuse together in order to create successful integrated report*ing*.

We organised a meeting in December 2009 with 20 leading organisations[4] to discuss the opportunities, the challenges and possible pitfalls on the road to integrated report*ing*.

We address four key questions in this publication:

1. What are key reasons to report – and why do this in an integrated way?
2. What is integrated report*ing* – and what isn't?
3. What are the key considerations for integrated report*ing* – and what are potential benefits?
4. How could the integration road be designed – and how would the management perspective and the communication perspective fuse together?

It was a clear conclusion by the participants in this meeting that integrated report*ing* is the way forward in corporate reporting.

The *ing* here is very important: it refers to the dominant opinion that it is not about *one report*. We will explain this in further detail on the following pages.

This publication is primarily aimed at key decision makers with regard to reporting: responsible board members, CSR managers and communication managers. With this publication we aim to provide you with key considerations on how to decide about further integrating corporate reporting to close the loop of strategy for your organization.

1 KPMG International Survey of Corporate Responsibility Reporting 2008
2 King Report on Governance for South Africa 2009 and King Code of Governance Principles (King III)
3 www.accountingforsustainability.org
4 Participants included representatives from ABN Amro, Achmea, Aegon, Allianz, ASN Bank, Ballast Nedam, BASF, Carlsberg, De Nederlandsche Bank, Eneco, EUROSIF, Fortis, Global Reporting Initiative, Heineken, KLM, KPN, Nederlandse Spoorwegen, Nutreco, Philips, Rabobank, Titan Cement, Triodos Bank and VNCI

The real meaning of integrated report*ing*

"Companies have to fulfil the information needs of those who provide them with economic resources."

The reason for reporting
Reporting is aimed at informing interested stakeholders about performance achieved against targets, the vision and strategy adopted to serve the stakeholders' interests, and other factors that can influence business performance in future.

Clearly regulations require companies to exercise transparency. However, a more fundamental reason for reporting lies in *accountability*: a company needs to account for the impact it has on the stakeholders it relates to. Not exercising such transparency would impose serious risks, including high financing costs to compensate for a lack of transparency or governance or, ultimately, losing the license to operate. By contrast, a transparent approach would not only improve reputation, but also would bind stakeholders such as employees to the company's objectives.

The reason for including environmental and social factors in reporting
In today's world companies play a significant role in shaping the future of society. Awareness of this has risen significantly over the last decades, resulting in changed attitudes towards the role business is expected to play. It also resulted in changes in the views of business leaders about the role they want to play.

Business these days is seen more than ever as the agent of a wide group of stakeholders. Unlike the old paradigm that 'the business of business is business', companies accept wider accountability in current times towards the stakeholders whose interests they impact - no longer can companies focus only on the interests of those with a financial interest.

This wider accountability implies that companies have to fulfil the (information) needs of those who provide them with other economic resources such as labour, space, air or natural resources and those who enter into transactions with the organization such as customers. Therefore a company's current performance and future ability to continue operations and achieve business growth needs to be evaluated on the basis of a comprehensive set of factors that influence these.

In the context described above, the environmental and social aspects of business conduct will influence the

"It is about integrated report*ing*, not about one integrated report"

business future (including the value of the company) as will the financial performance. Therefore elements such as environmental impact, labour rights, health and carbon emissions logically deserve a space in reporting on *total business performance*. This is the moment integrated report*ing* comes into play.

Integrated report*ing*: what it is – and what it isn't

First of all, integrated report*ing* would address the company's performance for a comprehensive set of factors – economic as well as social, environmental, governance and other relevant 'business-impacting' factors. As outlined above it is our view that this should be done on the basis of a well-developed business strategy that takes all these elements into account.

Secondly, integrating means that performance follows on from the strategy and targets set. One would expect, therefore, equal treatment of the various elements throughout the report, leading to a discussion of economic information alongside the other aspects – driving CSR and other information from a nice-to-have into a need-to-have.

On the assumption that integrated report*ing* is meant to serve the information needs of a wider group of relevant stakeholders, it follows that integrated report*ing* should be such that interested relevant stakeholders can evaluate what the company's performance, vision and future plans are in relation to their own perspective and specific interests.

This brings us to what integrated reporting, in our view, is not. Integrated reporting is different from simply combining the annual report with (selected) CSR information. This would not do justice to a company's business approach from strategy to performance management that is such a key element of meaningful integration into the heart of the business.

Integrated reporting is also different from one (annual) report. The one report concept assumes that all relevant stakeholders can fulfil their information needs with this single report. Although this may be the case for certain groups of stakeholders (e.g. shareholders or professional business partners), it could hardly be expected that this would apply for all groups.

In our view it is essential to view the decision about integrating reporting from two perspectives that ideally fuse together: management and communication, i.e. to let it follow on from strategy and targets set (management perspective) while ensuring that it meets the information needs of relevant stakeholders (communication perspective).

"Rewiring homo economicus, that's what it is about"

Rewiring Homo Economicus

Ernst Ligteringen, Chief Executive of Global Reporting Initiative

In the opinion of Ernst Ligteringen, the development of integrated report*ing* is much more than a technical exercise. The long-term objective is the transformation of corporate reporting. "Rewiring homo economicus, that's what it is about", says Ernst.

A fundamental change is needed in the way we deal with our world. Observing that the earth will have to feed and shelter 9 billion people by 2050, it is crystal clear that investing in sustainability is not a luxury. However, it is a challenge to connect the long-term perspective, which is difficult to measure in financial terms, to short-term decision-making. Investing in sustainability pays off in the long term but it needs to be connected to the steps a company takes today and tomorrow.

An integrated report can help, according to Ernst Ligteringen, in matching long-term business strategy with short-term business results.

"Many companies are still blind to the longer term, which is caused also by a lack of understanding of how to deal with the long-term impact of business operations." says Ernst Ligteringen, "Furthermore some experts accuse companies of deliberately flying blind as disclosure of the long-term sustainability effects would raise questions that cannot be fully answered within the parameters today's market conditions".

"In addition, it seems that many boardrooms still allow insufficient space to embed the sustainability theme into the heart of the organization. Retired top managers active in the sustainability field out of personal conviction admit the incentive structure of their former posts discouraged looking at these issues in the same way".

Integrating report*ing* on sustainability with financial reporting is both an outcome of the realization that businesses may have to account for a wider set of factors, as much as it can be driver for that change in mindset. According to Ernst Ligteringen, integrated report*ing* is not a transformation of the sustainability report; it is a transformation of corporate reporting. In essence it will provide a new language to measure, manage and be accountable, for the impacts and outcomes of the full spectrum of business operations, in which, for example, the value of biodiversity and ecosystem services will be incorporated and expressed. 'Rewiring Homo Economicus' refers as much to the change in mind-set necessary for doing business sustainably as it does to the process of getting there.

Significant work needs to be done to connect the two worlds, as the character and jargon of sustainability reporting and corporate reporting differ strongly. "Financial managers capture all performance in figures, but should tell a wider story. CSR managers tell the story and should be more explicit about the actual performance to underpin that story", says Ligteringen.

Considerations and benefits of integrated report*ing*

The right moment to start integrating

Each company will have its own right moment to start integrating financial with other business-impacting information.

In line with the conclusions from the Accounting For Sustainability Report 2007[5] we believe that reporting follows strategy and implementation throughout the company. Therefore starting to integrate reporting without a clear vision and commitment to sustainability does not seem to make sense. Furthermore, as the Accounting For Sustainability Report also explains, sustainability should be embedded in target setting and performance measurement. As this can only be done on the basis of reliable measures and credible information, robust systems to report and monitor performance on key aspects are another indispensable condition for external integrated report*ing* that can add to a company's credibility, trust and reputation.

Key considerations for the integrated report*ing* decision

On the basis of the meeting on integrated report*ing* we held on the 2nd of December 2009 we outline in further detail key considerations that are believed to be important for you as a decision maker when you consider to integrate CSR reporting, other business-impacting information and financial reporting.

Integrated business conduct

Reporting in an integrated manner provides the message to the readers of a report that CSR is an integrated part of daily business conduct. This incorporates not only the business strategy, but also continuous decision-taking at lower management levels in the organization – leading to a balanced decision with regard to the financial profit and the wider impact on society. Furthermore, reporting on such aspects of business in an integrated way assumes you are able to deliver the information at the same level of reliability as financial information – or to disclose it when this is not the case – on the basis of a closed management cycle.

The key message conveyed by the participants in our meeting was that one should not start integrating reporting in the absence of an integrated CSR approach in business conduct.

Reaching relevant user groups

An integrated report can be seen as a 'one size fits all'. As we have outlined above the key objective of reporting relates to reaching stakeholders who want to take decisions on the basis of the information reported. It is of key importance therefore to consider whether integrated report*ing* will let you achieve this objective. As participants outlined, specific user groups can get lost or confused when the decision results in 'one report for all'. Considering this in more detail from the communications perspective can be of help in solving this issue.

Legal risks

The current practice of a separate CSR report (regardless of the medium used) from the annual report leaves freedom in reporting in terms of the associated legal risks. An annual report comes with specific reporting requirements, external oversight and legal accountability towards parties with a financial interest in the company. Therefore, if integrated report*ing* is approached as integrating CSR information (and other business-impacting information) into the annual report, additional legal risks can appear that you would rather avoid.

Robust information and monitoring systems

Reporting in an integrated form comes implicitly with an additional obligation: to report on the CSR and other business-impacting information at the same level of quality as for financial information – or to disclose it if this is not the case. This obligation relates

5 Accounting For Sustainability Report, December 2007, The Prince's Accounting For Sustainability Project, United Kingdom

to the information and monitoring systems that need to be in place to ensure that performance information is reported reliably. However, it also relates to the narrative information. The company should also have processes in place to ensure its quality, including controls to balance positive and negative information and to collect the information in a structured and complete way – to ensure a fair picture is provided of business aspects that are not regulated and defined to the level that financial information is.

Readiness to go beyond combining reports

As mentioned earlier we believe integrating is more than combining two reports into one. Starting with integrated report*ing* should be based on a planned and comprehensive road ahead in terms of communication strategy and media available to disseminate the company's message to stakeholders and, just as important, in terms of a vision towards integrating other business-impacting information into every part of the organisation's conduct.

The benefits of integrated report*ing*

The road to integrated report*ing* can be challenging, as it entails more than the communication perspective. However, once you have set out on the integration road, a number of benefits can be created.

Proof of integration in business conduct

In our view, reporting in a fully integrated way demonstrates to the users of your reporting that you are ready to think about business performance in terms of a comprehensive strategic framework that is supported by demonstrable quality of information and performance management. Thus it positions the company as a leader in the field of business thinking – connecting all relevant information throughout business conduct.

Wider view of company's impact beyond financials

A benefit closely linked to the previous point relates to the fact that everyone faced with an integrated report*ing* approach will obtain a wider view automatically, as it includes information and parameters that go beyond normal financial information. Such a view can reveal valuable opportunities for value enhancement, sometimes from unexpected perspectives.

> "Suppliers may become inspired to offer carbon-efficient supply"

Increased internal awareness about corporate social responsibility

We know from experience that the road to corporate social responsibility can be bumpy, not least because convincing the internal world is as important as communicating with the external world. A top management approach to internal and external reporting that focuses on a comprehensive set of business-impacting information will by definition raise internal awareness about the importance of this – in the first place out of managers' self-interest in the light of performance management. Thus reporting can contribute to changing company's behaviour and profile.

Professionalization of integrated performance management

Whereas increased awareness is one benefit, this needs to result in additional business value to make sense. A loop of management reporting that integrates business-impacting information in the broadest sense will form the basis for improved performance management. This means learning and innovation to help improve business performance on the basis of the information reported as well as the model to reward managers for their contribution to total stakeholder value that also impacts the long-term health of your organization and its license to operate.

Educating specific stakeholder groups

In the current marketplace a number of stakeholder groups are in the process of learning about the added value of evaluating companies' performance more comprehensively. These include investors and customers. For these, and possibly for other groups, there is a case for raising awareness and educating them about the value of also evaluating performance from other business-impacting perspectives. Reporting in an integrated way can be used as a tool to assist in this process, as a start for further discussion about your vision, achievements and challenges in this regard.

Increased trust by transparent reporting about the full societal impact

As we know from the latest financial crisis, trust is of key importance for a company's value and existence. It can be deduced that trust follows on from credibility and that credibility is based, amongst others, on transparency as perceived by relevant stakeholders. This is where integrated report*ing* can support building trust: practising transparency by providing a full (and honest) picture about your company's achievements and challenges will help ensure that those addressed put faith in a company's report and performance.

"The key thought is that integrated report*ing* is not an afterthought, but a result of the business strategy"

Dare to discuss the real dilemmas in CSR reporting

Giuseppe van der Helm, Chief Executive of the Dutch Association of Investors for Sustainable Development and President of EUROSIF

"We are on the right track with (thinking about) corporate social responsibility, although there is some cynicism and frustration about progress made to date."

This is Giuseppe van der Helm's opinion about the current state of play. "During a meeting with students I was surprised by the lack of trust they have in the willingness of companies to contribute to a sustainable world", says Giuseppe. "There is a lot of distrust towards companies and students believe the government should solve the sustainability issues."

Nonetheless improved quality of reporting by companies can contribute to further change, as it supports further mainstreaming the concept and internalizing sustainability into the heart of organizations. Thus sustainability is seen increasingly as a way to generate value.

"In the long term only a sustainably operating company has a commercial right to exist. This is now increasingly realized in different companies and communities. This development needs to go with an evolution in CSR reporting. Integrating financial with CSR information is a good thing", believes Giuseppe van der Helm. "The key thought is that integrated report*ing* is not an afterthought, but a result of the business strategy that includes sustainability as a core element. This implies that the economic value of a sustainable strategy needs to be shown by the report."

He sees a number of challenges in integrated report*ing*. The relevance of the information reported is probably amongst the most important. Every company has to deal with challenging dilemmas when working on sustainability.

The value of reporting is strengthened if companies do not evade the dilemmas that do not have a straightforward answer. "This requires a willingness of top management to work on the basis of a sustainable strategy, as well as a sound transparancy and a solid multi-stakeholder dialogue."

Van der Helm is surprised that, to date, management's remunerations are rarely linked to sustainability targets. This could be related to information on sustainability performance being scattered and a lack of useful data for such purposes. He urges the incorporation of sustainability key performance indicators into regular management information. "This would also be the basis for better balancing the stories and measurable performance indicators in reporting."

The integration road

The considerations and potential benefits as explained earlier could form the basis for a decision to take the road of integrating strategy and reporting for your company. The decision about integrated report*ing* should be assessed from two perspectives simultaneously. On the one hand, reviewing the level of integration of sustainability in the organization is of relevance as a basis for credible, reliable and solid reporting. This we call the management perspective. On the other hand, the level to which you are able to respond to stakeholders' information needs with effective communication means is of key importance to assess whether integrated report*ing* would let you control or mitigate reputation risks and improve relations with stakeholders. This we refer to as the communication perspective.

Key steps to be taken

Without necessarily being complete given the nature of this publication, we present our suggested approach to decide about the integration road.

The management perspective

Starting the road to integration should not start without anchoring sustainability in the business strategy. Therefore a first key step is a fair and honest assessment of the level of integration of sustainability in the business strategy. As this would not be effective without a strong commitment to the theme by board members, this should be taken into account as well.

If these conditions are met, it would then be our advice to review the embedding of the key sustainability issues in the full management cycle. This would entail embedding it in all primary processes of the company, from R&D to sourcing to the sales process. This should be followed by a review of the internal management reporting and control cycle – as this would be an important basis to monitor and improve performance.

The availability of metrics to measure progress and the quality of related information systems is another aspect for review in light of the decisions to be taken – however in our view you can start integrating report*ing* whilst simultaneously bringing these to the appropriate level.

Finally, assessing whether sustainability is integrated sufficiently into performance management systems (or has the opportunity to be integrated in the short term) should inform your decision whether, from the management perspective, the integration road could be taken.

In evaluating all these aspects it is key to assess whether these are effective for all relevant levels and parts of the organisation – for business lines as well as products.

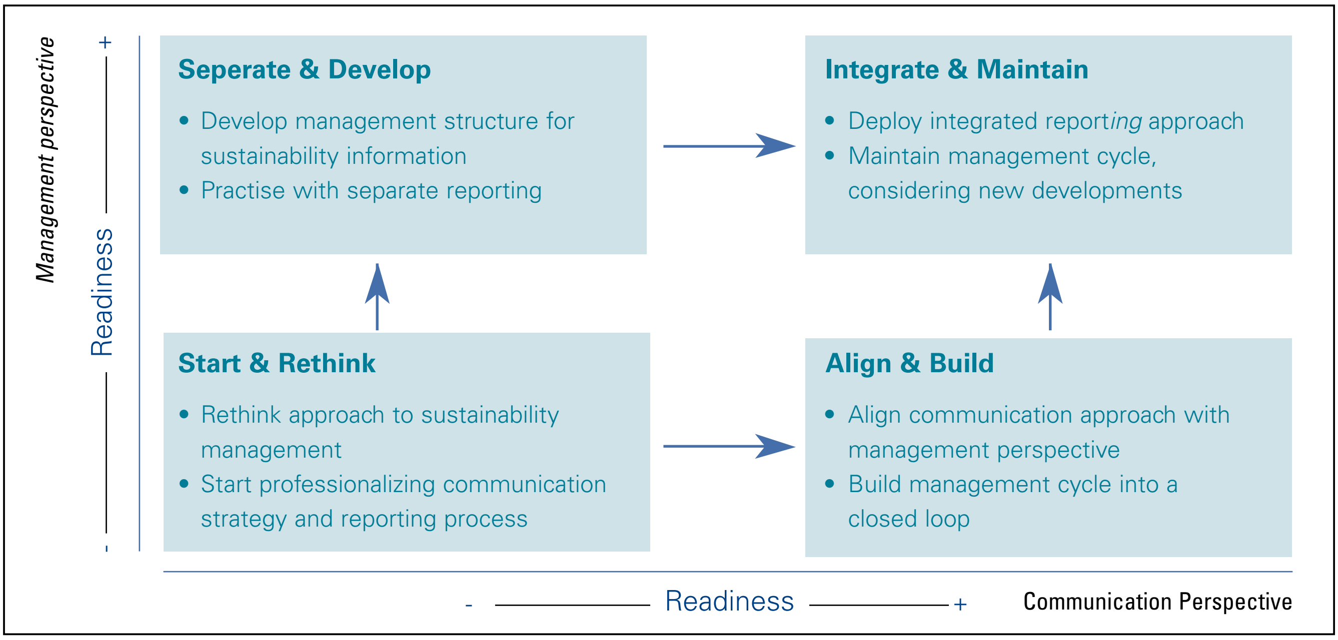
The communication perspective

The most compelling argument to integrate reporting from the communication perspective would be if it would meet the needs of those who use reporting for decision-taking. This is the most important and most challenging part of the communications perspective: (the process for) assessing stakeholders' needs. As part of its evaluation, it is of relevance to review whether this process covers all relevant issues, whether stakeholder interaction mechanisms (such as panels, forums, polls, et cetera) are in place to communicate on a continuous basis and whether the stakeholder process is sufficiently robust to manage and meet their expectations.

On this basis it appears to be appropriate to evaluate the organization's readiness with respect to communications – which involves assessing whether you have developed a proper vision about integrated report*ing*, whether your organization is equipped to deal with the different communications channels and means that are needed and whether connections between those involved in reporting are sufficiently established.

Design of the integration road

We believe there is not a single best road towards integrated report*ing*. Relating the two perspectives as described above can assist you in deciding the next step and the direction you could take.



Source: KPMG: Sustainability, 2010

As can be seen from this model, if the conclusion is that the company does not seem to be sufficiently ready for an integrated report (i.e. when sustainability is not integrated in the management cycle and/or communications are not ready to deal with the challenges of integrated report*ing*), either the road of prioritizing management first or the route of focusing on communications before further improving management control can be taken. Ultimately either route would result in an integrated report*ing* approach, where management attention would be maintained at a high level as part of the integration of sustainability in business conduct.

The decision to integrate comes with a number of other decisions to be taken: frequency, format and design, stakeholder groups, communication channels and assurance all deserve careful consideration on the road to integrated report*ing*.

Final considerations

A few points as addressed previously in this publication deserve special attention:

- Do not reduce the concept of integrated report*ing* to combining the CSR and other business-impacting information with the annual report; there is a risk of the information getting lost in the abundance of legally required information, space being too limited to tell the full and balanced story and the medium being inaccessible to key stakeholder groups. It might be an option to combine the annual report with web reporting should you wish to go via this route on the integration road.
- Take care to balance the story and the figures; not all information can be captured in figures and quantitative targets – while telling a story may be incomplete without the concrete results to support it.
- Be willing to share the key dilemmas your company faces in order to provide credible and transparent reporting.
- Consider the option of external assurance as part of the process to further improve the quality of the information and add credibility to the reporting.
- Look for tailored ways to provide easily accessible information tailored to key stakeholder groups; avoid an overload of information by putting it all together in one report.

With these in mind, it should help enable you to take the right direction on the road to integration.

KPMG's Global Sustainability Services practices deliver assurance and advisory services. For further information about our services please go to www.kpmg.com.

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