INTEGRATED REPORTING <IR>

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VALUE CREATION

BACKGROUND PAPER FOR <IR>

The Technical Task Force of the International Integrated Reporting Council (IIRC) established a Technical Collaboration Group (TCG) to prepare this Background Paper for <IR>. The TCG was coordinated by the lead organizations with input from participants from a range of disciplines and countries. This paper reflects the collective views of TCG participants, not necessarily those of their organizations or the IIRC.

The IIRC considered interim findings from the TCG when preparing the Prototype Framework released in November 2012, and considered aspects of this paper in developing its Consultation Draft of the International Integrated Reporting (<IR>) Framework.

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LEAD ORGANIZATION
Ernst & Young LLP (EY)

STEERING COMMITTEE
Susan Blesener, The Art of Value
Pedro Faria, CDP
Jonathan Hanks, Incite Sustainability
Rowland Hill, Marks & Spencer
Bob Massie, New Economics Institute
David Matthews, KPMG
Tom Rotherham, Hermes EOS
Richard Spencer, ICAEW
Fraser Thompson, McKinsey
Alan Willis, CICA/Independent
Joanne Westwood, Vancouver City Savings Credit Union (Vancity)
Roger Simnett, University of New South Wales
Lois Guthrie, International Integrated Reporting Council
Matthew Bell, EY (Australia)
Meg Fricke, EY (Australia)
Brendan LeBlanc, EY (United States)
Benjamin Miller, EY (Canada)
Kelly Gilman, EY (South Africa)

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CONTENTS

1 Executive Summary
2 About this Background Paper for <IR>
3 1. Introduction
3 2. Overview of the term "value creation"
9 3. Value creation for <IR> purposes
9 3A Explaining value creation for <IR>
11 3B Who assesses value for <IR> purposes?
12 4. Information that enables readers and users of integrated reports to assess value creation
12 4A Information that facilitates an assessment of value creation
13 4B Practical limitations to the communication of value creation
15 5. Examples of communication about value creation
16 Conclusion

Executive Summary

This Background Paper for <IR> explores the concept of value creation for Integrated Reporting <IR> purposes. Integrated Reporting <IR> is a process that results in communication, most visibly a periodic "integrated report" about value creation over the short, medium and long term[1]. The concept of value creation therefore lies at the heart of <IR>.

The International Integrated Reporting Council (IIRC) has developed a draft International <IR> Framework (the draft <IR> Framework) in order to encourage the transition to <IR>. Together with the business model and capitals, value creation is one of the three fundamental concepts identified as underpinning the requirements and guidance set out in the draft <IR> Framework.

Although organizations aim to create value overall, resources and relationships, also referred to in the draft <IR> Framework as different types of "capital", may be destroyed or depleted in the process of conducting business activities. Therefore, whenever the term "value creation" is used, it should be interpreted to include actual or potential value destruction or depletion[2].

Value is created, changed or destroyed by an organization through its business model. The Business Model Background Paper for <IR> defines the term business model as "the chosen system of inputs, business activities, outputs and outcomes that aims to create value over the short, medium and long term." Therefore, within the context of <IR>, the process of value creation is explained as follows:

Value is created through an organization's business model, which takes inputs from the capitals and transforms them through business activities and interactions to produce outputs and outcomes that, over the short, medium and long term, create or destroy value for the organization, its stakeholders, society and the environment.

The capitals from which the business model takes inputs are identified in the Capitals Background Paper for <IR> as financial, manufactured, intellectual, human, social and relationship, and natural capital. The capitals represent stores from which value is released when the capitals are combined, transformed and leveraged through an organization's business activities and interactions in order to produce outputs and outcomes that represent value creation or value destruction for stakeholders depending on their interests and perspectives.

The process of taking inputs of capital and applying, using, combining, transforming and sometimes destroying them through the business model to produce outputs and outcomes has both positive and negative effects individually and collectively on the capitals, on the organization, providers of its financial capital, society and the environment. The nature of those effects informs an assessment of whether, to what extent, for whom and over what timescales value has been created. This in turn depends in part on the outcomes from the business model for the environment and for consumers and other stakeholders affected by the organization's activities (e.g., competitors, regulators and local communities).

The assessment of value creation therefore involves considering the interdependencies between a company's competitiveness and performance and the communities, stakeholders, supply chains and natural environment it affects and on which it draws. An integrated report should enable providers of financial capital to assess whether, to what extent and how an organization's business model affects the wider context that supports or threatens value creation, including financial value, in the short, medium and long term.

[1] www.theiirc.org
[2] The Capitals Background Paper for <IR> footnote 7 page 4

About this Background Paper for <IR>

This Background Paper for <IR> is organized into five sections as follows:

Section 1 introduces the paper.

Section 2 provides an overview of some of the theory that informs the meaning of the term value creation.

Section 3 explains the process of value creation for <IR> purposes.

Section 4 considers the type of information that is likely to help readers and users of integrated reports to assess whether, to what extent and for whom value has been created and can continue to be created over the short, medium and long term.

Section 5 illustrates practice on communicating value creation based on extracts from reports published by selected members of the IIRC's Business Network.

1. Introduction

1 The IIRC's September 2011 Discussion Paper, "Towards Integrated Reporting – Communicating Value in the 21st Century" said that <IR> "provides a clear and concise representation of how an organization creates value now and in the future."

2 In response to the 2011 Discussion Paper 73% of respondents agreed, (2% of whom agreed with qualifications), that the ability of an organization to create and sustain value over the short, medium and long term is appropriate as a central theme for the future direction of reporting[3]. The concept of value creation has therefore been retained in the Consultation Draft of the International <IR> Framework (the draft <IR> Framework) as one of the three fundamental concepts underpinning the requirements and guidance set out in the draft <IR> Framework.

The scope of this Background Paper for <IR>

3 This Background Paper for <IR> responds to questions and comments that were raised in response to and since publication of the 2011 Discussion Paper, in particular the need for more clarity about the term value creation for <IR> purposes, to whom value accrues for <IR> purposes and how value should be communicated in an integrated report. This Background Paper provides a blend of theory and practical examples intended to explain the concept of value creation. The information contained in this Background Paper is neither exhaustive nor authoritative. Like the draft <IR> Framework itself, this Background Paper does not prescribe an ideal or universally applicable approach to communicating value creation. Rather, it sets out theories and examples that can be used by organizations to tailor their communication of value creation to their own circumstances, reporting needs, objectives and audiences.

4 The explanation of value creation in this Background Paper should be distinguished from the meaning of value. This Background Paper does not define value. Value has different meanings for different people and in different contexts and those meanings and contexts are not explored here. This Background Paper focuses on explaining the process of value creation for <IR> purposes.

5 Certain matters that are associated with the concept of value creation are not addressed in this Background Paper as they represent on-going bodies of research in their own right, which are beyond the scope of this paper. For example, the paper does not cover in detail the debate about whether and to what extent the role of the modern corporation is to maximize shareholder value or to create value for the whole of society, nor does it examine creation of intrinsic and extrinsic value. Furthermore, this Background Paper does not seek to reconcile value creation for <IR> purposes with other concepts of value such as enterprise value, total economic value, economic value added and total value. Finally, whilst it is recognized that notions of value capture and value appropriation are closely linked to the concept of value creation, the IIRC's work focuses on value creation. An examination of the way in which and by who or what created value is captured or appropriated is therefore beyond the scope of this paper.

2. Overview of the term "value creation"

6 Value creation is a widely used term. Calls for business reporting to focus more on factors, including non-financial factors, that create longer-term value date back some years. For example, a Special Committee on Financial Reporting established by the American Institute of Certified Public Accountants in 1991 recommended that the information companies should provide to investors and creditors should "focus more on the factors that create longer term value[4]."

7 Although there is no universally agreed definition of the term value creation or the manner in which it should be communicated, certain themes inform the meaning of the term generally. The following general themes about value creation emerge from the literature review conducted to support the development of this Background Paper for <IR>. The ten themes identified in this Background Paper do not represent a comprehensive list of all matters that influence the way in which value creation may be understood.

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[3] http://theiirc.org/wp-content/uploads/2012/06/Discussion-Paper-Summary1.pdf
[4] http://www.aicpa.org/interestareas/frc/accountingfinancialreporting/enhancedbusinessreporting/pages/jenkinscommittee.aspx

Ten themes that inform the meaning of value creation

Value creation takes place within a context
Financial value is relevant, but not sufficient, for assessing value creation
Value is created from tangible and intangible assets
Value is created from private and public/common resources
Value is created for an organization and for others
Value is created from the connectivity between a wide range of factors
Value creation manifests itself in outcomes
Innovation is central to value creation
Values play a role in how and what type of value is created
Measures of value creation are evolving

8 The themes are explored below, by way of context for Section 3, which explains the process of value creation for <IR> purposes. Each theme represents a major body of research in its own right. This Background Paper for <IR> summarizes elements of the research by way of general background only. The themes are numbered for ease of cross-referencing in this Background Paper for <IR>. The numbering does not imply any order or priority to the themes that have been identified during the literature review.

1. Value creation takes place within a context

9 Value is created by organizations from a wide range of interactions, activities, relationships, causes and effects[5]. Those interactions take place in the market, regulatory, societal and natural/environmental context within which the organization operates and on which it depends. The interactions occur between the organization and its consumers, employees, stakeholders, regulators, suppliers and others operating in the context within which an organization conducts business activities. The context is also affected by natural, environmental and planetary limits.

10 A report by WWF and SustainAbility states that "the Earth cannot keep up with the demand our economy is placing on its ecological assets. Evidence is mounting that the sheer volume of resources flowing through the global economy has become today's key environmental challenge and as human demand for resources grows, the Earth's life supporting natural capital will be liquidated at ever-increasing rates[6]."

11 The context and interactions within it therefore affect the degree to which and the type of value that can be created. For example, the context affects and to some extent determines:

- The type, cost and extent of resources that are available to an organization as inputs to the business model for the creation of value.
- The types of risk and opportunity, including their nature, timing, potential impact and uncertainties[7] that actually or potentially affect the organization's ability to create value. The risks to which organizations are exposed are examined in various reports including the World Economic Forum's Global Risk reports[8].
- The way in which value is perceived based on societal expectations of what represents value creation by an organization. For example, research by EABIS concludes that sustainable development goals have challenged the existing dominant convention of shareholder value and of how value is created or destroyed[9].

[5] Consultation Draft of the International <IR> Framework paragraph 2.37
[6] One Planet Business – Creating Value within Planetary Limits, WWF and SustainAbility, 2007
[7] Tomorrow's Company and CIMA - "Tomorrow's Value"
[8] http://www.weforum.org/issues/global-risks
[9] Outcomes from business activities are externalized where the costs or benefits associated with the production or consumption of goods and services are imposed on and experienced by others outside the organization but are not reflected in the prices charged for goods and services.

12 The assessment of whether and to what extent value has been created therefore takes account of contextual factors including: resource scarcity, the increasing connectivity of the globalized world and the way in which certain outcomes from business activity spill over into the environment, are "externalized" and are perceived by society.

According to the Organization for Economic Cooperation and Development (OECD), "externalities refers to situations when the effect of production or consumption of goods and services imposes costs or benefits on others which are not reflected in the prices charged for the goods and services being provided.

Pollution is an obvious example of a negative externality... Chemicals dumped by an industrial plant into a lake may kill fish and plant life and affect the livelihood of fishermen and farmers nearby.

In contrast, a positive externality or external economy may arise from the construction of a road which opens a new area for housing, commercial development, tourism, etc. The invention of the transistor generated numerous positive externalities in the manufacture of modern telecommunication, stereo and computer equipment. Externalities arise when property rights cannot be clearly assigned.[11]"

13 According to paragraph 2.44 of the draft <IR> Framework, "<IR> takes account of the extent to which effects on the capitals have been externalized (i.e., the costs or other effects on the capitals that are not owned by the organization). Externalities may be positive or negative (i.e., they may result in a net increase or decrease to the value embodied in the capitals)."

2. Financial value is relevant, but not sufficient, for assessing value creation

14 Financial value may be manifested in various ways, including in an organization's stock price, profits, balance sheet and organizational growth, and it may change over different timeframes. According to McKinsey, companies create value by investing capital from investors to generate future cash flows at rates of return exceeding the cost of that capital (i.e., the rate investors require to be paid for the use of their capital). "The faster companies can grow their revenues and deploy more capital at attractive rates of return, the more value they create. In short the combination of growth and [return on investment capital] drives value and value creation[12]."

15 However, recent analyses challenge the narrow focus of value creation on financial value and contend that value creation extends beyond benefits directly associated with financial value or financial capital accretion. Although relevant, it is not sufficient to assess value creation only through the process of exchange in markets which sets prices and expresses the quantified worth of goods and services or through accounting concepts of value expressed in profit and loss statements, balance sheets and organizational growth.

16 As well as value that may be quantified in financial terms, value may be also be manifested in utility value, that is the qualitative aspect of value: value in the eyes of consumers and users through its utility in meeting human needs. Utility value is expressed and realized through its consumption. Utility, that is the customer or stakeholder's assessment of worth, is not derived from a single source but from three overlapping areas: functional utility (what the product or service does), economic utility (how much it costs) and emotional utility (how it makes the customer feel)[13].

17 Similarly Benedickt, Oden[14]and Herman Daly[15] refer to value being manifested in "qualitative growth", being the increase in the quality of goods and outcomes produced by an economy rather than an increase in the quantity of goods and services, whilst offering the same or greater opportunities for profitable investment, full employment and decent wages.

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[11] OECD Glossary of Statistical Terms accessed 5 February 2013 from http://stats.oecd.org/glossary/
[12] http://www.mckinsey.com/client_service/corporate_finance/latest_thinking/value/the_four_cornerstones
[13] "What does value mean and how is it created, maintained and destroyed?" – C Bowman and V Ambrosini, Cranfield School of Management, 2003
[14] Better is Better than More M Benedikt and M Oden, Centre for Sustainable Development Working Paper Series 2011 (01
[15] Beyond Growth: The Limits of Sustainable Development, Herman Daly, Boston:Beacon Press 1996

3. Value is created from tangible and intangible assets

18 Tangible assets have a physical form and existence. By contrast, intangible assets do not have a physical presence. In International Accounting Standard (IAS) 38, the International Accounting Standards Board (IASB) defines them as non-monetary assets, which are without physical substance. Intangible assets include brands, patents, goodwill, know-how, reputation, the knowledge held by employees and the corporate strategy. Intangible assets contribute to the creation of value by organizations.

19 Increasingly value is created primarily from intangible rather than physical assets[16]. For example, 280 chief executive officers from over 21 countries surveyed by the AICPA and CIMA concluded that people's ideas, skills, knowledge and relationships represented the unique value of their companies in terms of where it comes from and how much of it is available. They therefore supported the need to measure and manage the human dimension in order to achieve long-term sustainable success[17]. Intangible assets, such as good reputation, have been described as "critical, because of their potential for value creation and also because their intangible character makes replication by competing firms considerably more difficult[18]."

20 Although intangible assets are recognized for the purposes of valuing organizations, there is no standard method of accounting for them, as there is for physical assets[19]. In many cases they are not reflected on the balance sheet despite contributing to the future success of the company[20]. Arguably this makes financial accounting incomplete and contributes to the widening gap between book and market value referred to, for example, in the Sonecon publication, "What Ideas are Worth: The Value of Intellectual Capital and Intangible Assets in the American Economy[21]." The Sonecon publication concludes that for ten industries it examined, intangible assets represent at least 90% of market, not book, value. The "value gap" between market value and book value indicates that physical and financial accountable assets reflected on a company's balance sheet comprises less than 20% of the true value of the average firm.

21 Given their contribution to value creation, some argue that "in order to assist managers of business enterprises and their providers of capital in their decision-making processes... guidelines [should be developed] for the identification of intangible [assets and for the] measurement and successful management of intangibles within...[22]" organizations. Many therefore call for measurement, reporting and management of all of the assets, tangible and intangible, that affect the ability of an organization to create value.

4. Value is created from private and public/common resources

22 In some cases an organization does not own or bear a direct charge for their use of, or effect on, sources of capital that are input to the business model to transform into outputs and outcomes that create value. Such sources of inputs are often known as the "global commons" or "common pool resources" – terms that refer to resources that are unowned, unprivatized, unregulated, free and shared by all. These include the oceans and the atmosphere and the environmental goods and services that they provide, as well as societal assets such as public road networks.

23 Garrett Hardin's "Tragedy of the Commons[23]" recognizes that the value of the commons for one actor in order to maximize or capture his gain can result in negative effects that are shared by all. For example, if the cost of discharging waste into the commons is less than the cost of purifying the waste before releasing it, the polluter will gain (or capture value) but society will bear the consequences and costs of the effects of the waste on the commons. Such consequences and costs are known as "externalities" (see theme 1 above). Externalities may impact on both private and public/common resources. Various solutions have been proposed to manage common resources and deal with externalities, including government intervention, allocation of property rights and the development by communities of their own rules and methods of enforcement[24].

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[17] Rebooting Business: Valuing the Human Dimension, Chartered Global Management Accountant, a joint venture between the AICPA and CIMA
[18] Corporate Reputation and Sustained Superior Financial Performance, Peter W Roberts & Grahame R Dowling
[19] Accounting for Intangibles: Financial Reporting and Value Creation in the Knowledge Economy - A Research Report for the Work Foundation's Knowledge Economy Programme by Ricardo Blaug and Rohit Lekhi, Research Republic LLP
[20] The Value Relevance and Managerial Implications of Intangibles - Leandro Canibano, Manuel Garcia-Ayuso Covasi and M Paloma Sanchez, March 1999
[21] http://www.sonecon.com/docs/studies/Value_of_Intellectual_Capital_in_American_Economy.pd
[22] The Value Relevance and Managerial Implications of Intangibles - Leandro Canibano, Manuel Garcia-Ayuso Covasi and M Paloma Sanchez, March 1999
[23] Science, New Series, Vol 162, No 3859 (Dec 13, 1968)
[24] The Future of the Commons; Beyond Market Failure and Government Regulation - Elinor Ostrom with contributions from Christina Chang, Mark Pennington and Vlad Tarko - A report for the Institute of Economic Affairs, 2012

24 All solutions for managing the commons are dependent upon transparency, information and common language. This is because, in order to manage and preserve their value creating potential, decision-makers need information about the nature of the common resources, the incentives and disincentives facing actual and potential resource users, the scientific and technological variables that affect common resources and so on.

5. Value is created for an organization and for others

25 Some of the literature on value creation reviewed for this Background Paper refers to the dichotomy between two views of the constituencies for which an organization creates value. The first, often known as "shareholder value theory", is widely attributed to Milton Friedman in 1962. Friedman's view declares the purpose of a company as being to maximize shareholder value and to pursue social activities only as long as they generate profit. The second view, attributed to Edward Freeman in the 1980s, is often known as stakeholder theory and states that the objective of organizations should be to augment the greater good for the many and to create as much value as possible for multiple stakeholders. The question therefore arises as to whether value should be created for shareholders or for multiple stakeholders or for both.

26 In Michael Jensen's report "Value Maximization, Stakeholder Theory and the Corporate Objective Function", Jensen states that business should get the most out of society's limited resources, while returning greater value to society so that the pursuit of stakeholder value and a healthy environment helps a business to maximize its financial value. The implication of Jensen's work is that the interests of shareholders and stakeholders are not at odds. Jensen states that any potential conflicts between them should be resolved through a focus on long-term value creation, as the long term value of a company "cannot be maximized if any important constituency is ignored or mistreated. We cannot create value without good relations with customers, employees, financial backers, suppliers, regulators, communities and so on[25]."

27 Increasingly, value creation is understood in terms of the value that is appropriated to the organization from its business activities and the value that is created for and captured by others. In "Creating Shared Value" Michael E. Porter and Mark R. Kramer define shared value as "creating economic value in a way that also creates value for society by addressing its needs and challenges". They describe shared value as "a concept that focuses on the connections between societal and economic progress… and that expands the total pool of economic and social value". Shared value is based on the premise that having environmental or social issues that are not addressed creates internal costs for companies (e.g., wasted energy, remedial training to compensate for inadequate education systems), which constrain the extent of value creation, destroy value or, over the longer term, make the business model unsustainable.

28 As well as being created for and captured by a wide range of stakeholders, value is increasingly created in collaboration with others, including consumers who "armed with new tools and dissatisfied with available choices... want to interact with firms and thereby co-create value[26]."

6. Value is created from the connectivity between a wide range of factors

29 The assessment of value creation is based on a "compound vector of qualitative, ethical, social, aesthetic and practical[27]" factors, the way in which they interact and the outcomes of those interactions for multiple stakeholders. As Edward Freeman notes, "no stakeholder stands alone in the process of value creation[28]." Therefore, communicating value creation is not simply a question of merging financial and non-financial information. As Ernst & Young observes[29], a comprehensive picture of value creation is communicated through alignment between many factors including business practices, tangible and intangible assets, material financial and non-financial capital risks, the company's strategy, its engagement with multiple stakeholders, sustainability agenda, governance practices and future goals over the short, medium and long term. Communicating value creation also involves describing the trade-offs between the various interdependencies on which the value creation process depends, such as between equity and advantage and quality over quantity[30].

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[25] Value Maximization, Stakeholder Theory and the Corporate Objective Function, Michael C. Jensen, HBS Working Paper, April 2000
[26] Co-creation Experiences: The next practice in value creation - C.K. Prahalad and Venkat Ramaswamy. Published in the Journal of Interactive Marketing, Volume 18, Number 3, Summer 2004
[27] Better is Better than More JS Mills
[28] The Journal of Business Ethics 2010 96:7-9, R. Edward Freeman - Managing for Stakeholders: Trade offs or Value Creation
[29] Insights for Executives - Driving value by combining financial and non-financial information into a single investor grade document
[30] Speth (2008) quoted in Better is Better than More

30 It is beyond the scope of this Background Paper for <IR> to examine the different approaches to the potential trade offs that are required to create value. However, Michael Jensen's work[31] is one example that recognizes the conceptual difficulty of making trade-offs between the various interdependent factors and different stakeholders that contribute to or are affected by business activities aimed at value creation. Jensen characterizes the difficulty by describing the multiple constituencies with competing and sometimes conflicting interests:

"Customers want low prices, high quality and full services. Employees want high wages, high-quality working conditions and fringe benefits including vacations, medical benefits and pensions. Suppliers of capital want low risk and high returns. Communities want high charitable contributions, social expenditures by companies to benefit the community at large, increased local investment and stable employment[32]."

31 In these circumstances, Jensen says that potential conflicts between various trade-offs can be resolved by setting an objective function, representing the core of any decision criterion to guide the way in which trade-offs between demands are made and enable management to evaluate decisions. In other words, reasoned decisions about trade-offs depend upon a clear objective. Jensen suggests that "the objective function, the overriding goal of the firm is to maximize total long term firm market value…" which recognizes "…the possibility that financial markets, although forward looking, may not understand the full implications of a company's policies" until they begin to show up in cash flows and customer and employee loyalty over time.

7. Value creation manifests itself in outcomes

32 The connections and interdependencies between the different factors that contribute to the creation of value result in different outcomes for different stakeholders. Outcomes are defined in paragraph 2.35 of the draft <IR> Framework as "the internal and external consequences (positive and negative) for the capitals as a result of an organization's business activities and outputs." Those outcomes inform the assessment of value depending on the perspective of the stakeholders and their dependence upon the stores of capital affected by the value creation process. Value creation is manifested in outcomes for, or changes to, those stores of capital that result from an organization's activities. Those outcomes may be affected by the way in which an organization governs environmental and social concerns in creating value for itself and its stakeholders[33].

33 Outcomes are not always stable and predictable and take place over multiple timeframes. Creation of value in the short or medium term has the potential to enhance or dilute or deny the potential for value creation in the future[34]. Therefore the assessment of value creation is not necessarily confined to a particular timeframe but takes into account the way in which value creating activities might affect future value creation potential and issues of intergenerational equity.

8. Innovation is central to value creation

34 Changes to the context in which organizations operate, including globalization, resource scarcity, demographical changes and competition require strategies that secure a competitive advantage for organizations. Such strategies are aimed at generating and innovating new outcomes that distinguish the organization from others in an increasingly complex and competitive environment and that make the organization resilient and capable of adapting to new circumstances. Various branches of research[35] including resource-based theory and evolutionary economics contend that value is created or maximized through innovation that allows organizations "to reconceive their sources of strategic advantage and master new mechanisms to build lasting or sustainable strength[36]" and creatively to rearrange resources in order to create new value[37].

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[31] Michael C. Jensen – Value Maximization, Stakeholder Theory and the Corporate Objective Function, October 2001 – The Monitor Group and Harvard Business School
[32] Michael C. Jensen – Value Maximization, Stakeholder Theory and the Corporate Objective Function, October 2001 – The Monitor Group and Harvard Business School
[33] Sustainable Value Creation Family Business Oct 2012
[34] Tomorrow's Company and CIMA - "Tomorrow's Value" extract – "Discount rates value future generations less than we value ourselves – but can we be confident of a basis of determining value that may deny our children's children the joy of nature and the increasing threat we pose to other species?"
[35] See for example the work of the Evolutionary Economics Group at http://www.econ.mpg.de/english/research/EVO/discuss.php
[36] Sustainable Value Creation Family Business Oct 2012
[37] Paul Romer quoted in Better is Better than More

9. Values play a role in how and what type of value is created

35 Whilst they are distinct from value creation, there is a relationship between value creation and values such as the beliefs, behaviors, cultural choices and philosophies embraced by an organization. Values or the absence of values, sometimes expressed in codes of business conduct, can play a role in determining the way and extent to which an organization creates and protects value.

10. Measures of value creation are evolving

36 It is beyond the scope of this Background Paper for <IR> to examine and explore the relative merits of the various ways in which organizations seek to measure and describe value creation. However, it is recognized that measures of value such as Economic Value Added, Balanced Scorecard, Enterprise Value, Total Contribution, Total Economic Value and Total Value are emerging as means of expressing value creation. These new measures go beyond the expression of value creation in terms of market valuation and pricing. They seek to reflect the full costs and benefits of the outputs and outcomes created by an organization.

3. Value creation for <IR> purposes

37 Section 3A explains value creation for <IR> and 3B considers who assesses value.

3A Explaining value creation for <IR>

38 Value creation for <IR> purposes is explained as follows:

Value is created through an organization's business model, which takes inputs from the capitals and transforms them through business activities and interactions to produce outputs and outcomes that, over the short, medium and long term, create or destroy value for the organization, its stakeholders, society and the environment.

Each part of the explanation is examined in more detail below.

Value is created through an organization's business model – For <IR> purposes value is created, changed or destroyed by an organization through its business model. The Business Model Background Paper for <IR> defines the term business model as "the chosen system of inputs, business activities, outputs and outcomes that aims to create value over the short, medium and long term."

which takes inputs from the capitals – An organization's business model takes inputs or resources in one form or another from the capitals, identified in the Capitals Background Paper for <IR> as financial, manufactured, intellectual, human, social and relationship and natural capital. The capitals represent stores from which value is released when the capitals are combined, transformed and leveraged to produce outputs and outcomes that represent value creation or value destruction, depending on the perspectives and interests of different stakeholders. Business inputs may include resources in the form of raw materials, common resources, employees, research, ideas, financial capital etc. as well as relationships with suppliers and other stakeholders. Inputs may be internal or external and direct (labor, raw materials or cash used in transactions) or indirect (transportation infrastructure, regulatory parameters or education of the workforce). Inputs are required to produce (via operational or other business processes) outputs and outcomes that in turn create or destroy value for the organization, consumers, the environment, providers of financial capital and others.

and transforms them through business activities and interactions – Taking inputs from various forms of capital does not in itself create value. Value is created through the activities business conducts in order to release value from inputs of capital. Business activities involve using, combining, applying, processing and transforming inputs from the capitals into outputs and outcomes. Business activities may involve the use of processes, tools, technologies and innovation to achieve intended outputs and outcomes identified through the organization's strategy and targets. A wide range of interactions occurs through the course of business activities both internally between employees and contractors and externally with suppliers, consumers, regulators, communities and the environment. Value creation is assessed in part by considering the interactions between a company's competitiveness and success, and the communities and natural environment it affects and on which it draws. Understanding the connectivity between internal and external forces that enable, enhance or frustrate the business model is therefore crucial to assessing whether value has in fact been created or destroyed, and whether it is likely to be created in the future.

to produce outputs – Through an organization's business activities, it applies, uses, consumes, destroys and transforms different types of capital to produce outputs, defined in the Business Model Background Paper for <IR> as "the key products or services that an organization produces, as well as the waste or other by-products that create or erode value... for example, in the case of a car manufacturer, the output is the car." Outputs are usually planned, intended and aimed for through a company's strategy and targets.

and outcomes – The process of taking inputs from different types of capitals and applying, using, destroying and transforming them through the business model produces outcomes as well as outputs. Outcomes are defined in the Business Model Background Paper for <IR> as "the internal and external consequences for the capitals as a result of the organization's business activities and outputs." The Business Model Background Paper for <IR> states that in the case of a car manufacturer, the outcomes for the consumer may be mobility, safety, reliability, comfort and status. Outcomes from an organization's business model may take the form of increased sales, profit, market share, enhanced reputation, better community links, customer satisfaction, decline or enhancement of natural environment, positive and negative externalities etc. Outcomes from business activity that have no financial counterpart or means of financial measurement are as relevant to value creation as financial revenue and capital. Therefore, whilst they inform and contribute to it, value creation for <IR> purposes is not just assessed by reference to outcomes such as an organization's performance, stock price, growth (in the form of return on investment capital) and profit. Although outcomes from an organization's business model are normally planned and intended, not all outcomes can be predicted because of the non-linear interaction of the wide range of factors on which an organization depends for value creation. Unintended outcomes from the business model may therefore manifest themselves in the short, medium or long term and may be positive or negative.

that, over the short, medium and long term, create or destroy value – Intended and unintended outcomes from the business model have both positive and negative effects individually and collectively on the capitals, on the organization, providers of its financial capital, on society and the environment. Those outcomes may manifest themselves over the short, medium or long term. The application, use, destruction and transformation, impact on and interplay between the capitals may therefore affect the extent to which providers of financial capital can expect outcomes in the form of financial returns, as well as the outcomes for society in terms of the access to and benefit from the capitals and for the environment in terms of its enhancement or degradation. Whether business activities have created or destroyed value may be immediately evident or may become apparent over time.

for the organization, its stakeholders, society and the environment – An assessment of the positive and negative outcomes from the business model informs the determination of whether, to what extent, for whom and over what timescales value has been created or destroyed. Whether outputs and outcomes represent value creation depends in part on the reaction of or outcomes for consumers and all other stakeholders affected by the organization's activities (e.g., competitors, regulators and local communities) and also on the outcomes from the organization's business model on the environment. An organization's ability to create value is closely linked to the supply chains, communities and natural environment, which may share in value creation or destruction. The way in which all of those constituencies experience the outcomes of an organization's business model informs an assessment of whether value has been created, and for whom.

3B Who assesses value for <IR> purposes?

39 Integrated reports should enable providers of financial capital to assess whether, to what extent and how an organization's use of, and outcomes for, all of the capitals adds to financial value.

40 Paragraph 1.6 of the draft <IR> Framework defines the primary intended audience for integrated reports and other communications resulting from the process of <IR> as providers of financial capital. Whilst recognizing that a range of stakeholders may benefit from integrated reports, they are specifically intended to enable providers of financial capital to gain an understanding of how an organization creates and sustains value in the short, medium and long term. Providers of financial capital equate value creation with the potential for future cash flows and sustainable financial returns, but this also takes into account the importance and limitations of different forms of capital for value creation.

41 This Background Paper acknowledges that questions are sometimes asked about whether certain providers of financial capital adequately advance the goals of and act as stewards for individuals who have invested with them[38]. Aspects of the institutional arrangements on which the relationships between providers of financial capital and corporations are based have been blamed for a growing gap between investors' financial interests and the public interest. These include:

- Short-termism which can be implicated in market failure because long-duration projects suffer disproportionately.
- Agency and contractual arrangements between financial actors (e.g., asset owners and asset managers) that produce perverse or unintended outcomes.
- Failure to take into account the value of and reliance on inputs from natural and other forms of capital that are vulnerable, limited or exhaustible.
- Definitions of value that are limited only to shareholder value.

42 The actions of various governmental, non-governmental and other organizations therefore seek to align more closely investors' long-term financial interests and corporate practices with the public interest.

43 Investors already currently place a value on companies either indirectly via analyst reports and valuation predictive modeling or directly from market bidding. <IR> is intended to provide greater clarity and insight to allow investors more comprehensively to consider the mutual inter-dependence between the long-term financial interests of the ultimate owners of financial capital, corporate practice and the public interest for the creation and preservation of value. Certain research[39] argues that the public interest and that of providers of financial capital are served by investment to support the long term, as well as the short and medium term, continuance of capitals on which human communities, economic and environmental systems depend. <IR> can therefore be seen to encourage a more comprehensive consideration of the effects that corporate and investor behavior and decision-making have on the public interest by requiring a broader range of information to be provided in communicating corporate performance in an integrated report.

44 Whilst they are not the primary intended users of an integrated report or other communications resulting from the process of <IR>, other stakeholders are also likely to benefit from <IR> and to have their views taken into account by organizations when preparing integrated reports. This is because the financial returns on which providers of financial capital are focused are ultimately dependent upon inter-relationships between and increases and decreases in all types of capital even where financial capital providers are not affected directly or immediately by movements in those capitals. The concerns and actions of stakeholders with wider interests in different capitals may affect financial returns, and similarly the availability and use of financial capital may affect other types of capital in which the wider stakeholder group are interested.

[38] Are Institutional Investors Part of the Problem or Part of the Solution? Ben W. Heineman, Jr., Stephen Davis, Center for Economic Development, Yale School of Management

[39] Acting in the Public Interest: A Framework for Analysis – ICAEW Market Foundations Initiative,2012

4. Information that enables readers and users of integrated reports to assess value creation

45 Integrated reports should communicate information that enables intended report users to assess whether and to what extent value has been created and is likely to be created for the organization so as to add to financial value. In addition, it must explain how the business model affects whether, how and to what extent value has been created or destroyed for others so as to increase or decrease the pool of capitals on which the organization can draw to create value over time given planetary limits and societal expectations.

46 Section 4A considers the type of information that enables readers and users of integrated reports to assess value creation. The type of information that enables such assessments is potentially very wide and must be balanced with the need for an integrated report to be concise. Section 4B therefore discusses how to limit and focus the information that is reported about value creation and goes on to consider how information should be reported given that standards, metrics and other approaches to the communication of certain aspects of value creation are not yet well established.

4A Information that facilitates an assessment of value creation

47 Information that is likely to facilitate an assessment of whether and to what extent value has been created or destroyed includes:

- A description of the business model including inputs, business activities, outputs and outcomes and links to the organization's strategy – Section 2C of the draft <IR> Framework and the Business Model Background Paper for <IR> explain the type of information that should be reported in order to enable users of integrated reports to assess how the business model contributes to the creation of value. The relationship between the business model and the organization's strategy helps to explain the context, direction and focus for the business model.
- Performance – Section 4F of the draft <IR> Framework describes the type of information that should be considered for communicating performance for <IR> purposes. Whilst not sufficient alone for an assessment of value creation, performance contributes to an understanding of the extent to which a company has created value from achievement of performance goals.
- What type of value the organization intends to create, how, for whom and why – including the organization's notion of value, the process that is used for value creation, what actions and activities the value creation process entails, for whom the organization aims to create value and why.
- Management's assessment of whether the intended value has been created, that is, whether the outputs and outcomes from the business model are as intended according to the organization's strategy and targets.
- Management's assessment of the way in which various forms of capital have been affected by the business model so as to create or destroy value – Business activities inevitably draw from or add to the capitals. Overall, in the long term, value for providers of financial capital is unlikely to be created through the maximization of one capital while disregarding the effect on other capitals. Understanding the various capitals the organization uses and affects, including the interdependencies and trade-offs that are made between them, is therefore essential for assessing whether and to what extent value has been created or destroyed. The capitals can also be used to express the type of value that has been created.

  Where possible, information about the extent to which costs or other effects on the various capitals have been externalized (i.e., the costs and other effects on the capitals are passed on outside the organization to society, the environment and future generations) also informs an assessment of how overall increases or decreases in value embodied in capitals that are not owned by the organization affects value to providers of financial capital in the long term.

- Governance – Information about the stability of the organization's governance structure helps intended users to assess its resilience against short term disruptions so as to continue to create value. Information about the organization's governance structure also influences the level of confidence in the organization's ability successfully to implement its business model and transparently and accurately to communicate performance.

- Innovation and future outlook, including the measures taken and research in which the organization has invested to innovate so as to ensure the resilience and efficiency of the business model for value creation over time. This will include management's view of the anticipated effect on financial and other types of value of their policies, decisions and innovations.
- Stakeholder engagement – As noted above, an organization's ability to create value is closely linked to the supply chains, communities and consumers, which may share or be affected by value creation or destruction. There is a symbiotic relationship between a company's competitiveness and success and the communities and natural environment on which it draws. The extent to which an organization's activities and offerings represent "value" depends in part on the reaction of consumers and other stakeholders affected by the organization's activities (e.g., competitors, regulators and local communities). Those reactions, manifested in increased sales, market share, enhanced reputation, better community links, etc., inform future iterations of the business model.
- The external context in which the organization operates – An overview of the external policy, regulatory, societal and environmental context in which an organization operates, the opportunities and risks it faces and how it responds to the external context is important for assessing the resilience of an organization's value creation mechanism. The policy and regulatory context can have a significant influence on how and the extent to which the organization is able to create value. Increasing regulation of pollution, waste and resources and changing approaches to subsidies can force changes to a business model and strategy and therefore affect value creation. Regulation and policy also influence the way in which an organization prepares corporate reports and communications. The growing trend for regulators to impose mandatory reporting requirements on social, environmental and governance issues may influence the way in which an organization measures, understands and communicates value creation.
- Value drivers are capabilities or variables resulting in outcomes that give an organization competitive advantage and over which it has some degree of control so as to create value. They may include:
  - financial drivers such as pricing strategy, operational efficiency, brand equity and cost of capital;
  - non-financial drivers such as customer relations, societal expectations, environmental concerns, innovation and corporate governance; and
  - values such as integrity, trust and teamwork that support value creation.

- Value drivers alone and in combination affect an organization's ability to create value over time or at a point in time. The type and combination of relevant value drivers are unique to each organization and are therefore likely to be relevant for disclosure in an integrated report. Connections – Value is created or destroyed by organizations from connections between a wide range of factors including business activities and the wider system and context in which they operate, including planetary limits and societal expectations. The Guiding Principle of Connectivity, when applied for <IR> purposes, encourages communications that reflect the dynamic nature of business, performance and the wider economic, environmental, social and financial systems within which the business operates. An organization should therefore reflect in its disclosures about value creation the connectivity between the various parties and factors that have an interest in the value that the organization purports to have created or plans to create and the value that is at risk.

4B Practical limitations to the communication of value creation

48 This section considers how information about value creation should be identified for communication in an integrated report, given that an organization cannot know all of the connections between their activities, outcomes and value creation or depletion for different constituencies over multiple time frames. This section also considers the way in which information about value creation may be expressed given the absence of standardized and recognized measurement approaches for some types of value creation or destruction.

Drawing a boundary around value creation

49 Integrated reporting should communicate whether value has been created or destroyed for the organization, economy, environment and society on the basis that all aspects of value creation (or destruction) may ultimately impact an organization's own ability to create value. However, business (or any) activity can have impacts far beyond those anticipated or capable of observation by the organization itself.

The full extent of the so-called "butterfly effect"[40] and the connections between corporate activity and outcomes and whether they create value cannot be known or assessed by an organization. The extent to which an organization can assess and communicate the connections between their activity and value creation over time therefore has practical limitations.

50 When reporting on value an organization may therefore draw a boundary around elements and interactions that are most relevant to their business model and strategy, and therefore to the way in which the organization expects to create value over time. The boundary should be disclosed together with any significant assumptions and estimates made by management in its disclosures about value creation, so that intended users understand the limitations of the connections that it is possible for the organization to make given that some of them might be outside its sphere of knowledge or might not yet be apparent.

The timeframe for considering value creation prospects

51 Similarly, the length of the timeframe over which future value creation prospects are considered will vary from business to business. The timeframe over which value creation should be considered and communicated is the one that is most appropriate in the circumstances (which in some cases will be short term and others longer term). In other words, the focus should be on the "appropriate" perspective and time horizon for creating sustainable value for the particular organization.

52 While focusing on the long term, information on short and medium term prospects and performance of course remains useful, in particular as this will be crucial in assessing the likelihood of an organization attaining its long term goals and assessing performance against previously stated objectives. Communication about when value is likely to be created or destroyed may therefore be useful.

Communicating value creation with or without quantitative measurements

53 Communication about value creation is not restricted to information that will eventually find expression as financial value or as results and outcomes that can be monetized. Information that supports the communication of value creation can be conveyed in quantitative or qualitative terms, or a combination of both. In considering the risks and rewards expected from an organization and its capacity to create value, providers of financial capital and others will consider whether the organization is using resources cost-efficiently and within planetary limits and societal expectations. Therefore, in addition to results about how the organization is making ends meet or balancing budgets, intended report users will need to understand the outcomes of the organization's business activities for its stakeholders and for the planet on the basis that those outcomes may affect the organization's ability to create future value.

54 For <IR>, value creation may be manifested in changes to the capitals. Arguably, value for <IR> is equal to the difference between the total value stored in the capitals at the beginning of the measurement period or reporting year and the total amount of value stored in the capitals at the end of the period or reporting year taking into account the inputs, activities and outputs of the organization. Communication about effects on the capitals does not necessarily involve measurement of the movements in, or changes to, the capitals. As the Capitals Background Paper for <IR> states, "it is not an objective of <IR> to measure all the capitals or movements in them. Many uses of and effects on the capitals are best (and in some cases can only be) reported in the form of narrative, rather than through metrics. Where it is not practicable to measure movements in the capitals quantitatively, qualitative disclosures may be used to explain changes in the availability, quality, or affordability of capitals as business inputs and how their use by the organization enhances or depletes them. In some cases monetization of these factors may, where possible, be appropriate, particularly where costs related to externalities are likely to become internalized as a result of new laws, regulations and economic instruments.

55 The <IR> Framework will not prescribe metrics to be used in an integrated report or for the purposes of measuring value. However, work conducted by other organizations (e.g., the Global Reporting Initiative and Sustainability Accounting Standards Board, World Intellectual Capital Initiative, European Federation of Financial Analysts, PUMA etc.), may inform the way in which aspects of value creation and destruction are communicated.

[40] Usually attributed to E. N. Lorenz to describe chaotic behavior in dynamic systems, whereby the smallest change in initial conditions (e.g., a butterfly flapping its wings), may lead to bigger changes in the behavior of the system.

5. Examples of communication about value creation

56 For many companies, their description of value creation is depicted holistically through their entire reporting and a separate section on value creation is not clearly distinguishable. Other companies are linking their value creation story to their business model and the strategies that they have in place to ensure their long term success. This section includes links to extracts from public reports to illustrate the way in which companies are attempting to communicate value creation. The extracts are not intended to represent best practice or a template for communication of value creation. Rather, they illustrate the current approach being taken by selected organizations for communicating aspects of value creation.

Example 5.1
SAB Miller PLC Annual Report
for the year ended 31 March 2012, p.15, www.sabmiller.com
These pages offer an overview of the core strategies that the company follows to create value.

Example 5.2
Fresnillo plc Annual Report
for the year ended 31 March 2012, p.3-9 & 33, www.fresnilloplc.com
These pages represent Fresnillo's description of its business model and how it creates stakeholder value by specifically disclosing the key inputs and outputs and key stakeholder relationships it depends on and how it creates value for each stakeholder.

Example 5.3
Anglo American plc Social Development Report
for the year ended 31 December 2012, p.24-35, www.angloamerican.com
These pages explain how Anglo American creates value for society, its host countries and its host communities in which it operates, discussing various infrastructure improvements, local spending and other factors that create value in the areas in which it operates.

Example 5.4
Standard Bank Annual Report
for the year ended 31 December 2012, p.8, www.standardbank.com
This page represents a depiction of how Standard Bank creates financial value.

Example 5.5
Vodacom Annual Report
for the year ended 31 March 2013, p.6-7, www.vodacom.com
These pages represent a description of what Vodacom does with the value it creates as well as a discussion on how its ability to create value is underpinned by delivering on its strategic priorities thereby connecting its value-adding activities to its strategic priorities.

Example 5.6
Go-Ahead Annual Report
for the year ended 30 June 2012, p.6-7, www.go-ahead.com
These pages depict Go-Ahead's business model represented in a table that links the business model to how it generates value, also mentioning the actions they put in place to be taken in order to make ensure that value is generated.

Example 5.7
Tata Steel Annual Report
for the year 2011-2012 p.62, www.tatasteel.com
This page describes the value creation process at Tata Steel.

Example 5.8
Danone Registration Annual Financial Report
For the year 2011, p.15, www.danone11.danone.com
This page identifies upstream activity as one of the sources of the Group's value creation process.

Example 5.9
Goldfields Integrated Review
For the year ended 31 December 2012, p.13 www.goldfields.co.za
The diagram on this page quantifies shared value creation as an output from 2012.

Conclusion

57 This Background Paper for <IR> reflects some of the theory and practice that informs an understanding of value creation, as well as explaining value creation for <IR> purposes. It does not provide a complete answer to understanding or communicating value creation, but offers theories, examples of practice, a definition and guidance that aim to advance thinking about value creation and the communication thereof by organizations. Just as it has taken time to develop and improve processes, language, frameworks and tools for reporting other aspects of corporate activity, new approaches will inevitably emerge to enable reporters to communicate, report, users to assess, and decision-makers to act, on information about the way in which organizations create value.

58 Ultimately value is to be interpreted by reference to thresholds and parameters established through stakeholder engagement and evidence about the carrying capacity and limits of resources on which stakeholders and companies rely for well-being and profit, as well as evidence about societal expectations. Interconnections between corporate activity, society and the environment and the purpose of the corporation should therefore be understood in terms of what the corporation, society and the environment can tolerate and still survive – that will be the main determinant of value. The challenges will be to reach agreement at corporate, national and international level on what those thresholds and limits are, how the resources within those limits should be allocated, and what action is needed to keep activity within those limits so that value can continue to be created over time.

INTEGRATED REPORTING <IR>

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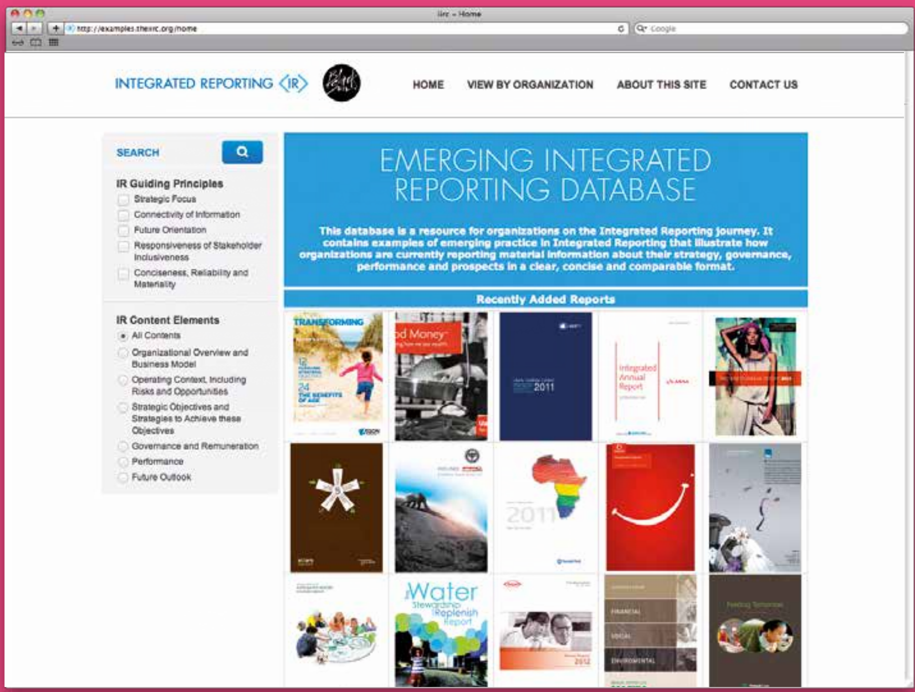

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