

FLASH
ALERT

**INTEGRATED
REPORTING AND
THE EMERGING
ROLE OF INTERNAL
AUDITING**



*A*UDIT *E*XECUTIVE
— C E N T E R —



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EVOLUTION OF CORPORATE REPORTING AND THE <IR> FRAMEWORK

For many, the term *sustainability* has lent itself to associations with topics like green energy and social accountability. In a revenue-driven landscape, these topics often take a backseat to an organization's financial objectives. As economies the world over become more interconnected, dependent on each other and shared resources, there is an increasing need for reporting that speaks not only to the financial stability of an organization, but also to longer-term value creation.

Within this context, the term sustainability reaches beyond the typical associations and poses the questions: What is the net effect of your organization on all the resources and relationships required for you to profit? Is that *sustainable*? For a chief audit executive, this question suggests a risk to the organization.

INTERNAL AUDIT IS WELL-SUITED TO SUPPORT INTEGRATED REPORTING

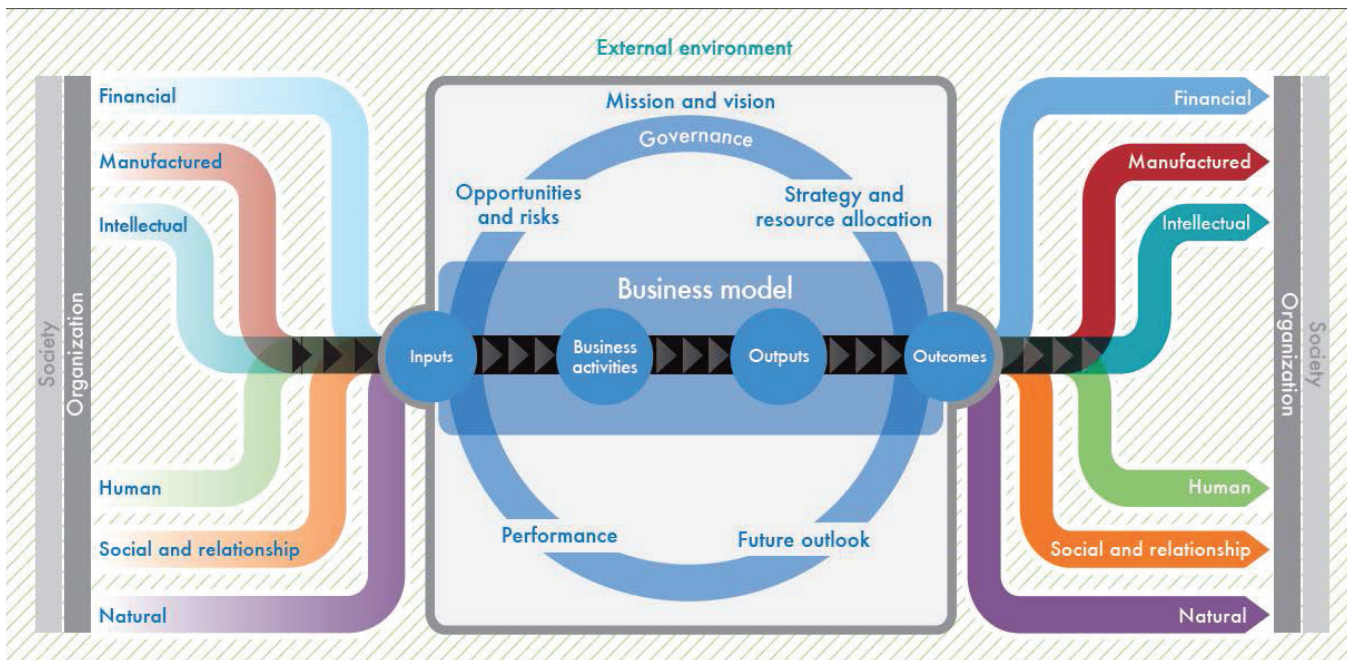
Internal audit is uniquely situated within an organization to provide insight on and support the implementation of integrated reporting.

Internal audit:

- ✓ Is familiar with process implementation in the organization.
- ✓ Can affect consistency of communication of metrics across business units.
- ✓ Provides assurance to increase the credibility of metrics in the integrated report.
- ✓ Offers insight on potential risks to the organization.
- ✓ Has a "seat at the table" from which it can influence the adoption of <IR> to improve and strengthen communications with internal and external stakeholders.

In an effort to account for the financial and nonfinancial influences that affect an organization’s sustainability, a global initiative for integrated reporting has begun, led by the International Integrated Reporting Council (IIRC), a coalition of regulators, investors, companies, standard setters, the accounting profession, and non-governmental organizations (NGOs). Years of research and planning came to fruition on April 16, 2013, when the IIRC launched the second draft of the International Integrated Reporting (<IR>) Framework. The final draft is expected to be issued by December 2013.

In broad terms, integrated reporting seeks to communicate how an organization’s business model affects the multiple resources and relationships needed for that organization to create value in the short-, medium-, and long-term. Stated another way, the goal of integrated reporting is the concise communication of value over time. The Framework categorizes these resources and relationships into six areas: financial; manufactured; intellectual; human; social and relationship; and natural. The <IR> Framework refers to these resources and relationships as *Capitals* and describes the business elements and processes likely to affect these resources and relationships as *Content Elements*. To conceptualize the relationship between the *Capitals* and the *Content Elements*, the <IR> Framework provides the following visual representation:



Source: The Consultation Draft of the International <IR> Framework, April 2013.¹

¹ Published with permission from the IIRC.

By applying this holistic and future-oriented view to corporate reporting, the <IR> Framework seeks to drive capital investor behavior away from the shortsighted investment strategies that have dominated over the last several decades to longer-term strategies that will ultimately lead to market stability.

THE CLOROX COMPANY'S EXPERIENCE

Underlying the <IR> Framework is the concept of integrated thinking, which addresses not only how organizations approach corporate reporting, but also how they look at their business activities. Integrated thinking challenges an organization to draw the connections among disparate reporting elements in order to communicate a more accurate and complete picture of value creation. In action, integrated reporting has the potential to break down silos and lead to greater innovation. As part of the <IR> Pilot Programme², The Clorox Company shares in a recent blog that their experience with integrated reporting has them “thinking in a more integrated fashion day-to-day and that’s helping to drive accountability, innovation and resource allocations in such areas as product and packaging development.”³

In conversation with Clorox’s Aileen Zerrudo, director, corporate communications, she shared that the company had previously adopted a globally recognized sustainability reporting framework. After acquiring Burt’s Bees® in 2007 and launching their Green Works® line in 2008, Clorox started hearing more questions about its sustainability commitments and performance. Essentially, once they got into the “green space” they needed to begin reporting on environmental, social, and corporate governance (ESG) and subsequently issued their first corporate responsibility report in 2010. Now, in addition to corporate responsibility reporting, Clorox is moving toward integrated reporting and is beginning to incorporate some of the principles of the <IR> Framework. As Zerrudo explains, “We needed to give people a holistic view — financial and nonfinancial — because we’re talking about the company’s total performance.”

² The IIRC pilot program includes participants from over 95 international reporting organizations such as Unilever, Microsoft, and China Light Power, along with a 25-member investor network. Research from this pilot informed the creation of the Framework and provided insight from organizations’ case studies as they implemented <IR>.

³ Kathryn Caulfield, *Corporate integrated reporting for today’s world*, <http://www.thecloroxcompany.com/corporate-responsibility/blog/integrated-reporting-for-todays-world/> (May 2013).

Communicating about integrated reporting through concise and understandable language and using such language in the annual integrated report is a challenge. Zerrudo discussed the importance of adhering to good communication principles in order to address the needs of investors in addition to a broad set of other stakeholders — from employees to NGOs and the sustainability community. Another challenge Zerrudo mentioned comes with determining which nonfinancial metrics are most material and then showing how they affect financial performance. This concern brings up a good point, namely that integrated reporting demonstrates that there are a wide range of factors that determine the value of an organization — some of which are financial or tangible in nature, while many are nonfinancial.

THE <IR> FRAMEWORK PROVIDES GUIDANCE ON HOW TO ADDRESS *CONTENT ELEMENTS*

According to the <IR> Framework, the integrated report should answer the following questions regarding the *Content Elements*:

- ✓ Organizational overview and external environment — What does the organization do and what are the circumstances under which it operates?
- ✓ Governance — How does the organization's governance structure support its ability to create value in the short-, medium-, and long-term?
- ✓ Opportunities and risks — What are the specific opportunities and risks that affect the organization's ability to create value over the short-, medium-, and long-term, and how is the organization dealing with them?
- ✓ Strategy and resource allocation — Where does the organization want to go and how does it intend to get there?
- ✓ Business model — What is the organization's business model and to what extent is it resilient?
- ✓ Performance — To what extent has the organization achieved its strategic objectives and what are its outcomes in terms of effects on the *Capitals*?
- ✓ Future outlook — What challenges and uncertainties is the organization likely to encounter in pursuing its strategy, and what are the potential implications for its business model and future performance?



In fact, rather than reporting on sustainability merely because it is the right thing to do, Clorox seeks to show through integrated reporting how various nonfinancial metrics speak to the long-term financial viability of the organization.

As a recent addition to the <IR> Pilot Programme, Clorox is just beginning to answer some of the questions around how they will move forward with integrated reporting. One of the pieces they are putting into place is obtaining external assurance on nonfinancial metrics. Moving forward, they are considering that internal audit may play an assurance role for nonfinancial metrics since that falls within the scope of their process.

DECIPHERING INTERNAL AUDIT'S ROLE IN INTEGRATED REPORTING

The communication with Clorox provides an indication that the role internal audit plays in integrated reporting will continue to evolve as more organizations adopt <IR> worldwide. We can, however, anticipate that in order for integrated reporting to be seen as a reliable instrument for assessing sustainability, organizations will need to provide assurance regarding the information reported therein. Internal audit is an obvious choice to help provide assurance. The forward-looking nature of integrated reporting also presents the potential for internal audit to take a more strategic role in assessing the risk for an organization in the short-, medium-, and long-term.

With 95 percent of Global 250 companies already reporting on sustainability⁴ and more than 5,000 sustainability reports published annually worldwide⁵, the stage is set for organizations to move toward integrated reporting. The impetus for this move is to provide a clearer narrative around how sustainability measures provide or secure longer-term financial return. For internal audit, the question becomes not if integrated reporting will be adopted, but what should internal audit's role be in preparation, during implementation, and through to maturity.

⁴ Global Reporting Initiative, "Report or explain: a smart EU policy approach for non-financial information disclosure," <https://www.globalreporting.org/resourcelibrary/GRI-non-paper-Report-or-Explain.pdf> (May 2013).

⁵ Joel Makower, "State of GreenBusiness 2013," 2013 GreenBiz Group Inc. (www.greenbiz.com).



This chart maps sections 4B and 4C of the proposed <IR> Framework to Standards 2110 and 2120. Conformance to the governance and risk management elements of Standard 2100 allows internal audit to meet current objectives while helping prepare for the move toward integrated reporting.

Two areas where internal audit can help are risk management and governance. The <IR> Framework requires that organizations address these areas, similar to the way that the *International Standards for the Professional Practice of Internal Auditing (Standards)* requires these areas to be addressed. As such, internal audit can prepare for an effective implementation of the <IR> Framework by meeting requirements in the *Standards* related to risk management and governance.

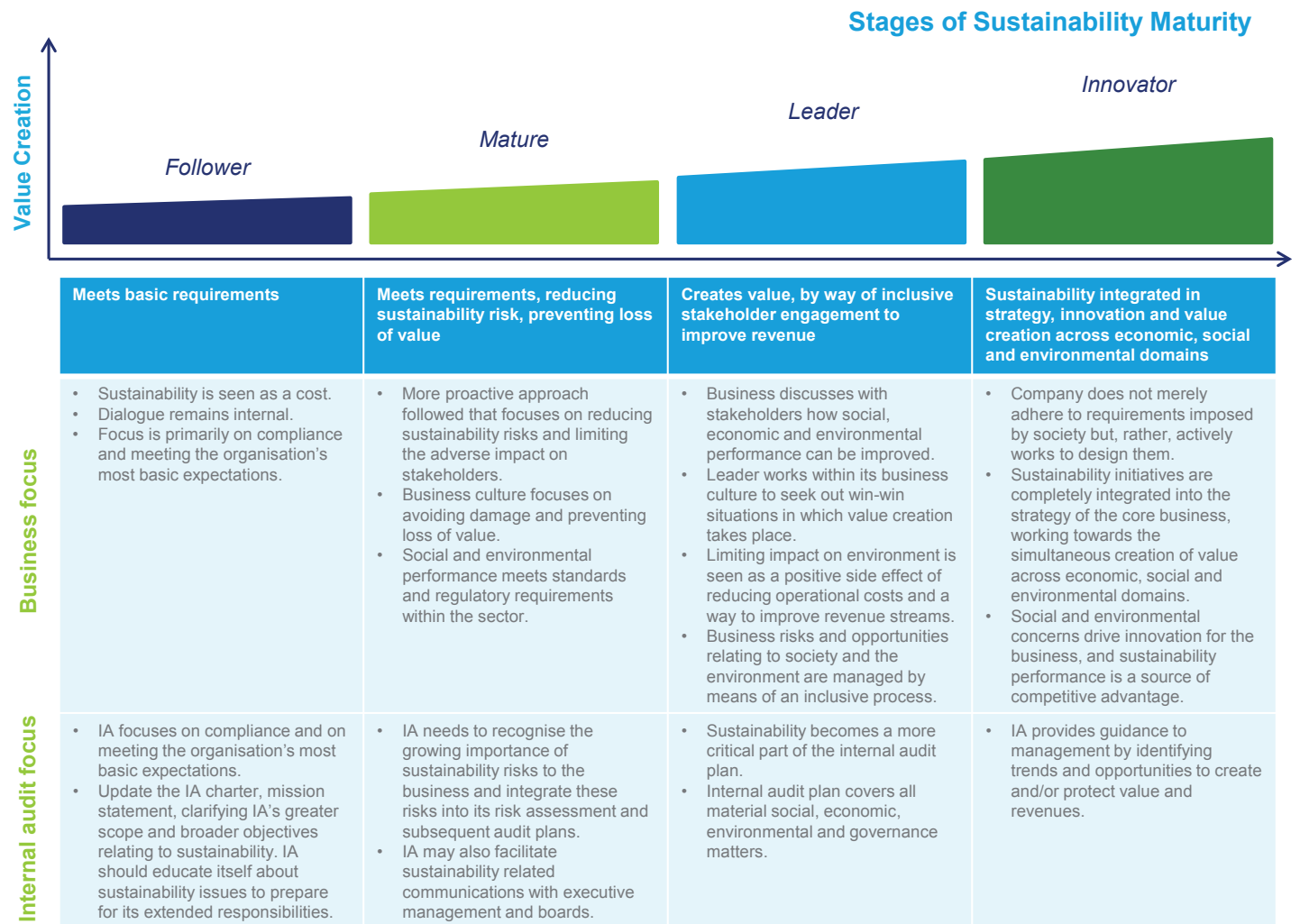
According to Standard 2100, “The internal audit activity must evaluate and contribute to the improvement of governance, risk management, and control processes using a systematic and disciplined approach.”⁶ Similarly, the <IR> Framework requires the integrated report to speak to the role of governance in the organization and to be transparent about emerging risks. The chart on page 10 demonstrates how the proposed <IR> Framework maps to the existing requirements within the *Standards*.

Initially, internal audit may be called to provide assurance on nonfinancial metrics. Over time, the role of internal audit will likely change to expand from primarily an assurance role to an advisory role, “providing recommendations in terms of enhancing the relevance and reliability of the related reports.”⁷ This opinion was offered in a 2011 paper issued by Deloitte South Africa regarding an integrated reporting discussion forum, which was launched by IIA–South Africa, Johannesburg Region. The Deloitte paper proposed that as organizations move from meeting the minimum requirements for integrated reporting to adopting fully integrated thinking, the role of internal audit will become more strategic, ultimately providing guidance to management on ways to protect and create value.⁸ The illustration on page 12, initially published in the Deloitte paper, proposes a maturity model for internal audit’s role in relationship to integrated reporting.

⁶ *International Professional Practices Framework, 2013 Edition*, (Altamonte Springs: The IIA Research Foundation, 2013), 29.

⁷ Deloitte, “The role of internal audit in integrated reporting: A blend of the right ingredients” <http://www.deloitte.com/assets/Dcom-SouthAfrica/Local%20Assets/Documents/The%20role%20of%20internal%20audit%20in%20integrated%20reporting.pdf> (2011).

⁸ *Ibid.*



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Source: *The Role of Internal Audit in Integrated Reporting: a blend of the right ingredients, summarizing a discussion forum out of IIA-South Africa, published by Deloitte.*⁹

⁹ Published with permission from Deloitte.



While this maturity model provides a good example of how internal audit’s role may evolve, internal audit’s advisory role is equally valuable earlier in the implementation process. Operating in this role demonstrates The IIA value proposition: Internal Auditing = Assurance, Insight, and Objectivity. As stated in the 2011 research report *Insight: Delivering Value to Stakeholders*, “Governing bodies and senior management rely on Internal Auditing for objective assurance and insight on the effectiveness and efficiency of governance, risk management, and internal control processes.”¹⁰ The following chart suggests ways internal audit can contribute to the integrated reporting in an assurance and an advisory role:

INTERNAL AUDIT’S INVOLVEMENT	
INTERNAL AUDIT IN THE ASSURANCE ROLE	INTERNAL AUDIT IN THE ADVISORY ROLE
Reviews risks related to integrated reporting identified in management’s and the board’s risk assessments concerning: brand reputation, compliance, liability, operational, stock market, employment market, sales market, and external business relationships. ¹¹	Consults on management’s process design with recommendations for improvements during the roll-out phase of <IR>.
Meets stakeholder demands for accountability through verification and assurance processes for reports related to corporate social responsibility (CSR). ¹²	Communicates to senior management and the board the value of <IR> to short- , medium- and long-term business sustainability and the benefits of using a maturity model approach to determine the organization’s current maturity with opportunities to improve in the future as processes mature.
Addresses compliance with laws, regulations, and contractual obligations for CSR reporting with a focus on governance; ethics; environment; transparency; health, safety, and security; human rights and work conditions; and community investment. ¹³	Once <IR> is in place, acts as the 3rd line of defense in their role of providing assurance to senior management and the board on effectiveness and efficiency of the <IR> process.

¹⁰ Patty Miller and Tara Smith, *Insight: Delivering Value to Stakeholders* (Altamonte Springs: The IIA Research Foundation, 2011), v.

¹¹ “Evaluating Corporate Social Responsibility/Sustainable Development” <http://www.theiia.org/guidance> (February 2010).

¹² Published with permission from Deloitte.

¹³ Ibid.

CONCLUSION

The adoption of the <IR> Framework by organizations such as Clorox and their involvement in the <IR> Pilot Programme is a good indicator that implementation of integrated reporting will continue to expand. The question for internal audit is not whether to expect integrated reporting to affect our audit universe, but rather how to be prepared for it when that time comes.

Without assurance on nonfinancial metrics, the benefits of integrated reporting are greatly diminished. Internal auditors are uniquely positioned to look at risk across the organization to provide that assurance. Additionally, internal auditors can support the adoption of integrated reporting by fulfilling existing requirement to contribute to governance, risk management, and control processes as stated in Standard 2100. At the same time, the trend toward integrated reporting offers a great opportunity for internal audit to act in an advisory role that can heighten the status of the profession.



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