KPMG INTERNATIONAL

Active Governance: the core of Better Business Reporting

By Nick Ridehalgh, KPMG in Australia

In brief:

- The profile of corporate stakeholders and their ability to influence business has changed. Companies must demonstrate they are managing the interests of all their capital providers in order to show that they have a sustainable business model
- Boards have a duty to maximise a company's overall economic value and ensure best use of all types of capital. They need to report openly on the companies' achievements and challenges
- Boards need to take responsibility for driving the organizational change towards integrated thinking and for ensuring the content of their corporate reporting meets capital provider's information needs

A new focus for 21st century companies

The key providers of capital in much of the 20th century were wealthy families with a single bottom-line agenda – to make money. Today the providers of financial capital are largely ordinary people investing through their pension funds. Often these same investors are also the company's employees, customers and impacted communities. So even though these 'universal investors' still require financial returns (and security in their retirement), those returns need to be made over the long-term with a positive (or at least neutral) impact on, amongst other things, the environment and community in general.

The result is that companies are dependent on and must manage a much broader range of capitals – the continued availability of intellectual, manufactured, social, human, and natural capitals cannot be taken for granted.

Obligations of the 21st century board

Directors need to work together to identify and assess changes today and potential changes over the short, medium and long-term that may materially influence the company's strategy and longer-term success. They have to make decisions based on best available information and an honest application of the collective mind of the board operating in the best interests of the company. In doing this, the directors must try to maximise the company's total economic value (not its book value) for shareholders whilst meeting other stakeholders' needs.

To do this, boards need to embed Integrated Thinking into every decision made by them, the organization's management and its staff. All decisions should consider not just returns on financial and manufactured capital, but also on the organization's human capital, intellectual capital, natural capital and social capital.

Shareholders Recognize that long-term business viability depends on providing a balanced return across all capitals over time, and are telling boards to provide visible oversight and leadership in ensuring the required cultural change is embedded into business-as-usual at all levels of the organization. Progress has to be candidly reported through to the board and ultimately to the shareholders.

Readers' information needs

Shareholders have varying time and abilities to read and analyze long company reports. Companies all over the world complain about the regulatory reporting burden and users complain about the length, complexity and boiler-plate nature of the documents produced. No-one in the reporting supply chain is satisfied with the totality of information available to help them make and monitor their capital allocation decisions.

The world in which companies operate is changing. Businesses are facing capital constraints from a broader range of resources than just finance. Boards are responsible for addressing these capital requirements in a sustainable manner for a company's long-term success.

We consider why boards need to provide active governance, how Integrated Reporting helps, and the board's vital role in driving the changes needed from the top down for Integrated Thinking to become embedded in the organization's culture.

They need different types of information at different stages of their decision making:

- Due diligence phase – when the investor, supplier, customer, employee, banker, etc. undertakes an initial investigation into a specific organization in deciding whether to invest, supply, purchase, join or finance the company.
- Ongoing monitoring phase – the user undertakes a regular review of the organization's performance and prospects to ensure nothing material has occurred that might change the original decision.

In order to meet due diligence information needs, the company must provide a broad suite of information about the organization.

However, once due diligence has been undertaken and a decision made, then the shareholder or other user only requires information that explains:

- Material changes to governance, strategy and future outlook, including changes to key directors and executives, the company's risk profile or appetite, the business environment or external factors; and
- Performance against strategic objectives to confirm delivery against strategy to date across key value drivers, and an explanation of any proposed changes to key value drivers based on experience to date and/or changes to strategy, risk and future outlook.

Much of the information required for due diligence is standing data that can be provided on the company's website and updated from time to time, as improvements and other changes are made. Only changes that are potentially material to stakeholder decisions should be reported in company reports produced for the monitoring phase, with reference to website amendments where appropriate (subject, of course, to any regulatory constraints).

An Integrated Report, in which the organization tells its own value creation story, aims to provide the information investors require for their ongoing monitoring needs. By addressing these needs we expect that it will meet many if not all of the material needs of other stakeholders.

So why are companies not providing this Integrated Report now? Many jurisdictions allow for this kind of report in the Review of Operations & Financial Condition (OFR) or Management Discussion & Analysis (MD&A). However, 20th century corporate reporting was driven by boiler-plate imposed frameworks, complex rules, aversion to litigation risk and an over-reliance on the 'commercially sensitive' argument over-riding full and transparent reporting.

The board must drive Integrated Reporting

The board's role in corporate reporting has sometimes been too little, too late. Although certain key reports are approved at board meetings, there is often too little time for any major overhaul of the content.

In the Centro case (2011) in Australia, in which errors and omissions found in the annual filings led to a significant loss of economic value, the Federal Court's judgement reminded directors that they take overall responsibility for the content of the financial report and directors' report. (Mr Greg Medcraft, ASIC Chairman, June 2011).

The findings of the Centro case, combined with the expectations and challenges of managing a broader set of stakeholders, mean boards must be more involved – and involved at an earlier stage – in developing the structure and messaging of key reports, such as the OFR or MD&A.

Indeed, if the Integrated Report provides the annual 'monitoring' information required by shareholders and other stakeholders, then directors must be involved not only in developing the structure of this reporting framework, but also for more detailed internal reporting (to the board and executive management) which focusses on the key value drivers and performance, and provides a clear assessment of material future risks and opportunities to longer-term value creation.

Practical Concerns

The 21st century board must take the lead in controlling the information it receives and communicates. In driving development of a candid and concise strategy-aligned Integrated Report, it must actively debate and contest management's claims that some material is 'commercially sensitive' or 'not legally required'. If the information is potentially material to the decisions of capital providers, is the Board prepared to take the responsibility for not reporting it?

What if directors are concerned about their own liability if a future event does not turn out as expected? Professor Mervyn King, Chairman of the International Integrated Reporting Council, suggests companies should maintain an Explanations Register setting out the due diligence undertaken by the company and the board's rationale in making the decision/ disclosure based on best available information. Different permutations of such a register, and potentially other safe harbour provisions, will need to be developed for specific jurisdictions to protect directors who are taking care and diligence and making educated decisions using the best available information.

There is growing global regulatory focus on broader based reporting. Integrated Reporting is now required for listed companies in South Africa on an 'apply or explain' basis. Many other companies throughout the world are starting to adopt Integrated Thinking in day-to-day business decision-making, and are quite transparent in their public disclosures, but many others follow regulatory-driven boiler-plate disclosures in their public reporting. It is up to 21st century directors to take positive action to meet their reporting obligations to their stakeholders through more active governance.

Action points for boards

Active governance requires positive action and candid disclosure by boards to meet the material information needs of their capital providers. Directors should ask themselves whether they are satisfied with the following:

- Are the board and management's **strategic planning activities**, including the impact on strategy and strategic objectives, being communicated effectively?
- Is the board's **assessment** of **strategic risks and external factors** (including going concern) being communicated properly? Does this communication include an explanation of what has changed and the consequential impact, including any changes to the organization's risk profile?
- Have **executive and staff** incentives been discussed? Is the link to integrated thinking, cultural change and effective implementation of short and longer-term strategies explained?
- How have **one-off reportable events** been handled? Has there been continuous disclosure? Does disclosure include board activity, speed and accuracy of response, and consequences/outcomes?
- Has the **content of the Integrated Report** been discussed regularly? Have the directors been involved in the structure and design of the primary report, other public reports and other board papers?
- Have **changes to standing data** been properly explained? What about the implications of the changes on the business model, strategy and risk?

Contact us

David Matthews
KPMG in the UK
T: + 44 (0) 207 311 8572
E: david.matthews@kpmg.co.uk

Matt Chapman
KPMG in the UK
T: +44 (0) 207 311 3236
E: matthew.chapman@kpmg.co.uk

Wim Bartels
KPMG in the Netherlands
T: + 31 206 56 7783
E: bartels.wim@kpmg.nl

Oliver Beyhs
KPMG in Germany
T: + 49 30 2068 4485
E: obeyhs@kpmg.com

Michael Bray
KPMG in Australia
T: + 61 3 9288 5720
E: mgbray@kpmg.com.au

Nick Ridehalgh
KPMG in Australia
T: +61 2 9455 9312
E: nridehalgh@kpmg.com.au

Etienne Butruille
KPMG in Spain
T: +34 914 565 953
E: ebutruille@kpmg.es

Mark Hoffman
KPMG in South Africa
T: + 27 82 496 3697
E: mark.hoffman@kpmg.co.za

Yoshiko Shibasaka
KPMG in Japan
T: + 81 3 3266 7670
E: yoshiko.shibasaka@jp.kpmg.com

Nina Straume Stene
KPMG in Norway
T: +47 4063 9851
E: nina.straume.stene@kpmg.no

Bill Murphy
KPMG in Canada
T: +1 416 777 8998
E: billmurphy@kpmg.ca

Hans Peter Lindegård Buhrkal
KPMG in Denmark
T: +45 2529 3921
E: hpbuhrkal@kpmg.dk

RR Donnelley | RRD-281221 | March 2013 | Printed on recycled material.

www.kpmg.com/integratedreporting