First Draft

Integrated Reporting, XBRL, and Corporate Governance

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Abstract

The International Integrated Reporting Committee (IIRC) primarily objective is to create a globally accepted framework for integrated reporting: integrating financial reporting and sustainability information. Sustainability reporting includes information on social responsibility, environmental impact, and economic viability (SEE). This reporting includes financial and non-financial information for reporting to the capital markets. Currently investors and creditors are using various sources for information and manually integrate various information types. The problem is that most investors are not sophisticated users to integrate separate reports to access more relevant information for decision making. Also integrated reporting (IR) as part of the management disclosure system will help the management to efficiently produce and release the information in a timely manner.

Today many companies are interested in providing integrated reporting, but facing lack of standards and expertise. There are a number of non-for-profit professional organizations currently involved in developing and testing various standards for sustainability. There is anecdotal evidence suggesting integrated reporting (IR) will be in demand in the future. There are some efforts to integrate financial reporting with SEE reporting. However integrated reporting is not required by regulators and not practiced by major corporations in America. Current limited adoption of IR is not necessarily due to any mandate, perhaps it is motivated by the pressure from the social media, and the opportunity for some companies to renovate themselves and re-establish relationships with current and potential customers.

The purpose of this paper is to make a case for integrated reporting and explore ways it could be implemented under current regulatory environment particularly in the U.S. This analysis will be in the context of corporate governance model that considers transparency and monitoring as two guiding principles.

Introduction

The International Integrated Reporting Committee (IIRC) primarily objective is to create a globally accepted framework for integrated reporting: integrating financial reporting and sustainability information. Sustainability reporting includes information on social responsibility, environmental impact, and economic viability (SEE). This reporting includes financial and non-financial information for reporting to the capital markets. Currently investors and creditors are using various sources for information and manually integrate various information types. The problem is that most investors are not sophisticated users to integrate separate reports to access more relevant information for decision making. Also integrated reporting (IR) as part of the management disclosure system will help the management to efficiently produce and release the information in a timely manner. “This process, referred to as “integrated reporting,” has been heralded as a way to emphasize the interrelationship of sustainability and profitability, further assimilating non-financial performance data into the investment community… IIRC chief executive Paul Druckman called on “businesses, investors, the accounting profession, regulators, standard setters and other interested parties to contribute to the consultation and shape this corporate reporting evolution which matters so much to the future of business and the global economy” (IIRC 2013)

Today many companies are interested in providing integrated reporting, but facing lack of standards and expertise. There are a number of non-for-profit professional organizations currently involved in developing and testing various standards for sustainability. There is anecdotal evidence suggesting integrated reporting will be in demand in the future. In March 2012, Global Reporting Initiative (GRI) launched its XBRL Taxonomy. Deloitte Netherlands’s sustainability report was one of first reports using the GRI taxonomy for its reporting cycle. This report has more educational value than showing trends. Fujitsu of Japan also is using corporate governance and XBRL internal control taxonomies to report to the public on areas beyond traditional financial reporting. Though there are some activities in integrating financial reporting with the SEE reporting. IR is not required by regulators or practiced by major corporations in America. Current limited adoption of IR is not necessarily due to any mandate, perhaps it is motivated by the pressure from the social media, and the opportunity for some companies to renovate themselves and re-establish relationships with current and potential customers.

The purpose of this paper is to make a case for integrated reporting and explore ways it could be implemented under current regulatory environment particularly in the U.S. This analysis will be in the context of corporate governance model that considers transparency and monitoring as two guiding principles. The discussion includes current practices, challenges and opportunities of integrated reporting.

Demand and Supply of Non-financial Reporting related to Sustainability

In general, investors in the global capital markets tend to look for opportunities to maximize their profit, and this profit is generally defined in accounting terms and concepts; for example, earnings per share (EPS). Accounting standards that are used in most industrialized countries today often lack considerations for sustainability reporting – reporting on SEE elements. In the absence of integration of these factors to the main stream financial reporting process, it can be argued that investors really lack relevant information on such factors today. Some companies now voluntarily disclose such information while others will wait until a mandate. For example, in South Africa standards for sustainability are legally enforced by the capital market regulators, as a result public companies are obligated to disclose information about activities of the company that may impact sustainability of resources employed. In the absence of a mandate social media is likely to play a larger role in distribution of information in a timely manner.

The Global Reporting Initiative (GRI) is an advocate not-for-profit entity that sets standards for sustainability. GRI defines three dimensions for sustainability: social impact, economic viability, and environmental impact. The sustainability initiative was primarily launched in response to situations where corporations engaged in activities/issues that not only impacting the present generation but also "compromising the ability of future generation to satisfy their own needs" (UNWCED, 1987). The goals of social responsibility reporting are grounded in self-policing of the company by its board of directors and to be in compliance with policies instituted by the corporation, local communities and national governments.

Corporate environmental reporting perhaps has been around for a longer time and with some traction. Traditionally environmental reporting has been primarily a regulatory reporting in response to various environmental statues, for example, the U.S. Clean Air Act and U.S. Clean Water Act. Such statues deal with licensing industrial facilities, reporting and disclosure requirements for the amount of pollution substance such as toxic chemicals. In a broader term, one may observe some overlapping concepts among elements of sustainability: social responsibility, economic viability, and environmental reporting. However, major factors that separate these types of reporting are rooted in the source of standard and the standards setting process.

It is interesting to note that reporting based on GRI standards is voluntary, but increasingly progressive corporations opt to report on some GRI guidelines, as they see the value of having friends in the world of social media. The GRI guidelines are self-scoring and grading guidelines generally appeal to the social media community.

Case of Integrated Reporting

There are two major organizations that deal with development of guidelines for integrated reporting: International Integrated Reporting Council (IIRC) and the Global Reporting Initiative. These organizations reach out to governments and other regulatory agencies in an attempt to find ways for companies to adopt the guidelines. GRI has developed guidelines for sustainability reporting. The GRI's framework is gaining global acceptance for sustainability reporting, and reportedly there are over 2,000 reports employing full or partial application of the GRI's framework, including companies like Johnson & Johnson and Coca-Cola (About GRI 2012).

The IIRC develops principles for integrated reporting and encourages companies to focus on forward looking information disclosures and achieve certain level of integration of SEE elements. This should highlight business aspects of the organization, strategic objectives for the future, impact of governance regulations, remuneration, key performance indicators (KPI), and future outlook . According to IIRC, there are over 70 companies worldwide adopted the integrated reporting concept.

Currently, South Africa, Australia, Brazil are major countries with organized efforts in SEE reporting. In South Africa companies listed on the Johannesburg Stock Exchange must issue sustainability reports following GRI, this is the first exchange in the world to mandate sustainability reporting. Companies subject to this rule, hope that benefits of creating such reports eventually outweigh the potential cost of integrated reporting. There are some companies that produce integrated reports, based on the framework suggested by the International Integrated

Reporting Council, for example almost 40% of companies traded on the Australian Stock Exchange (ASX) do distribute sustainability reports (Marc 2011). In 2009, 149 organizations used GRI's guidelines; in 2010 183 organizations use it, which is a 30% jump.

Delivery and Obstacles of Achieving IR

XBRL (extensible business reporting language) has been developed by the international community to standardize the financial reporting and facilitate exchange of financial data in the business reporting supply chain where companies, investors, regulators, and accounting professionals participate. In the U.S. XBRL taxonomies are officially endorsed by professional standards setters and provide guidance for consistent reporting of financial statements. Any extension to these taxonomies is discouraged unless proper justification is presented, this restriction should improve the data quality. Financial statement filing of XBRL with the SEC has been required since 2009, and there is enough evidence that companies are on the learning curve of proper filing and avoiding unnecessary extensions.

We have seen standard of business reporting (SBR), though not completely XBRL reporting, has integrated various non-accounting information from multiple entities, responding to the demand by various regulators. As results, XBRL is suggested in this paper as mechanism or platform to accept non-financial information. In some jurisdictions XBRL has been offered as a vehicle to deliver either sustainability reporting or one step further - integrated reporting. Financial reporting process today is more focused on the compliance reporting and there are some implementation variations in different jurisdictions. Yet it is still a good framework for integrating important non-accounting information such as sustainability for the following reasons:

1- Integration with financial statements will help SEE reporting to move up to the main-stream reporting
2- Building upon existing financial accounting reporting model – even the model is not perfect.
3- XBRL has gone through considerable development and testing – is not without implementation issues but solutions are emerging as problems arise.
4- Regulators may be more open to require financial reporting to integrate SEE reporting to promote one-stop reporting.
5- Tools and solutions are emerging on XBRL side and could be utilized for IR reporting

6- It will move financial reporting process from all-or-nothing to side-by-side to fully integrated
7- It will reduce the total cost of disclosure management and compliance cost

Here is the speech by the CEO of the Royal Bank of Canada emphasizing the value proposition of integrated reporting: *While we are compliant with the regulations, the debate has been about something else. The question for many people is not about doing only what the rules require – it's about doing what employees, clients, shareholders and Canadians expect of RBC. And that's something we take very much to heart* (Daniel Tisch 2013)

Current State of Integrated Reporting in the U.S.

At the present time, integrated reporting is for all practical purposes banned in the U.S. due to lack of agreements in the auditing community, and legal system- it cannot be integrated with the US GAAP financial reports, audit opinion cannot cover other than US GAAP information. Although there are some instances of filing of SEE reports in other jurisdictions as noted earlier, there is no prospect of integrated SEE reporting as part of regulatory reporting in the U.S. at the present time. Also, in the U.S. if there is any major report on SEE it would likely be on the positive side, companies are worried about incrimination or any release of potentially bad news.

Integrating reporting, however, is on the rise on websites, Tweets, company Facebook etc. This is primarily because stakeholders need more operational and strategic information about the company and accounting reports extracted from compliance-based financial reports no longer fully satisfy stakeholders. The pressure to have additional information using integrated SEE reporting for users is not necessarily coming from the regulators; it is coming from users through social media. Today stakeholders through social media make themselves heard; there have been a number of situations where the boards of directors and management have reversed a policy due to pressure from the social media. For example, Bank of America's fee on debit card was removed rather quickly due to pressure from social media, over 200,000 people declared stop doing business with the bank. Many types of company information are now available on-line, some with restricted access and some with open access. For example, interested investors can find out through social media about community welfare aspect of the company by linking to various sites monitoring such activities. The Dow Jones Sustainability Index is a new measure where some investors look for sustainability information. It is arguable that companies would be interested to be included and rank high in the Index. In summary, three approaches emerge:

One approach is to take advantage of GRI taxonomy that already exists and create a sustainability report, and present the report side by side with financial reports. For reason we explain later in this paper, integration with financial reporting may not be possible in the U.S. at this time. Disadvantage of this approach is that sustainability information and financial reports are not fully integrated. Then a third party vendor has to do the integration between two XBRL reporting regimes, financial and sustainability reports. Obviously the advantage of this approach is that we get one step closer to the optimal solution of full integration.

Another approach is to take advantage of already developed taxonomies in XBRL, and add extensions that are clearly designated as sustainability reporting elements. The advantage of this approach is that no new taxonomy infrastructure needed for additional reporting elements, savings on research and development costs. This approach may not be a satisfactory solution to regulators who have not allowed integration of financial and sustainability information for official filing purposes.

Yet the third approach is to use the GRI reporting framework and make the report readily available on company websites, Facebook, Twitter, and other social media. Under this approach the public becomes the final arbitrator of the usefulness and adequacy of sustainability reporting. This way there is no regulatory deadline or prescriptive model of sustainability reporting, companies can release to the public their operational and strategic goals and achievements even beyond the GRI framework. The difficulty with this approach is how to carry the sustainability message/data throughout the reporting supply chain. It would also be difficult to properly parse the sustainability report to given objectives and goals.

Source of Difficulties to SEE or Integrated Reporting in the U.S.

Integrated reporting in the U.S. is facing the same issues as IFRS (international financial reporting standards) adoption, the issue is what role do the regulators play? It is widely accepted that the corporate governance in the U.S. capital markets is regulator-led vs. corporate governance that is shareholders-led. In some countries in Europe individual shareholders have much to say about strategic and direction of the company than in the U. S. Also, Management

Discussion and Analysis (MD&A) and auditor report are not as restrictive as they are in the U.S. The PCABO's new audit model proposal is a step towards giving more opportunity to the auditors to discuss matters of importance to the client and investors. For example, the PCAOB proposed Auditor Discussion and Analysis (ADA) document for further understanding of materials covered under audit report.

In general any information collected through the regulatory compliance has a narrow focus and gets outdated easily, because the filer is worried that disclosing more than minimum may have legal consequences. Current SEC compliance system is still largely paper-based or PDF-based. There has been no regulation in the U.S. to encourage or enforce SEE reporting. Even a voluntary IR reporting could be problematic, SEE information cannot be mixed up with the content of current regulatory reporting. For example, Management Discussion and Analysis surprisingly has become more restrictive after Sarbanes-Oxley Act of 2002 (SOX) looking more like a boiler plate. Interestingly enough, SOX did not ask for more restrictions to the MD&A, but pressure from the legal community encouraged the management to use a boiler plate approach, and now most MD&As look very similar in 10-K Forms. If SEE information such as the impact of documented/undocumented employees, fair wages practices, recycling computer hardware manufactured are added to the financial statements - external auditors most likely will refuse to issue unqualified audit report. This may push the company to report on SEE information separately using GRI standards, and most likely on the company web sites, or company Facebook. As a result, the SEE information is not really integrated with financial reports. This conflict can eventually be mitigated by the social media as the U.S. SEC has recently recognized that the information put on social media such as Facebook, Tweeter, and company websites are considered disclosure.

IR is also important aspect of internal reporting. Company generally collects information about employment, social welfare contributions, efforts towards clean environment, key performance indicators (KPI), and governance risk model for internal reporting purposes. Therefore, given information is available via ERP (enterprise resource planning) systems, the integration process will not be expensive for internal reporting purposes. Some companies are already disclosing much of SEE information to other regulatory agencies as part of mandatory reporting. For example the U.S. Department of Labor and U.S. Environmental Protection Agency (EPA) all have significant and specific annual disclosure requirements that normally not integrated as part of financial statements filings of the company. Also, Internal Revenue Service Form 990 for not for profit (NFP) organizations requires information about the mission, significant activities, management compensation and governance.

Final Note

Integrated reporting perhaps goes beyond sustainability reporting to include other reports the management is required to prepare and deliver. As part of efforts to streamline management disclosure system, integrated reporting is the first and important step. Currently there is no mandate in the U.S. for a third party assurance report on sustainability (or integrated) information disclosure. However, this could change as investors and regulators have to rely on such information for decision making

IR should be a wakeup call for the accounting profession, because reports on SSE elements fill the expectation gap currently exist between what accountants currently report and assure and what accountant should report and assure. Overall there are two distinct forces that influence decisions made in corporate boardrooms: (1) consumers who are directly impacted by the quality and pricing of products/services the company offers, and (2) investors and creditors who do seem to care about products/services offered; but primarily are in for short-term or long-term financial gains. Such investors often disregard concessions or considerations for social, environmental, and economic wellbeing of the company; however, this seems to be changing.   One way to address demands of investors and creditors, and consumers of product and services is to pass regulation and establish a regulatory solution. At least in the U.S., the Congress has no appetite for imposing more regulations on businesses. In today widespread of Internet access, however, the social media seems to serve a relatively reliable monitoring force. Whether the social media eventually be the final arbitrator of what companies disclose to the public is yet to be seen.

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