An integrated approach

Internal audit is set to play a pivotal role in the adoption of integrated thinking and reporting in the Australian market, but some regulatory hurdles need to be overcome, writes Peter Jones.

The new buzzword "integrated thinking" was first floated by the International Integrated Reporting Council (IIRC) in 2013 and is defined as the active consideration of the relationships between various operating and functional units of an organisation, and the financial and non-financial capitals that it uses or affects.

Integrated thinking ensures the long-term sustainability of an organisation through the sustained creation of value. In other words, it helps an organisation recognise all that is necessary for its long-term survival in an ever-changing and challenging business environment.

The integrated reporting (IR) framework is effective when an organisation can successfully implement integrated thinking. Integrated thinking is a precursor to successful implementation of the IR framework.

The South African connection

The drive for integrated thinking and reporting started in 1993, when South Africa's Institute of Directors asked former Supreme Court judge Mervyn King to chair a committee on corporate governance, resulting in the first King report (King I) being released in 1994.

The third edition, King III (known as the King III principles promoting IR), was released in 2010, and King IV is now going through industry consultations, and is due for release later this year.

In March 2010, the Johannesburg Stock Exchange required listed entities to adopt the King III principles of IR focusing on strategy, risk, performance, leadership, sustainability, and corporate citizenship – in effect, an integrated company report.

While IR has its birthplace in South Africa, it has gained increasing acceptance internationally.

A recent survey of 500 industry leaders by the Chartered Institute of Management Accountants (CIMA), the American Institute of CPAs (AICPA), and corporate communications agency, Black Sun, found that half of all chief executive officers, chief financial officers and chief operating officers say they are moving towards IR, with 35 per cent saying they will adopt IR in the next two to three years.

Major global corporations such as Microsoft, Unilever, Pepsico, HSBC, Hyundai and Deutsche Bank have embraced the concept, and are jumping on the IR bandwagon. IR has now become part of the boardroom lexicon.

Australian story

However, in Australia the concept has not had the same take-up with few high-profile companies, such as National Australia Bank, adopting the IR framework.

A study by KPMG between 2006-2013 applied the underlying concepts of the framework to a group of 80 firms in the Asia Pacific. One of the main findings was that companies that disclose more than just financial information started outperforming their control group in mid-2010, around the same time as the introduction of IR.

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The report concludes that capital markets are likely to reward firms that adopt the international IR framework. And as an added advantage, it helps firms rethink and integrate their strategies and business models in line with stakeholder expectations.

However, there is little appetite for regulation around IR partly because of the recent development of the Australian Securities and Investments Commission's *Regulatory Guide 247*. Any regulatory shifts they say should be taken in line with requirements for an operating and financial review and recommendation 7.4 of the ASX's *Corporate Governance Council's Principles and Recommendations*.

The Australian Government's Financial Reporting Council (FRC) made a submission in 2013 to Professor Mervyn King at the IIRC, arguing they had concerns the IR framework is too theoretical and would increase reporting burdens. In particular, the "six capitals", they argue, would add volume and complexity to reporting.

The FRC makes the valid point that Australia has approximately 2,200 listed entities, the vast majority of which are in the small and mid-cap sectors. They argue a simpler, more concise, practical framework could be developed around Regulatory Guide 247, which would drive market-led adoption.

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But there is also a widespread recognition, says academics Dr Colin Higgins and Dr Wendy Stubbs from Deakin and Monash Universities, that annual financial reporting requires some changes.

In their 2014 study, *Regulatory standards vs. non-regulatory guidelines: Financial stakeholders' perspectives on the appropriate route to effective integrated reporting*, funded by CPA Australia, the academics argue: "that existing standards have not kept pace with new drivers of value creation and company performance".

Despite reservations of regulatory burdens, there is clear evidence that the adoption of integrated thinking may well serve more complex organisations better than the current methodologies.

Internal auditors

So what is the role of internal audit in IR? And how should board members view their relationship with internal auditors?

As IR becomes more widely discussed and accepted in Australia, the internal auditor does play a significant role in "integrated thinking". Internal audit as an assurance provider and adviser to the board will need a way of ensuring that processes and practices are put in place.

Importantly, as internal audit's mission is "to enhance and protect organisational values by providing risk-based and objective assurance, advice and insight," the internal auditor is ideally placed to oversee the introduction of the IR framework into an organisation.

Internal audit professionals, unlike external auditors, work across an organisation and business units to provide a helicopter view of the internal and external environment. This helicopter view facilitates integrated thinking.

As they are already familiar with the internal processes beyond the tick-a-box compliance function, they are uniquely placed to oversee the transformation process. Internal audit can also ensure consistency of communications of measurement across business units, and provide assurance of the accuracy of those metrics.

Thus, the internal auditor as a "well-informed" and "well-placed" adviser can provide valuable insight into the process of integrated thinking. They can also offer insight into the potential risks, and a strategy to overcome those hurdles for the benefit for any organisation, and its senior management and board to consider.

Once the process of transformation has begun, then internal auditors play a key role in ensuring the process stays on track and delivers the expected benefits.

Interestingly, a 2011 Deloitte South Africa paper concluded that value creation increases as an organisation's integrated reporting function matures from *follower*, where basic functions are met, to *innovator*, where sustainability has been integrated into strategy, innovation and value creation across economic, social and environmental domains.

Like all new ideas, it will take some time for early adopters to set the pace and apply integrated thinking and the IR framework to the regulatory and business conditions in Australia. But it will happen, and internal auditors will play a key role in this transformation. ■

10 key positive outcomes of integrated thinking to an organisation

- Long-term viability of organisation.
- Greater appreciation of "value-creation" process.
- Less siloed thinking and greater strategic overview.
- Greater identification of the organisation's key internal and external stakeholders.
- Better information and decision-making.
- More effective risk management processes.
- Increased transparency and communications between all parties.
- Increased investor, public and other stakeholder confidence.
- Positive impact on organisational culture.
- Early identification of issues arising from actions.